Andreas Dombret: Foreign banks between financial crisis and financial stability

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, to mark the 30th anniversary of the Association of Foreign Banks in Germany, Frankfurt am Main, Germany, 22 August 2012.

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1 Introduction

Ladies and gentlemen

Let me begin by offering the Bundesbank's warm congratulations to you, Mr Winter, and all the members of the Association of Foreign Banks in Germany on its jubilee 30th anniversary. Thirty years is quite a long period of time – nearly one-third of a century – and something of a landmark. As the old saying used to go, "Never trust anyone over 30". That catchphrase was popularised by the 1968 student movement – the students who used it are now themselves over 60!

Trust is indeed the key word. Its importance is being learned by governments and banks alike as the sovereign debt and financial crisis tightens. So it is a good thing that the day-to-day dealings between the banking associations and individual banks, on the one hand, and central banks and supervisory authorities, on the other, are characterised by mutual confidence and trust – notwithstanding the necessary arm's-length relationship between central banks and supervisory authorities, on the one hand, and banks and their associations, on the other.

I can say that because I have worked in both camps. I was once a foreign banker myself. Since joining the Bundesbank in 2010, I have had a chance to see things from the other perspective. I would like to take this opportunity to thank you for the constructive cooperation I have been privileged to enjoy with all banking associations over the past two years.

I hope that this cordial relationship will continue in future – including after the possible emergence of a new, overarching single European supervisory body. If it is carefully conceived and constructed, it could make an important contribution to safeguarding financial stability. And it might well refashion the current triangular relationship between banks, supervisors and central banks. Let me nail my colours to the mast right away: I do not believe that it is absolutely essential for the central bank to have ultimate supervisory responsibility in order to capitalise on the synergies provided by central banks' macroeconomic and macroprudential expertise. The crucial requirement is the efficient exchange of information.

2 Stimulating competition

In his book *Fault Lines – How Hidden Fractures Still Threaten the World Economy*, former IMF chief economist Raghuram Rajan argues that a fault line is created when two different financial systems based on different principles interact. He is referring to the contrasting cultures of the capital markets and relationship banking. Financial market integration has certainly increased the possibilities of contagion. However, I do not believe that the "fault line" necessarily runs along the border between the capital market and relationship banking.

Seen from the perspective of a universal bank, drawing a rigid distinction between capital market orientation and a banking philosophy seems a huge oversimplification. Germany's universal banks came through the financial crisis pretty well on the whole. And the contacts between foreign banks and German banks have stimulated and enlivened competition, benefiting both groups of banks. Moreover, it should be noted that the foreign banks

operating in Germany, which each bear the specific hallmarks of their home country, are probably the most heterogeneous group of banks included in the Bundesbank's statistics.

How important are foreign banks in Germany's banking system? For many foreign banks, traditional banking activities account for just a small part of their business. This makes their market share – currently 12.9% measured in terms of total assets – all the more remarkable. This trend has been driven by the arrival of new banks through mergers as well as growth, particularly in deposit business and instalment loans. The approximately 30,000 members of staff employed by foreign banks at the German financial centre do make quite a meaningful impact on employment. These figures point to a significant influence.

In some business lines, especially those involving the capital markets, foreign banks have a much more prominent position than in traditional banking fields. Today, it is hard to imagine M&A activity in Germany without the influence of the Anglo-American banking culture. Foreign banks play an important role in advising and assisting on German corporate bond issues; the same goes for IPOs and capital increases.

The financial crisis has naturally also led to the market withdrawal of individual foreign banks. On the whole, however, it has thankfully not triggered a mass exodus of foreign banks from Germany – unlike in some other countries.

For a long time, foreign banks struggled to gain a foothold in the German market. Banks that accept deposits and grant loans normally had to begin by setting up a branch network as a prerequisite for winning new customers.

The creation of the single market in Europe has made things much easier. The European Passport made it possible to set up branches anywhere in the EU without requiring additional authorisation. However, barriers to market entry still remained. These included the high overhead costs of creating a branch network, the challenge of finding skilled staff, the continued strong importance of brand names, and the justifiably high reputation of German banks among German clients.

In this tough business environment, foreign banks wanting to expand into Germany had to rely on innovation and cost-efficiency. They were given a helping hand by liberalisation and the technological advances of the internet in the 1990s; this gave foreign banks a fast and low-cost channel for communicating with customers.

And they seized their chance. Some foreign banks therefore set up shop as online banks to conduct deposit business but also to engage in business with standardised consumer loans. For retail customers this translated directly into a larger product range at lower prices. That is good both for customers and for competition.

Providing advice and expertise to enterprises is a key investment banking service, and one from which German firms have benefited. That requires putting down roots in the real economy and offering a real service. And the last few years have taught us that foreign banks with roots in the real sector are unlikely to pull out in times of financial crisis.

Integrated financial markets *per se* enhance economic growth and our prosperity. Foreign banks in Germany constitute a part of this financial market integration. The downside of integration is that market players are much more interconnected, which means that crises spill over more quickly from one country to another. This can lead to dislocations. However, that is simply the reality of today's financial world.

3 Capital: the key to greater trust

Having, or building up, sufficient capital is essential, particularly in the current climate. And it is also crucial to restoring confidence and trust.

In its last *Financial Stability Review*, the Bundesbank wrote that, in times of systemic stress, "the task of restoring confidence is not merely the responsibility of an individual bank but also

a call to arms for the system as a whole". This demands not just adequate capitalisation of national banking systems but also convincing Europe-wide solutions.

I'll make no bones about it: a level of capitalisation that just meets the *minimum* supervisory requirements would fall far short of what is needed, in my view. I think it was the UK economist Charles Goodhart who told the following tale to illustrate the dangers of minimalist compliance.

