Andreas Dombret: Banks and trust

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 58th Kreditpolitische Tagung, a conference on the theme of "Banks and trust", held by the magazine "Zeitschrift für das gesamte Kreditwesen", Frankfurt am Main, 9 November 2012.

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1 Banks in the service of society

Banks and trust – this is a wide-ranging topic which relates both to individual institutions and to the economy as a whole, and one which I would like to take up from the point of view of a central banker whose responsibilities also include the stability of the financial system. In the following, I wish to look at aspects relating to individual institutions, the economy as a whole, regulatory matters and wider society.

The social aspect is already apparent in your introductory announcement for today's conference, in which you write, "The era of the well-respected banker is over: nowadays, traits such as greed, lack of self-restraint, and immorality are to the fore". This social perspective reminds us that there is a responsibility towards society which goes beyond the concerns of homo oeconomicus as found in the textbooks.

According to Adam Smith, the striving of each individual after his or her own happiness leads to prosperity for society at large. This is the proverbial invisible hand of the market. Or, in his own words from his magnum opus, The Wealth of Nations, "It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own interest." Translated to the financial sector, this means: it is not to the loving kindness of banks that we owe our mortgage, but to their desire for profit and interest. And that is as it should be. Systems which are based on selflessness fail because people are not selfless. Any stable economic system needs to take due account of the fact that people think of themselves first.

This is overstating things somewhat. By which I mean that this view requires some qualification. If everyone were purely selfish, then we would all be cheating one another the whole time. Thankfully, cooperation is an empirically observable fact. It goes beyond what can be explained simply by self-interest. We are only able to live together because people do not think exclusively of themselves but are also prepared to take responsibility – not just for themselves, but for others, too.

In this sense, a change in consciousness is required. Trust, long-term thinking and sustainability: these are all challenges which face our society as a whole. Short-termism, on the other hand, is one of the principal causes of the current financial crisis and crisis in trust.

In terms of short-termism on the financial markets, there are two opposing theories. One theory says that enterprises and banks – the large ones at least – belong to their shareholders, and should therefore be managed in their interests. Shareholders' income rises and falls with the bank's performance. The shareholders' interests therefore lie chiefly in the enterprise's long-term success.

The opposite theory says that because shareholders are the most mobile, they are the ones least concerned with the long-term future of the bank or enterprise – unless they hold so many shares that selling them might inflict damage on the enterprise. Therefore, they favour short-term profit growth and pay little regard to long-term prospects.

There is certainly evidence pointing to a long-term approach being in the best interests of proprietors. Many owner-managed banks held up well in the financial crisis. In concentrating on investment advice, most of these institutions have a business model which continued to work in the financial crisis. The savings bank sector also weathered the crisis well. And the same goes for the cooperative banks, in which the customers are also owners. These institutions did not lose people's trust.

Let me be clear: this does not mean that banks operating as public limited companies are obliged to take a short-term approach. But they need to put in place functioning management and incentive structures. And they most certainly have to restore a greater sense of social responsibility to their own houses. The financial sector's role in serving the real economy needs to be clearly discernible in their business models.

Investment banks can do this too. Equipped with the right business model, they can be genuine "servants" of the real economy. There are many ways of doing this. For instance, providing good advice in the business of mergers and acquisitions. Such services are of value for customers in the real economy. And a suitable price can be charged for such services. Or if a bank undertakes currency-hedging on the foreign exchange market for an exporter, this can be of existential importance to an enterprise which is part of the real economy. Good advice is therefore essential here.

Things become dangerous when banks get wrapped up in a world of their own. When speculation becomes an end in itself. Properly functioning management structures need to be able to prevent this. This relates not least to remuneration structures. It also has to do with questions of organisation and often with the quality of a bank's risk management.

And it has to do with the rules banks set themselves and live by in their dealings with customers: for instance, finding out what the customer actually needs first, instead of starting off by seeking to maximise fees. Or take, for example, "payment by customer satisfaction". Obviously, customer satisfaction is difficult to measure and to attribute to individual advisors. Or there is the issue of "product information for investment products". The importance of clearly explaining the opportunities and risks involved in financial products should be self-evident. And yet, quite a lot of people feel they are on shaky ground with these products, partly because the products are complex, possibly too complex. There is still work the banks can do in this regard.

