Andreas Dombret: Resilient banks – essential building blocks of a stable financial system

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 18th Annual Banking and Insurance Conference "Making finance work in a higher capital world", organized by Bank of America Merrill Lynch, London, 24 September 2013.

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1 Introduction

Ladies and gentlemen

Many thanks for inviting me to this year's conference. It is a real pleasure for me to speak before you today because I spent many years of my career in the private sector. Today, however, I speak to you as a central banker and thus from a regulator's point of view.

From time to time banks and regulators are portrayed as opposing forces. To me, this seems a bit off the mark – not least because I know both sides rather well. In the end we all share the same objective: a stable financial system.

And a natural starting point from which to build a stable financial system is the individual bank. Banks are the elementary building blocks of the financial system and to ensure financial stability we need resilient banks.

2 What defines a resilient bank?

But what is a resilient bank? To begin with, a resilient bank is able to withstand shocks. A resilient bank enjoys the confidence of investors and customers. Thus, it will receive funding – both wholesale and retail – at adequate prices even during periods of stress.

But how do investors and customers recognize a resilient bank? Is it like the famous giraffe: hard to describe but you know it when you see it? Well, there are certainly times when this is the case. Usually, however, resilient banks have specific characteristics that set them apart from other banks.

In my remarks today I would like to discuss three of these characteristics – three pillars on which resilient banks rest.

2.1 Capital and liquidity buffers

Capital and liquidity buffers should be regarded as the centre pillar. Capital provides a cushion to absorb losses during times of stress. And with the benefit of hindsight, it is now widely acknowledged that prior to the crisis banks' capital buffers were neither high nor solid enough.

The same is true for liquidity. Banks' role in financial intermediation makes them particularly vulnerable to liquidity risks. And a lack of liquidity can break a solvent bank's neck. After all, a liquidity squeeze was the defining element of the financial crisis in 2008.

In terms of strengthening individual banks' capital and liquidity buffers, we have come a long way. The Basel III rules require banks to hold more and better capital. These rules have since been transposed into European legislation. Once they are implemented, banks will be able to absorb bigger losses while remaining a going concern – they will be more resilient.

Although the implementation will be gradual, banks have already become eager to build up their capital buffers early on. In doing so, they are responding to increased market expectations. In Germany, for instance, the 12 major banks with an international focus increased their tier 1 capital ratios from 13.2% to 15.3% by mid-2013 on a year-to-year basis.

However, some banks will still have to raise their capital or adjust their balance sheet positions accordingly.

Regarding the issue of liquidity, we have, for the first time ever, agreed on an international standard. I am sure that this new standard will increase banks' resilience to liquidity shocks, promote a more stable funding profile and enhance overall liquidity management. However, more analytical work needs to be done – not least because liquidity regulation is uncharted territory. Moreover, a lot of side effects and unintended consequences need to be fully thought through.

2.2 Profitability

The second pillar on which a resilient bank rests is profitability. Banks that are not profitable will lose the trust of their investors and customers, especially in times of stress. Also, they are not able to build up reserves, for instance by retaining earnings. This further weakens them in times of stress.

Prior to the crisis, many banks' ambition to increase shareholder value led to expectations of returns on equity of more than 20%. Generating returns of that order may be profitable but not necessarily sustainable. But banks need business models that are both profitable and sustainable. I am fully aware, though, that this is easier said than done.

Just take a look at German banks. Like many of their international peers, German banks have been under pressure from a number of challenges for several years now – some crisis-related, others structural. In addition, the German banking market is still highly dense and highly competitive.

For all these reasons, many banks still need to optimise their business models – for instance, by diversifying their funding sources or by giving up business units whose risks cannot be managed effectively. Those banks that cannot adapt swiftly enough to changing conditions should exit the market.

Now, when discussing the issue of profitability, it is often held that regulation increases banks' costs and reduces their earnings. It is certainly true that regulatory requirements do entail some costs for banks. However, I would take a more balanced view on the costs of regulation. Banks tend to overlook the costs of crises, as these are usually borne by taxpayers. Taking these costs into account puts the banks' criticism in perspective. At the social level regulation still generates a net benefit.

2.3 Good governance

Having said that, let us turn to the third pillar of a resilient bank. A resilient bank has a sound governance structure and is committed to high ethical standards. Investors and customers need confidence that banks are managed prudently.

These aspects have gained a lot of attention in the aftermath of recent scandals, such as the manipulation of LIBOR and similar financial benchmarks. These cases of misconduct spoil confidence in a twofold way.

Firstly, the trustworthiness of banks involved is impaired. And this has negative consequences for the banking sector as a whole. Banks will have to work hard in order to heal the wounds. Secondly, the reliability, robustness and representativeness of financial benchmarks have been called into question. Without doubt, the integrity and credibility of benchmark-setting processes are in urgent need of a general overhaul.

We all know: trust is gained only over a long period of time but may be shattered quickly. In a sense, trust is similar to Humpty Dumpty: it is very fragile and, once it has been shattered, all the king's horses and all the king's men will not be able to put it back together. In that vein, all efforts to strengthen banks' resilience can be undone instantly if banks cannot avoid severe cases of misconduct in future.

