Jens Weidmann: Digitalisation, financial regulation and low interest rates

Dinner speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the 6th Frankfurt Finance Summit, Frankfurt am Main, 11 May 2016.

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1. Introduction

Dr Raettig

Ladies and gentlemen

Good evening, and a very warm welcome to you all at the conference dinner of this year's Frankfurt Finance Summit here at the Deutsche Bundesbank.

I am speaking this evening not as a host but as a guest speaker, but I think that has little bearing on what I have to say. So thank you very much for your invitation and for giving me the opportunity to share my thoughts.

Once a year, Frankfurt Main Finance e.V. brings together decision-makers from commercial banks, insurance companies, stock exchanges, regulatory authorities and central banks as well as academic experts to discuss the latest issues in the financial business.

As you all know, Frankfurt is Germany's leading financial centre and the euro area's foremost financial hub. However, some of you might not be aware that we are gathered this evening at this city's nucleus as a financial centre after the Second World War.

The old part of this building complex, which today houses the Bank's Regional Office in Hesse, was once the domicile of the Bank deutscher Länder. And the establishment in 1948 of the newly founded German central bank in Frankfurt is widely seen as marking the start of Frankfurt's emergence as Germany's leading financial centre.

The establishment of Germany's post-war central bank ignited a fierce debate among the English-speaking Allies. While the Americans preferred a decentralised central banking system rather like the Federal Reserve System, the British authorities were more in favour of a centralised set-up with a central bank in Hamburg.

With hindsight, we now know that the British gave in on this particular point. But what, in an alternate history, would have happened if the British had prevailed on this issue? Would you perhaps be attending the "Hamburg Finance Summit" tomorrow – indeed, what would Frankfurt look like today if all the skyscrapers had not been built? That's something we'll never know.

Ladies and gentlemen, fear not. In the following, I will neither delve into historical anecdotes, nor will I present you with any further hypothetical questions. Rather, I would like to talk about the current challenges facing the financial sector.

The financial industry is indeed "on the move", as the title of this conference suggests. I am quite confident that market processes will move us in the right direction, though I am well aware that the "market road" can sometimes be a bumpy and curvy one. Yet it is worth keeping an eye on developments – from a supervisory perspective and also from a regulatory angle.

2. Digitalisation

Digitalisation is certainly one of the major challenges the financial sector is facing. Fintechs, big data, blockchain technology and the like, it is rumoured, have the potential to revolutionise the financial business, including central banks. And like every revolution, it could have the potential to reshape the establishment – as some people say.

Every financial institution is therefore well-advised to adapt to new technologies where there is a sound business case for doing so. On the other hand, I don't expect banks to become redundant. All the more so as it wouldn't be the first time in history that a supposed revolution turns out to be nothing more than evolution.

You may remember the song "Video Killed The Radio Star". I'm not expecting "Fintechs Killed The Retail Bank" to become a hit – simply because, rather than being substitutes, fintechs and banks actually complement each other. From a bank's perspective, it's a classic "make or buy" decision whether to make use of internal development resources or to harness the innovative power of financial technology start-ups.

In the digital era, it may appear irrelevant where business partners are located, but even in times of bits and bytes and the ultra-fast exchange of data, proximity is still an advantage. So providing a supportive business environment for such newcomers can give financial centres a decisive competitive edge. The Frankfurt financial centre will certainly benefit from the recent fintech initiative launched by the Hessian Ministry of Economics and Deutsche Börse AG.

And even central banks – which don't normally rank amongst the early adopters of new technologies – are doing experimental work of their own. As Yves Mersch from the ECB recently told an audience, "From a central bank perspective, in the context of our strategic reflections on the future of the Eurosystem's market infrastructures, we are certainly open to new technologies and, like many market players, have launched some experimental work with the distributed ledger technology."

Overall, the new digital age opens up huge opportunities for the financial sector. At the same time, however, it is an increasing source of risk – I am referring here to the ever-greater reliance on technical infrastructures and the considerable growth of cyber risks.

Europe's banking supervisors have identified IT and cybercrime risk as one of the key risks banks are confronted with – and rightly so. Digitalisation therefore poses a challenge to supervisory authorities, too. Cyber-attacks and system failures can tarnish the reputation of banks and undermine confidence in the financial system as a whole.

As for fintechs, regulators also need to keep an eye on the potential risks to financial stability originating from fintechs without impeding their innovative power. John Williams, the President of the Federal Reserve Bank of San Francisco said, and I completely agree with him, that "it's important that we have a level playing field, regardless of how institutions prefer to describe themselves or what kind of charter they hold. As a matter of principle, if it walks like a duck and quacks like a duck, it should be regulated like a duck."