So, there is a lot that individual banks can improve if they are to regain the trust of customers and the public, not least by setting an example and leading from the front.

2 The Gordian knot

But what can the state do? One thing the state certainly can and must do is create a suitable overall organisational framework and supervise institutions effectively. I will have more to say about this later.

But, above all, there is an ethical principle which needs to be heeded more closely, particularly in these times of financial and sovereign debt crisis. The principle is that of subsidiarity, on which Walter Eucken, one of the founding fathers of the social market economy, based his notions of how the economy and society should work.

The aim of subsidiarity is self-determination and individual responsibility. According to this principle, problems should be solved through individual responsibility as far as possible, which is to say by the individual or individuals, or by the smallest group or at the lowest level of an organisation. Only if this is not possible should subsidiary assistance be provided by groups or public collective organisations of progressively increasing size or at progressively higher organisational levels. This principle places ethical limits on the scope for state action in the current crisis. And it also follows that those who receive assistance must learn to live with monitoring and control.

There are economic limits in any case. It is all too clear, after all, that the current crisis is also a crisis of trust in the viability of countries' debt positions. And it is a crisis of trust in the soundness of the banks. Indeed, in the crisis-hit countries there is a close connection between the crisis of trust in the banks and the crisis of trust in government finances. What we need, therefore, is clear organising principles both for the financial system and for monetary union, principles which prevent the creation of unhealthy incentives. First, bank risks and sovereign risks must be prevented from being too closely intertwined. Second, the principle of subsidiarity must be anchored still more firmly.

The intertwining of bank and sovereign risks is likened by many to a Gordian knot, which it needs a sword to cut if the current financial and sovereign debt crisis is to be resolved. I have to admit that I find this view surprising and, indeed, astonishing.

It reminds me of a story by the novelist Manès Sperber, in which a teacher asks one of his pupils what he knows of the Gordian knot. The boy's answer is somewhat unexpected: "No one could undo the Gordian knot, not even Alexander. But instead of admitting this, Alexander took a sword and cut the knot, which any idiot could have done. After this, Alexander was called 'the Great'". The teacher did not see the funny side of this: "Six, sit down", he replied. (In those days, grades went from one to six, not AAA to D.)

3 The loops of the knot: systemic and fundamental aspects of the crisis in trust

Few words can have had such a high-profile career as the term "systemic". I would like briefly to define it in connection with the financial and sovereign debt crisis. If an event is not systemic, it can be dealt with in isolation. If this were the case, the debt problems and problems with the banking systems in the various countries could be regarded as a series of standalone phenomena, rather than as a systemic phenomenon which affects the euro area as a whole.

Things are rather different with systemic events: there are contagion effects between the countries and contagion between financial institutions. Hence my image of the Gordian knot, which refers metaphorically to the feedback loops between the financial sector and the real economy.

At the end of last year there were clear indications of a systemic financial crisis. The provision of central bank liquidity for a period of three years relieved some of the pressure initially. But only for a short time. The markets soon realised that this measure had pulled the knot between the public sector and the banking system tighter rather than loosening it. There is no way round the need for reform and restructuring. Government bond purchase programmes increase the level of interdependency, and firewalls are no substitute for the restoration of solvency and investor trust. To return to my original metaphor: neither is an effective means of untangling the knot. This can be achieved only through economic adjustment, through structural reform and through balance sheet adjustment – action is required here from national governments and banks in equal measure.

Since the outbreak of the financial crisis, the banks have made considerable adjustments. Legacy assets have been scaled down and balance sheets shrunk. However painful this may have been for individual institutions, it was right and necessary. But the banks cannot afford to stand still. There are new challenges they have to confront. In particular, margin pressure and increasing competition in domestic business come to mind.