This also applies to banks' risk management capacities. On this issue, however, much progress has been made. The requirements for adequate internal control systems and appropriate governance structures have been tightened substantially.

Let me elaborate on this by referring to reforms of banks' compensation schemes. In the run-up to the crisis, asymmetries in compensation in terms of risk and reward led to short-termism and excessive risk-taking by some employees. Inadequate pay and reward systems contributed to large – and in some cases extreme – absolute levels of compensation. That in turn left firms with less capacity to absorb losses as risks materialised.

To safeguard financial stability, compensation schemes in the financial sector must be better aligned with the long-term performance of firms and with prudent risk-taking. International guidelines to this effect have been developed by the Financial Stability Board.

To date, the implementation of these guidelines is still seeing good progress. But much work still lies ahead for national authorities and banks. They have to ensure effective implementation of sound compensation policies that lead to more prudent risk-taking behaviour of employees. The strong compensation requirements that Europe has set in the legislative package on capital requirements are an important step in this direction.

But achieving lasting change in behaviour and culture will take time and stamina. Banks need to undertake further efforts to publicly disclose easy-to-understand and consistent data on their compensation structures that allow for comparisons across jurisdictions.

3 Looking beyond the individual bank

To sum up the characteristics of resilient banks, we can state that they are well-capitalised and have enough liquidity, that they have profitable and sustainable business models and that they are managed prudently. First and foremost, it is certainly the banks' responsibility to fulfil these criteria. It is the responsibility of regulators, however, to put in place a stable regulatory framework.

Nevertheless, in designing such a framework they have to look beyond the individual bank. Experience over recent years has shown that certain dynamics can jeopardise the entire financial system even though all single entities were believed to be sound: the whole is more than the sum of its parts.

Therefore, setting regulatory standards to increase the resilience of individual banks is necessary but by no means sufficient. Authorities have to broaden their perspective to cover the financial system as a whole. They have to take into account the problem of systemic risk.

Systemic risk can be created by cyclical or structural developments, such as exposure concentrations or externalities caused by the interconnectedness of financial institutions.

3.1 The "too-big-to-fail"-problem

The first step in this regard is to acknowledge that even resilient banks can fail. And this might become a problem if the failing bank is very large and interconnected. In such a case it can drag other banks down with it and cause a systemic crisis. Consequently, we have to ensure that such systemically important financial institutions (or SIFIs) can fail without destabilising the whole financial system.

What we need are insolvency frameworks that are in tune with the interconnectedness and complexity of the financial sector. Major steps have already been taken in this regard at the international level. The Financial Stability Board has already presented key attributes of effective resolution regimes for financial institutions. These were endorsed by the G20 heads of state and government in November 2011.

Since then, work has been under way to transpose this new international standard into national law. A draft directive for the recovery and resolution of credit institutions has now been presented at the EU level. This proposal clearly sets forth the sequence of liability for failing financial institutions – shareholders and creditors are now first in line to bear losses, and rightly so.

3.2 The bank-sovereign nexus

Nevertheless, there is still another aspect of interconnectedness that has to be taken into account: the link between banks' balance sheets and public finances. The crisis has exposed a vicious circle in that connection.

If many banks run into financial difficulties at the same time, that can threaten the stability of the entire financial system. Governments then often have no option but to bail out these banks to prevent the system from collapsing. This costs a lot of money. Look at Ireland, for example: rescuing its banks raised the country's 2010 budget deficit to more than 30% of GDP.

By the same token, if government finances run into difficulties, that causes problems for banks – firstly, because many banks have large government bond holdings and, secondly, because the general economic situation initially worsens when a government has to adjust its finances.

This feedback loop between banks and sovereigns has to be severed in order to promote financial stability. One measure would be to establish resolution regimes for banks as I have already discussed. Having them in place would shield the government from having to rescue banks with taxpayer money.

Another measure refers to capital requirements for banks, which I have also discussed. The objective is to ensure that banks' economic situation no longer depends on the state of public finances. We can only achieve this if we stop giving government debt preferential regulatory treatment over other loans or securities. Government debt should be backed with a level of capital which adequately reflects its risks. At the same time caps should be imposed on bank sovereign debt holdings.

And on a side note: appropriate capital rules and caps on lending to governments also have a disciplining effect on national fiscal and economic policy. Former IMF chief economist Kenneth Rogoff considers this effect to be stronger than that of stricter fiscal rules.

4 Conclusion

Ladies and gentlemen, resilient banks are the essential building block of financial stability. With a view to regulation we have come a long way since the recent crisis. We have reformed the regulatory framework in a way that will help to increase banks' resilience.

At the same time we have acknowledged the fact that we have to look beyond the individual bank if we want to safeguard financial stability. Thus, although we are on the right track, we should probably move a bit faster with regard to implementing the new rules and standards.

But what about the banks themselves? Have they finally understood their role in the recent crisis? Have they looked beyond their own losses and realised the burden they have put on society?

I have argued that we have to look beyond the individual bank to safeguard financial stability and what I was referring to was the systemic perspective. But we also have to look beyond the banks to capture the personal perspective. Eventually, it is the bankers' attitude and culture that are the most essential building blocks of financial stability. Here we still need a change. Bankers have to subscribe to the idea that the financial system is, in essence, a service provider for the real economy.

Thank you.