Andreas Dombret: Boring banking?

Opening statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the panel discussion, organized by “Bündnis 90/Die Grünen”, Frankfurt am Main, 28 May 2013.

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1. Introduction

Let me start with some reflections on the slogan of today’s event, “Boring Banking”. Actually, I will argue that banking has become more challenging since the outbreak of the crisis. And I am not at all sure whether making banking boring is exactly what we want to do.

Regulators are working hard on the “too-big-to-fail” issue. We want to ensure that large banks are resolvable. Do we make banking boring when banks can no longer benefit from an implicit state guarantee? Do we make banking boring when large banks can no longer rely on the tax payer stepping in when losses pile up? I don’t think that a functioning resolution system makes banking boring.

At the same time, we are analyzing how we can best use new instruments to reduce pro-cyclicality in the banking system and to curb exaggerations. Do we make banking boring when we raise costs for banks that simply earn money by following and augmenting the market trend? I don’t think that driving back pro-cyclicality makes banking boring.

Another topic on the reform agenda is remuneration. Do we make banking boring when we combat greed and short-termism? I don’t think that aligning compensation more closely to a bank’s longer-term success makes banking boring.

Finally, we have to distinguish between banking and finance. Making banking boring does not necessarily mean making finance boring. Only think of the shadow banking issue.

2. Simplicity and complexity

I was asked to speak about simplicity and complexity. I want to start with the latter. I am deeply concerned about complexity. Where does the real risk of complexity lie?

With respect to regulation and the change of the landscape it is not so much a single measure or a single initiative that creates complexity. It is more the interplay of different approaches. Let me give you two examples:

One important strand of regulation is concerned with liquidity. Regulation sets new requirement in order to protect the banking system against a shortage of liquid assets. At the same time, a financial transaction tax is envisaged that might have drastic effects on the liquidity on some important markets. How do these measures interplay? What will the outcome be? To my mind, this is a truly complex question.

Another example – this time concerning the structure of the banking industry. If the US follows Volcker, the UK follows Vickers and the euro area follows a version of Liikanen, how much complexity will we add to banking?

Or think of the issue of accounting standards: How complex is the system if it remains hard to compare the balance sheets of US banks with those of European banks?

So, I believe that complexity is mainly caused by the multitude of approaches; not by a single regulatory step. The main point is: Basel is likely to make the global banking system even more complex if it were not adopted in all important jurisdictions.

Now let me turn to simplicity. I very much like simplicity. But it is important to remember another basic principle: It is unfair to treat different things equally.

In the early days of football, the rules were much simpler than today. One simple rule was that if a player commits a foul, the opposing team will get a free-kick. That rule applied regardless of whether it was a mild or a harsh foul, whether it took place in the midfield or close to the goal. A perfectly simple rule.

But it became increasingly clear that the rule was too simple. After a player committed a deliberate goal line handball in an important English Cup match, the idea of a penalty kick came up and was finally added to the rulebook in 1891. Of course, that made the rulebook more complicated. Since then we have had to distinguish between fouls that lead to a free-kick and fouls that lead to a penalty. But after all, that distinction does seem to be appropriate.

So, there is always a trade-off between appropriateness and simplicity. And now, taking a very bold leap from football back to banking regulation: It is appropriate to demand more capital for holding high-risk assets than for holding nearly risk-free assets. In addition, an apparently simpleleverage ratio could serve as a valuable backstop and act as a safeguard, in particular, against model errors and mis-calibration of risk weights. I fully agree with the leverage ratio's overall intention to deliver transparent and credible ratio, complementing the risk-based capital requirements – how simple it really is still has to be seen, especially in the light of different national accounting standards.

Nevertheless, the core message of Basel III itself is quite simple. It is all about:

- more capital,
- better-quality capital,
- and introducing a global liquidity standard.

All in all, it is about tightening the micro-prudential dimension of regulation, which forms a first line of defense against systemic risk.

3. Macroprudential dimension of regulation

The new macroprudential dimension of regulation serves as the second line of defense. There are three pressing issues on the reform agenda:

The first problemconcerns systemically important financial institutions, SiFis for short. To realign risks and return, the reform agenda is putting much effort in resolving the "too-big-to-fail" problem. Capital surcharges for SIFIs will be applied to help achieve this goal.

In addition, a proposal for a framework for the recovery and resolution of credit institutions and investment firms has been adopted; this is even more essential, as only a system that allows an orderly restructuring of SIFIs will impose the necessary market discipline on them.

Thus, thesecond pressing issue which needs to be solved is the concern with shadow banking and its lack of transparency. Here, the adoption of the EU regulation on the OTC derivatives market represents a significant step towards greater stability and transparency in an important segment of shadow banking.

Obviously, there is a risk that stricter banking regulation will set incentives to move business to less regulated parts of the financial system, thus causing regulatory arbitrage.

The thirdpressing issue is the inherent bias of the financial system towards pro-cyclicality. In the next stage, macroprudential policymakers will have to learn how to handle the new instruments and will need to define strategies which include intermediate objectives.

4. Conclusion

Let me conclude by making a prediction. I don't believe that banking will become boring. I actually happen to believe that banking in Germany may become even more challenging.

- I say this with several aspects in mind:
- Some banks have to adjust their business models.
- There is still significant overcapacity in German banking.
- Firms have improved access to credit via bonds, thus bypassing banks.
- Competition with insurance companies may well increase.
- Funding for banks is becoming more challenging.
- Equity investors' appetite does not reconcile well with boring banking.

Coping with difficult market conditions remains the private sector's job. But let me tell you: For them, since the outbreak of the crisis there is no such thing as dull banking.