Andreas Dombret: The state as a banker?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Institute of Monetary and Financial Stability, Frankfurt am Main, 28 January 2014.

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1. Introduction

Ladies and gentlemen

It is a great privilege for me to speak at the Institute for Monetary and Financial Stability, and I wish to thank Professors Siekmann and Wieland for their invitation. An invitation from an institute of this name certainly cannot fail to impress a central banker.

One of the central objectives of the IMFS is to promote the exchange of views between scientists, and the transfer of knowledge between academics, financial institutions and central banks. Against this backdrop, I am very happy to be here and to present today's distinguished lecture on "The state as a banker?"

The question mark at the end of the title signals that the state playing an active role as a banker is something which should be called into doubt. The issue is indeed closely connected with the fundamental conceptual question of financial stability and our market economy in general.

2. Blurring of the lines between the state and banks

If one were to ask the question whether or not the market economy merits our trust, another question has to be added immediately: "Does the state merit our trust?"

In the aftermath of the financial crisis, the two questions are unfortunately inseparably linked. I believe that the loss of confidence in our economic system, or in parts thereof, has a lot to do with this blurring of the lines between the public and financial sector, and here mainly between the state and the banks.

Both have suffered a loss in confidence over the last few years – the banks as a result of the financial crisis, of scandals and of manipulations, and the state, at least in Europe, as a result of the European sovereign debt crisis.

In the past, a discussion similar to the topic of my speech would have focused on the traditional direct links between the public sector and parts of the financial sector. And by that, I am referring to the state as an owner of banks. And indeed, one can call into question whether such a role is appropriate.

Nowadays, such a narrow focus seems less fitting for two reasons:

First, implicit guarantees for, and explicit bail-outs of, banks have become an omnipresent phenomenon since 2008 for those parts of the sector generally viewed as "too big to fail" or "too interconnected to fail".

Second, Europe's banks have substantially increased their investments in sovereign bonds. Over the last few years they have invested increasingly in bonds of their home governments and their home regions.

The links between bank risks and sovereign risks have become much stronger, not looser, in recent years. Nonetheless, the reasons for this development are more nuanced than simply the outright public ownership of banks. In any case, it is critical from a financial stability perspective, especially for those countries hit by the European debt crisis, and indirectly for the entire financial system.

So the links between the state and the banks, between the public and the financial sector have become a challenge for financial stability – despite the fact that they are partly a result of measures needed to ensure financial stability.

In his book "Our wealth and its enemies", the German journalist Gabor Steingart describes the blurring of lines between banks and the state as follows:

> "Precisely in the centre […] of our market economy a mutation took place. The close connection between risk-taking and responsibility, a constitutive element of the market economy, was decoupled […]. An economic hybrid came into the world, which skipped over the border between the state and the private economy."

Journalists are, of course, entitled to use a more controversial tone, but in my view there is some truth in this argument. Blurring the lines between the state and banks risks deforming our market economy and our thinking about it.

Sometimes it seems as if we are witnessing a transformation of values and a redefinition of fundamental concepts. The close connection between risk-taking and liability, which is an important element of a market economy, has weakened.

Conservative and risk-averse business models have become somewhat old-fashioned. If the state is bearing a significant part of the losses in the case of a default of a bank, banks are encouraged to take on more risks.

High capital buffers which were originally viewed as a sign of a sound bank became an obstacle for maximising the return on equity. And those banks that nonetheless followed a sustainable strategy ran the risk of being punished by the markets. Long termism has been increasingly replaced by short termism.

Bonuses are another example of transformation and redefinition. In the past, bonuses were seen as additional income for those working better and harder. Nowadays, they are generally regarded suspiciously as an instrument of inappropriate enrichment.

I believe that an analysis of the reasons for inappropriately high bonuses in the banking industry reveals a combination of two factors. First, bonuses were correlated to the return on equity, such that operating with low equity and high debt led to a higher return and thus higher bonuses. Second, there are implicit guarantees by states, meaning that the risk associated with low equity ratios has been socialised – at least partially.

All these symptoms are the result of violated market principles and blurred lines between the state and the banks. They are not the result of a well-designed market economy but rather indicative of deformed economies. However, the market economy stands accused of these faults.

3. Redrawing the lines between the state and banks: credible bail-in procedures are important

Of course, the million dollar question is: how can we successfully redraw the line between the state and the banks?

In my view, the solution is to be found in returning the state to its role of providing a framework in which the private sector can operate. This means a return to the role the founding fathers of the social market economy had in mind.