3. Financial regulation

He did not literally mean the regulation of ducks, of course, but that of banks.

The regulatory and supervisory environment for banks has been transformed over the past few years, and this process of improvement has not been completed yet. Basel III and the respective European rules are forcing banks to hold more liquid assets, and better and more capital. A bank resolution regime has been established, and banks will be asked to hold capital instruments which, in a resolution event, can be converted into liable capital.

Financial stability and a resilient banking system benefit the entire economy, including the banks. The objective of regulatory reforms, then, is not to upset the financial industry, but to strengthen the resilience of the banking sector and to prevent the taxpayer from bailing out banks in the future – which is in my view crucial for the public support of our market economy.

There is a nice aphorism on this issue by Nassim Nicholas Taleb, the author of The Black Swan: "The main difference between government bailouts and smoking is that in some rare cases the statement 'this is my last cigarette' holds true."

Translated into the language of economics, that quip is a typical example of time inconsistency. Governments might promise to refrain from bailouts in order to prevent moral hazard behaviour. But when financial stability is at stake, they have an incentive to deviate from their previous commitment.

So, do higher capital ratios and the bail-in regime resolve the time inconsistency problem? No, but they do mitigate it substantially.

While the revamping of the Basel framework has not been finished yet, its completion is scheduled for this year. A further significant tightening of the capital requirements, in the sense of a "Basel IV", is not on the agenda. I feel that's something that needs to be said in order to prevent the financial industry from facing needless regulatory uncertainty.

There is one field of regulation, however, where too little has been done so far – the treatment of sovereign exposures in banks' balance sheets. A banking system can only truly be stable if the fate of banks does not hinge on the solvency of their national sovereigns. Thus, I have been advocating, for quite some time now, a phasing-out of the preferential treatment of sovereign borrowers over private debtors.

In the euro area, the introduction of non-zero risk weights and a large exposures regime for sovereign bonds would also help to inject greater credibility into the "no bail-out clause" of the EU Treaty if banks were then able to digest a sovereign debt restructuring.

Appropriate capital rules are the best and most important contribution which financial market regulation can make to the stability of the banking sector. In this respect, it is good to see that, in Germany, the average Tier 1 capital ratio rose from 9.1% at the beginning of 2008 to 15.6% in mid-2015, and that the quality of capital has improved substantially.

All in all, I wouldn't say that banks are being overburdened by regulation.

Nevertheless, for small and medium-sized banks, the burden is relatively heavy. In keeping with the principle of proportionality, we should reflect on an adjustment of regulatory and supervisory standards to the size of banks – provided that financial stability is not at risk. There is no doubt, however, that the new regulatory environment poses a challenge for all banks.

4. Low interest rates

Another challenge facing banks is the current low-interest-rate environment.

Ultra-low interest rates, or even negative rates, and an unusually flat term structure are squeezing banks' profits. Particularly affected are those banks whose profits mainly originate from net interest income.

From the perspective of a central banker, bank profitability is not an objective per se. Yet in financial stability terms, dwindling profitability is an unfavourable development as it impedes banks' ability to bolster their equity by retaining earnings.

However, while bank profitability may be a necessary condition for financial stability, it is not a sufficient condition. Recent BIS calculations for a group of large euro-area banks show that, over the period from 2007 to 2014, accumulated retained earnings could have been 75% higher if banks had not paid out dividends.[1] On the other hand, I would not deny that a no-dividends policy could impair a bank's ability to raise capital.

1 See Hyun Song Shin, Bank capital and monetary policy transmission, Panel remarks at The ECB and its Watchers XVII conference, Frankfurt, 7 April 2016.

Banks' ability to cushion shocks also affects the transmission of monetary policy. Thus, low profitability tends to make it more difficult, not easier, for monetary policymakers to fulfil their mandate. Our mandate is to maintain price stability.

While the Treaty does not precisely say what price stability actually means, the Governing Council of the ECB has clarified that it aims to maintain the inflation rate at a level below, but close to, 2% over the medium term.

Measured by this yardstick, the ECB is currently navigating difficult waters. Inflation is close to zero and projected to accelerate only very gradually. Bearing this in mind, an expansionary monetary policy stance is justified for now.

But we must not over-extend the period of ultra-loose monetary policy because various risks and side-effects are part and parcel of the current policy stance.

Just to give you one example: The longer a central bank pursues an ultra-loose monetary policy, meaning, for example, the longer forward guidance is in place and the more aggressively quantitative easing is pursued, the greater the risk that a slight tightening of policy, or even expectations of a slight tightening of policy, will send market interest rates sharply higher.