4 Recapitalisation: a "sword" to cut the knot?

Adequate capital buffers strengthen the essential resilience of the financial sector. The risk of contagion is reduced. If a systemic event occurs, such buffers create room for manoeuvre before risk assets and lending have to be cut back. Therefore, to win and retain trust, banks need to be sufficiently well capitalised.

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 believe 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 taxi driver 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. Trust cannot be won by attending merely to the minimum requirements.

Recapitalisation can nonetheless restore trust. Where it has been lost, or where it risks being lost. Ideally, the capital buffers should be put in place by banks when the economy is in an upward phase, so they are ready to use in a crisis.

In this context, assistance from the public purse for recapitalisation can be a key measure. But it places a burden on government finances – particularly if a number of banks get into difficulties at the same time, which is what happens when there is a general crisis of solvency and trust. In turn, weak government finances and falling prices for the government bonds on banks’ balance sheets undermine trust in the solvency of the banks. Therefore, government recapitalisation assistance is not a sword to cut the knot, but merely an auxiliary measure to make the necessary adjustments easier.

5 Banking union: another sword?

To disentangle the Gordian knot on a lasting basis, the tight-running feedback loop between banks and government finances needs to be loosened. Greater separation between bank and sovereign risks can without doubt be achieved partly through suitable banking regulation which puts strict limits in place in this regard. Improving the banking system’s risk-bearing capacity is also a necessary part of the package. A banking union, too, may make an important and useful contribution. Core elements of such a banking union would be, first, common banking supervision, and, second, a common resolution regime for banks which get into difficulties.

In putting these measures in place, the risk to the taxpayer should be limited as far as is possible. Mutualisation of risk cannot be the goal. The principle of subsidiarity requires that risks be borne where they arise. The individual investors have to bear liability first, with the state stepping in as a true last resort. Thus, private creditors have to play their part in restructuring and resolution – investors have to bear their responsibility. “Bailing in” investors prevents implicit state guarantees, or at least limits them. This has important implications for the structure of incentives to take on risk. It means market participants cannot rely to the same extent on being bailed out when the crunch comes.

With regard to a banking union, I am sorry to disappoint those who would like it to be a means of mutualising liability for legacy assets on banks’ balance sheets. This, too, follows ultimately from the principle of subsidiarity. Mutualisation of risk is conceivable only at some future date, but certainly not mutualisation of losses which arose on the watch of national supervisors. Anything else would be like taking out an insurance policy after the insured event has occurred.

Banks now need to formulate resolution plans – I shall return to this shortly. This is extremely important if bail-outs are to be rendered unnecessary. And in order to separate systemic functions from non-systemic functions, and thereby allow banks to become insolvent. They have to free their balance sheets of problematic legacy assets themselves, rather than passing them on to the community.

6 Making regulation effective and sustainable

Trust in the banks will only return if we succeed in bringing decisive improvement to the applicable “rules of the game”. The crisis has made clear that a fundamental reordering of the international financial system is essential. This does not mean simply banning undesirable activities on the financial markets and stopping market processes. Rather, it is a matter of creating the right incentives for market participants to engage in risk-aware behaviour and putting in place a consistent and reliable overall organisational framework which creates lasting obligation. This means, for instance, imposing the right kind of regulation on the right kind of business, irrespective of whether it is carried out by a bank or by an institution in the shadow banking system. In this way, regulation can create trust.

Because banks are the central players in the financial system, the process of working through the implications of the crisis must start first of all with the rules applying to the banking sector. We have already achieved a great deal in revising banking sector rules – even if this is not always appreciated by the public.

The central achievement of our reform efforts is without doubt Basel III, which is to say the fundamental revision of capital rules and the introduction of global liquidity rules for banks. The new rules will add significantly to the resilience of the banking sector. In order to maintain a level playing field internationally, it is important that all the countries involved adhere to what has been agreed and transpose the new rules into national legislation in timely fashion. Although it has become apparent recently that some countries are having difficulties sticking to the timetable, I am confident that we will succeed in achieving implementation on time.