They knew that good banking regulation is a key element of a well-designed framework for a well-functioning banking industry and a proper market economy in general.

The problem is, however, how to achieve such a return to fundamental concepts of a well-designed market economy. This is not at all easy.

Ultimately, five years on from the Lehman insolvency, the “too big to fail” problem is far from being solved and remains a real threat. The damage resulting from the default of a bank deemed “too big to fail” can affect many, even beyond those directly involved.

Excessive borrowing by such banks exposes all of us to risks, costs and inefficiencies. The bankruptcy of a “too big to fail” institution can cause severe disruption and damage to the global financial system. Stock prices can implode. Money markets can dry up. Other banks can face the prospect of default. And it can cause a severe downturn in the real economy.

So, should we allow banks to fail? As a matter of principle the answer is: of course. Nevertheless, as Martin Hellwig and Anat Admati point out in their book “The Bankers’ New Clothes”: “The question of whether banks should be allowed to fail rarely arises as a matter of principle.” Thus one would argue that, from a policymaker’s perspective, it may be better to forget about principles and to do what needs to be done to prevent immediate damage.

However, beyond the necessities of the moment, letting banks fail might have positive effects. If the threat of failure is credible, then it may encourage banks to behave prudently. The financial system is likely to become smaller and better capitalised. If the threat is not credible, however, the prospect of benefiting from the “too big to fail” status can give banks strong incentives to grow, borrow and take risks in a way that exploits implicit guarantees, making the overall costs of failure even higher.

So it is not at all sufficient to commit to the principle that banks should be allowed to fail: the threat of failure has to be credible. Credibility, in turn, requires two things. First, the costs of a bank failure for the overall economy have to be reduced significantly. I will discuss this issue in more detail later. Second, credibility requires consistent legal frameworks across countries that make it possible to master the process of resolving a bank.

Especially in the international context, practicability of resolution procedures is difficult to achieve. Systemically important banks have large numbers of entities in many countries, all with their own procedures and supervisory tradition. Without a sound legal basis and close cooperation, resolution measures executed in one country may often not be recognised by other legislative authorities. During the financial crisis, national authorities froze assets and liquidity pools of banks within their jurisdictions to avoid the risk of not having them at their disposal when needed. This kind of ring-fencing has significantly impeded restructuring.

To make the threat of failure credible, we need international agreements that are binding. They should leave no room for a “prisoner’s dilemma” in which some countries are better off not cooperating and freezing asset and liquidity pools early on. A well-coordinated approach between authorities is therefore needed. The purpose is to maintain systemically important activities while resolution procedures are applied. Coordination and advanced planning of resolution measures enable authorities to consider financial stability from an international point of view, not merely from a national perspective.

International cooperation should establish a common assessment of an institution’s risk profile and coordinate supervisory reactions accordingly. To achieve this, the Financial Stability Board has determined core elements of effective cooperation.

The first element is the institution-specific cross-border cooperation agreements for global systemically important financial institutions. They form the legal basis for cooperation.

The second element constitutes crisis management groups for each systemically important institution. Their role is to assess a bank’s resolvability and to support the process of recovery and resolution planning.

The third element is a specific resolution strategy. This is the key component of resolution planning. The strategy will be chosen according to the respective business model.

In the same vein, we need to establish the Single Resolution Mechanism as a central pillar of the European Banking Union. It will be a quantum leap if the bail-in principle is generally accepted as it is foreseen by ECOFIN. If banks incur losses in the future, shareholders and creditors will be first in line to bear these losses; the taxpayer, on the other hand, will be last in line. If the bail-in principle is implemented as currently foreseen, bail-ins are going to become the rule, bail-outs the exception.

With the envisaged general acceptance of the bail-in principle, an important necessary condition for a return to the fundamental principle of market economies will be fulfilled: control and liability will be in balance, those who make the decisions will bear the costs.

4. Redrawing the lines between the state and banks: capital buffers are essential

I argued how important it is that the Single Resolution Mechanism be applied effectively in the spirit of the bail-in principle.

As I mentioned earlier, the bail-in threat can only be credible if the costs of the failure of a systemically important bank are significantly reduced. Without reducing these costs, the bail-in threat would be questionable. The overall costs of a failure would be greater than the costs of a bail-out. Hence, establishing effective resolution procedures and reducing the overall costs of a bank failure are two sides of the same coin.