Morris and Shin, for example, argue that asset managers cannot afford to be the last ones to notice a switch in monetary policy, because their financial loss increases if many others try to sell their securities before them.[2] Consequently, they might become increasingly nervous, the longer monetary policy tries to maintain the low-interest-rate policy. This, in turn, could raise the probability of a sudden increase in risk premiums.

It is crucial that the zero interest rate policy does not remain in place for longer than is really needed to restore price stability, and that the benefits and costs of monetary accommodation are carefully weighed against each other against the background of our price stability mandate. In the meantime, monetary policymakers need to take care of their independence. And they should avoid being taken hostage by financial markets or fiscal policies.

Of course, monetary policy has contributed to the unusually low level of long-term interest rates. Not only the forward guidance, but also the purchase of long-term bonds – issued by sovereigns, banks or enterprises – aimed at lowering long-term rates.

But long-term interest rates are not only determined by monetary policymakers. They are also a reflection of nominal growth expectations, and if potential growth is slowing, it has a depressing impact on the real rate of return.

Making our economies more prosperous would therefore pave the way for higher real interest rates. There are plenty of growth-enhancing measures – like strengthening competition in product markets or making labour markets more flexible – and all of these measures go beyond the central bank's sphere of influence.

Blaming savers for saving too much is therefore, in my view, just as mistaken as blaming investors for investing too little. Both accusations have been levelled at this country very frequently indeed: Germans invest too little, it is claimed, and they save too much. And sometimes, the conclusion is drawn that Germans themselves are to blame for the low level of interest rates.

The high current account surplus and the purportedly too low investment ratio in Germany would appear to back up this accusation. However, while it is true that a current account surplus of more than 8% of GDP is certainly not sustainable, let us not forget that its most

[2] See Stephen Morris and Hyun Song Shin, Risk Premium Shifts and Monetary Policy: A Coordination Approach, Princeton University – William S. Dietrich II Economic Theory Center Research Paper No. 075_2016, 2015.

recent rise owes a great deal to the depreciation of the euro and the strong decline in oil prices.

Moreover, Germany is an ageing society, so it has good reason to engage in precautionary savings. If those savings were invested in other euro-area economies – or even outside the euro area – everyone would benefit – provided the funds were invested in projects generating an adequate return.

Should more funds be invested in Germany? That's something I would wholeheartedly welcome, but the disclaimer remains the same: the funds should only be invested in sensible projects.

However, the question of whether or not private investors deem an investment project to be sensible very much depends on the future economic prospects of the euro area and Europe. And nobody would deny that uncertainty is rife in this regard at the moment – the "Brexit" risk is just one source of uncertainty.

Is this the right time for German fiscal policy to step in – for example, by lifting public investment?

While I would not deny that there is scope for some more public investment in infrastructure or education, it is worth noting that fiscal policy in Germany is already in expansionary mode due to the cost of accommodating the refugees while the long-term sustainability of public finances calls instead for Germany, with its demographic burden, to run a structural surplus.

In any case, the sound state of the German economy does not necessitate an additional deficit-financed fiscal stimulus and – if such a measure were taken nonetheless – its positive spillover effects on other euro-area economies would be marginal at best.

A simulation exercise conducted by Bundesbank economists found that temporarily increasing public investment by 1% of German GDP over two years would lift GDP in the rest of the euro area by a mere 0.2% in the second year. Hence, a deficit-financed fiscal stimulus would be neither necessary nor helpful.

That said, it is clear that banks need to adapt to the low-interest-rate environment. To use a metaphor coined by my colleague Sabine Lautenschläger, they "should not try to just hold their breath until they surface from the low-interest-rate phase. They could rapidly run out of air."

Banks should scrutinise their business models, they should harness the benefits offered by digitalisation, and they should continue to improve their cost efficiency. With regard to banks' business models, I firmly believe that it is in banks' own interest to strive for high standards.

Banks should refrain from running questionable business models – those based squarely on exploiting tax loopholes, say. Banks have to make sure that their businesses conform not only with the law, but also with ethical standards – indeed, just because something is not explicitly prohibited doesn't mean it's necessarily allowed.

5. Conclusion

Ladies and gentlemen

If you're facing a strenuous challenge you should at least make sure your energy intake is adequate. So on that note, I will refrain from keeping you from enjoying the main course.

The conference tomorrow will undoubtedly provide many opportunities to delve into the topics which I have just touched upon.

May I conclude by wishing you all a very fruitful conference day tomorrow and of course, a pleasant evening today.

Thank you very much for your attention.