As well as Basel III, the rules agreed for dealing with systemically important banks are also noteworthy. The Financial Stability Board recently published an updated list of 28 global systemically important banks. Amongst other things, these banks have to meet still stricter capital requirements. Furthermore, the Basel Committee has published a set of rules which will apply to banks that are systemically important at a national rather than a global level. These banks, too, will be subject to capital surcharges.

As well as strengthening banks’ resilience, the focus is also on developing credible resolution regimes. In future, banks have to be able to exit the marketplace without impairing system stability and without the use of taxpayers’ money. Only if this is a credible threat will trust be restored. This is the only way that banks’ ability to “blackmail” the taxpayer can be curtailed. Thus, the passing of a new international standard was an important step towards achieving regulation which promotes trust. This is the first time rules have been put in place on a global level setting out how insolvent banks are to be wound up. The rules laid down by the standard now need to be transposed into national law and regulations consistently and on schedule.

7 Limiting risk-taking incentives

Before the crisis, implicit guarantees created moral hazard. It is here that the root cause of the loss of public trust suffered by the banks is to be found. Thus, the ultimate reason was an inadequate overall organisational framework which set up the wrong incentives.

In this context, profit targets were announced which now look “unrestrained” or “greedy” but which at the time investors demanded – with support at the end of the day from an inadequate overall organisational framework. And the false incentives led banks to lose touch to an ever increasing extent with traditional banking services. Banks lost a sense of reality. But since the onset of the crisis five years ago, there has been a deep-seated change, even if it perhaps does not go far enough for many. A lot of institutions are saying farewell to pre-crisis profit targets. And they are factoring in less financial leverage, partly because of the Basel III capital rules.

In many cases, business models are being reworked as well. Many banks are looking to focus more on business with personal and corporate customers while scaling back their investment banking. They are now seeing themselves more in terms of being “servants” to the real economy. In this way, banks will be able to regain public trust. After all, the savings banks and cooperative banks, with their traditional business model, rode out the crisis years well.

Another element in the realignment of business models is the rethinking of remuneration practice in the financial sector. There is no disputing that mismanaged remuneration systems helped cause the crisis. Remuneration in the financial sector needs to be brought back into line with the risk entailed in business activities, and needs absolutely to be based on a financial institution’s creation of lasting value, rather than on rapidly pumping up earnings. Banks must prove through their business models that they are trustworthy, and their remuneration culture is the litmus test for this – whether they like it or not.

From the point of view of financial stability, it is the structure of remuneration which requires reform rather than the amounts involved. However, it is also clear that the amount of remuneration received has to be adapted to lower medium to long-term earnings in the financial sector. Thus, the efforts to establish a sustainable remuneration culture in harmony with the goal of financial stability must not be allowed to wane.

It is good to note in this connection that remuneration systems and principles of good governance are now receiving increased attention from shareholders. They have been impressively active in the votes on remuneration reports at the AGMs of a number of European and US banks in recent months. Clearly, the era of the sound, trustworthy, respected banker is actually not quite over. Or at least it is coming back into fashion.

8 Conclusion: banks and trust

To sum up: banks mainly have to earn trust themselves. And that is hard work, admittedly. The banks need to strengthen their capital base and adjust in timely fashion to the new Basel III requirements. And the banks have to gear their portfolios more towards the needs of private households and enterprises and less towards government financing. We regulators also have to ask ourselves searching questions about whether regulatory privileges for governments are still appropriate. At the end of the day, only this can permanently loosen the knot between the sovereign debt crisis and the banking sector.

A lot has already been set in train. But the banks cannot rest yet. Trust, after all, is a scarce resource which needs to be managed carefully. Trust needs to be sought anew each day, both with customers and with the public.

Without trust, without “credit”, banking cannot function. The media and politicians have a responsibility here, too, in not undermining public trust, for example through talk of allegedly missing gold at the Bundesbank which has absolutely no basis in fact.

Banks provide the grease which makes the wheels of the real economy turn, and they will continue to be needed in the future. Therefore, as well as criticising them, we must also give them constructive support.

Or – and this is more than apt here in Frankfurt’s Abs Saal – in the words of banker Alfred Herrhausen: “Say what you think, do what you say, and be what you do”.

Thank you for your attention.