This is where good bank capitalisation comes into play. It is the other side of the coin. Good regulation should directly address the key problem. If the system is too fragile, an important and direct measure to reduce fragility is to have enough capital.

With the Basel III requirements, regulation is taking an important step in the right direction. Banks have to hold not only more capital but also capital of a higher quality. The system is therefore more resilient now compared with the situation after the Lehman insolvency. And German banks are going to anticipate the higher regulatory requirements of Basel III.

Good capitalisation will have the positive side effect of reducing many of the wrong incentives and distortions created by taxpayers' implicit guarantees and therefore making the bail-in threat more credible ex ante.

More equity reduces the likelihood of distress and insolvency, and therefore the likelihood that a situation occurs in which a bail-out is inevitable. This, in turn, makes the bail-in threat more credible ex ante. With higher equity, the unity of risk-taking and liability is restored. Furthermore, with higher capital requirements, banks have lower incentives to become "too-big-to-fail". Thus a natural tendency to become smaller and less interconnected might evolve, again making the bail-in threat more credible ex ante.

If capital requirements are higher, not only the probability of failure is reduced markedly, but also shareholders and creditors would bear more of the losses incurred by the bank. Thus banks can no longer benefit from their former "too big to fail" status by borrowing cheaply.

Here I can see many practitioners objecting on the grounds that capital is too scarce and too expensive. In this line of reasoning, shareholders have a certain expectation about the return on capital. If the equity share is increased, other things being equal, expenditures are greater than in a situation with higher borrowed capital.

The crux of the matter is this: all other things are not equal. This is because the required return on capital contains a risk premium. And the risk premium falls if the capital is increased, which means that the entrepreneurial risk is spread over more capital. There is no way around the fact that the risk premium and the required return on capital should go down if the capital share goes up.

Explicit and implicit guarantees for systemically important institutions as well as tax subsidies for loan capital mean that borrowing is eventually being subsidised. From the point of view of a big bank, loan capital becomes cheaper than equity capital.

Is the practitioners' view that equity capital leads to higher costs therefore right in this context after all? No, because the implicit guarantee on loan capital means that, in the event of a crisis, the costs are transferred to the general public or, in other words, the taxpayer. This results in a disconnection between individual and social costs and benefits, as was pointed out by the German Council of Economic Experts.

There is fallout from this, of course. It sets the wrong incentives. It favours highly leveraged business models. It gives an excessive stimulus to risk-taking. In short, it creates moral hazard. Thus, if a higher input of borrowed capital is cheaper for the bank, this is only because the costs of this are payable elsewhere. Conversely, the business costs of higher capital requirements are offset by relief elsewhere, namely for the taxpayer. And we should not forget the positive effects that larger capital buffers have for financial stability, which I have already described.

From an individual perspective, one can, of course, well understand that bankers are resistant to higher capital requirements. But from an overall economic perspective, we have to consider negative externalities for society as a whole.

5. Conclusion

Ladies and gentlemen,

There is a close relationship between the state and the banks due to implicit guarantees. This is not in line with the core principles of a market economy. These guarantees are threatening to destroy the close connection between risk-taking and liability and have created wrong incentives for the risk-taking behaviour of banks. Thereby the social costs of a failure of a big bank have increased. Given these high costs, a bail-out seemed ultimately inevitable.

To overcome this situation, we need well-designed and credible bail-in procedures. The practicability of resolution regimes requires coordination under the institutional setting as foreseen by the Single Resolution Mechanism. And we have to reduce the overall costs of a failure. Without reducing these costs, any bail-in procedure would lack credibility. High capital buffers would reduce the overall costs of letting a systemically important bank fail. Hence, practicable bail-in procedures and higher capital buffers are two sides of the same coin.

If we follow this approach in real life, we have the opportunity to make important headway towards redrawing the lines between the public and the financial sectors, between the state and banks. And thus we also have the opportunity to restore confidence in our banking sector, our public sector and in our economic market system as a whole in the spirit of those who advocated our social market economic system so brilliantly, in the spirit of Ludwig Erhard and the founding fathers of the social market economy.

Let me sum up:

- First, blurring the lines between the state and banks threatens to destroy the unity of risk-taking and liability.
- Second, redrawing those lines calls for credible and practicable bail-in procedures.
- Third, for these procedures to be credible, the overall costs of a failure have to be reduced through higher capital buffers.
- Fourth, the state is not a good banker and should not try to become a banker. It should only take on this role in the most exceptional cases, if at all.

Thank you very much.