A weary traveller arrives at a rural railway station. To his delight, he sees exactly one taxi waiting there and asks the driver to take him to his destination. To his amazement, the cabdriver tells him: "*I would love to take you there but cannot, I'm afraid*".

"Why not?", he asks, flabbergasted.

"There is a local bye-law that says a taxi has to be here at all times."

"But a taxi is here*."*

"Ah yes, but if I take you home, there would no longer be a taxi waiting here. That would violate the bye-law."

This is what can happen with statutory minimum requirements. Only capital *in excess of* the minimum requirements is available to truly and independently absorb business risk. In an actual crisis, it is only this capital that can be used to buy the time needed, for instance, to write down impaired assets, adjust portfolios or restructure business units.

In an ideal world, of course, such buffers should be built up *before* systemic events occur. That is the rationale behind capital cushions. They provide a certain breathing space before institutions are forced to unload risky assets and curb their lending. If the buffers are too small, however, the pressure to deleverage during a shock can become overwhelming and cyclical movements may be amplified.

This is where public capital assistance comes into play. In theory, it provides a counterweight and reduces deleveraging pressure.

4 Getting the basics right: aspects of a European system of banking supervision

The reality can be much rougher, however, for a euro-area country that is struggling to cope with the close interlinkages between the sovereign debt crisis and the banking crisis. The stability of the banking sector is then called into question because the country is no longer regarded as being fully capable of resolving its banking crisis unassisted. For such cases, the EFSF has clear rules according to which other euro-area countries can step in to help that country. The affected country remains the partner for the donor countries' assistance.

By providing such assistance, the donor countries are already taking on considerable risks. Extending this risk-sharing role, as is being proposed in connection with a banking union – in the form, for example, of a European restructuring fund or a European deposit insurance scheme – would necessitate far more extensive intervention in countries' national sovereignty and in their fiscal and economic policies. I hope you will agree with me that joint liability must not be allowed to be introduced covertly through the back door.

Instead, joint liability must be predicated on two basic principles. One is the unity of liability and control. As long as control rests with nation-states, liability must rest there, too. This is important to avoid promoting excessively risky business models that threaten financial stability. Moreover, no incentives should be created to build a bloated financial industry in individual countries that is way out of proportion to the size of the real economy.

The other principle that must be observed is taking the appropriate steps in the right order. The logical sequence requires, first, further moves towards European control, which in turn necessitate democratic legitimacy and accountability.

I am firmly convinced that all concrete proposals must be informed by these considerations and guided by these principles.

Moreover, many important details remain to be clarified. These remaining uncertainties have perhaps contributed to the intensity of the recent public debate on this topic. In a situation marked by uncertainty it can even happen that one or two economics professors sign both a petition and the corresponding counter-petition. And this does not even have to be a contradiction if the two countervailing positions depart from different assumptions concerning the principles and the details of their implementation.

One of the questions regarding a possible pan-European banking supervision regime that still needs to be clarified is the range of countries that will be subject to it: should it cover all EU member-states or only the euro-area countries? Given the interlinkages between financial institutions throughout the EU and against the background of the single market, I see merits in integrating all EU member-states in a European supervisory structure. This would strengthen the single market, it would be consistent with the Single Rule Book, and it would help to create a level playing field.

Taking this logic further, it would make sense in principle for all banks to be supervised by this European authority. In line with the principle of subsidiarity, the European supervisory authority could then delegate the supervision of systemically unimportant banks to national authorities, subject to the proviso that such banks could then be brought back into the fold of European supervision on a case-by-case basis. I believe a Europe-wide prudential regime would definitely benefit from the operational involvement of national supervisory agencies. Such involvement, in fact, may well be essential.

A key issue for central banks is the precise nature of their involvement in European banking supervision. There can be little doubt that they ought to play a role, given their wealth of macroeconomic and macroprudential expertise, as this is the only way to exploit synergies. The question, however, is how this can be best accomplished. I believe that central banks do not necessarily need to assume ultimate responsibility for supervision. The key imperative is, rather, for supervisory agencies and central banks to cooperate efficiently and, above all, to exchange information.

In my view, this would be consistent with central bank involvement in operational supervision.

In this manner, potential conflicts with ensuring the independence of monetary policy can be avoided and the credibility of central banks maintained.

It follows from this that an agency other than the ECB could be given ultimate responsibility for supervision. Supervisory powers imply extensive rights of intervention which, in turn, require direct democratic legitimacy and accountability. Thus if the central bank were to have ultimate sovereign responsibility, its independence would have to be constrained. And let us not forget either that monetary policy decisions can also impact on banks' robustness. This might well cause a conflict of objectives.

All of these arguments are, I believe, sound reasons not to transfer ultimate responsibility to the ECB but, instead, to a different authority headed by a council in which the banks' home countries are adequately represented. Such representation should reflect the size of each country's banking industry. In such a set-up, the ECB would undoubtedly play a particularly important and wide-ranging advisory role.

Whatever solution is ultimately implemented, I am firmly convinced that monetary policy and prudential supervision should be kept as far apart as possible.

If a European supervisory regime is based on the right principles and its detailed workings are well thought out and implemented, it has a good chance of making a major contribution to financial stability.

5 Conclusions

Those are a few thoughts that I wanted to share with you going forward. Your anniversary has undoubtedly come at a critical juncture for the world of finance. The sovereign debt and banking crisis will probably keep us occupied for quite some time to come. The problems are deep rooted. The future will tell how well we have been able to cope with the challenges of our time. However, of this I am convinced: if the right measures are taken, a very good solution will emerge in the end.

On this note, I would like to congratulate you once again on your landmark anniversary and thank you for being such an attentive audience.