Andreas Dombret: The euro, the banks, and the crisis – reshaping the world of finance

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the American Academy, Berlin, 10 March 2014.

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1 Introduction

Ladies and gentlemen

Thank you for inviting me to speak at the American Academy in Berlin. As you may know, I was born in the United States and still carry a US passport in addition to my German one. And this is why I very much appreciate the work of the Academy in fostering dialogue between the United States and Germany, and why I wholeheartedly support Gary Smith and his team.

In general, a dialogue based on trust and mutual understanding is essential in order to master challenges and solve problems. However, trust and mutual understanding do not always come naturally. What I am thinking of is the world of finance. Over the past years, people around the world have lost trust in the financial system in general and in banks in particular.

This lack of trust is not only reflected by rather sobering polling results; it is also reflected by what people on the street are saying. Just the other day I heard a short remark that was intended as a joke but, to my ears, certainly did not sound like one. It went like this: "An honest criminal becomes a bank robber. A dishonest criminal becomes a bank manager."

Although I do not subscribe to the message, this remark does capture the general mood rather well. And this sentiment should not come as a surprise to us. We have lived through a succession of crises for almost seven years now. Banks and the financial system have, unfortunately, been at the heart of each of these crises.

Against this backdrop, everyone agrees that we have to reshape the world of finance. Regarding the banks, change has to come from within and from without. A change in culture is what must come from within, and from without must come a reform of regulation.

But we also have to look beyond the banks. The first thing that comes to mind is the link between banks and the state. The crisis in the euro area has emphasised how closely the fates of banks and states are intertwined. To break this link, further reforms are important and they are necessary.

Finally, we have to acknowledge that the financial system comprises more than just banks. There are other players that can become a source of risks to financial stability, to the economy, to taxpayers' money and to our wealth.

But let us begin by taking a look at the banks.

2 The banks

Leaving aside all the nitty-gritty, there is one thing I believe we should do: we have to bring more market to the financial market. This may sound counterintuitive at first. Some of you may ask: "Even more market? Wasn't liberalisation what brought us these problems in the first place?" My answer to this question is that I am not talking about liberalisation but about the fundamental principle of a market economy.

This principle is the ever-important principle of liability. Everywhere it is common sense that people should be held responsible for their actions. Everywhere but in the world of banking, it appears to some critics. During the crisis, governments around the world spent billions of dollars out of taxpayers' pockets to save the banks. At the same time, many companies in the real economy failed and exited the market.

Why is it that banks seem to play by a different set of rules? Are they not being held responsible for their actions? Are they staying in the market even if they have unsuccessful business models?

The answer can be found in a concept that is sometimes labelled "systemic relevance" and sometimes "too big to fail". Now, what does it mean when a bank is systemically relevant or "too big to fail"?

In essence, it means that the bank in question is very big or very interconnected. It is woven so deeply into the fabric of the financial system that its failure might bring down the system. The most prominent example is the fall of Lehman Brothers in September 2008. This event marked the beginning of the global financial crisis we are still in.

The consequence of "too big to fail" is this: whenever a big or interconnected bank gets into trouble, the government might be compelled to bail it out in order to avoid a full-blown financial crisis. This means that these banks have an implicit insurance. Whatever happens, the government is likely to stand ready to help.

Thus, these banks indeed play by a different set of rules. And this has consequences for the nature of the game. The implicit insurance provides incentives to engage in risky business that promises high returns. If things turn out well, the bank wins. If things go wrong, the taxpayers lose.

The principle of liability is violated, and we have returned to the point where my argument began. The crucial question at this point is: what do we need to do in order to restore the principle of liability?

The decisive point is that banks must be able to fail without dragging down the entire financial system with them. To this end, a new international standard on the recovery and resolution of systemically relevant banks has been developed. Having this new standard is a major step forward.

At the same time, a Single Resolution Mechanism will be a central pillar of the European banking union. It will allow authorities to restructure or resolve banks without putting taxpayers' money at stake. The owners of the bank and the creditors will be the first in line when it comes to bearing the costs of a bank failure.

Due to its importance, let me stress how crucial it is that those involved in the negotiations reach an agreement on the European Single Resolution Mechanism prior to the European elections in May. A European banking supervision cannot be effective without a European resolution mechanism.

In the same context, the Comprehensive Assessment is crucial as a precondition for a successful banking union. The objective is to uncover any legacy assets in banks' balance sheets and to assess their resilience to stress scenarios. With that objective in mind, the Asset Quality Review and the stress test have to be tough and thorough. This will ensure that European supervision and European resolution mechanisms do not have to deal with problems that arose under national supervision.

3 Banks and states

Aligning the banking sector with the principles of a market economy will take us a big step towards financial stability. But it won't take us all the way. To safeguard the stability of the entire financial system, we have to look beyond the banks.

One issue we definitely have to address is the connection between banks and the public sector. The banking system is closely linked with public finances. This link was a major driver of the crisis in the euro area. So, let us now take a closer look at the link between banks and states.

When the financial crisis unfolded and banks everywhere ran into difficulties, governments had to step in to avoid a breakdown of the entire financial system. This experience is a real world example of the "too big to fail" problem which I discussed a moment ago.

However, saving banks is a costly endeavour for governments. Let's take Ireland as an example. In order to save its banking sector, Ireland ran up a budget deficit amounting to 30% of its economic output in 2010. In the same year, Germany added almost €33 billion to its public deficit as a consequence of supporting the banking system.

Obviously, saving banks puts a lot of strain on public finances. And this brings us to the other side of the vicious circle.

When public finances run into difficulties, the banks are put under strain. Fiscal distress is particularly problematic for those banks that hold government bonds. And it was mainly banks in the crisis countries as well as in Italy and Spain which bought up large volumes of domestic government debt – even during the crisis.

At the end of January, Italian banks' exposures to the Italian general government amounted to almost 10% of their total assets. The equivalent figure for Spanish banks was almost 9%. And it was chiefly weaker banks that bought up sovereign debt.

Altogether, the link between banks and states is so close that it can easily become a vicious circle. To preserve financial stability we have to break through this vicious circle from two sides. We have to protect public finances from banks running into difficulties and, vice versa, we have to protect banks from public finances running into difficulties.

Regarding the first objective, I have already sketched out the solution. We need resolution mechanisms that allow us to resolve and restructure banks without placing the financial burden on public finances. As I said before, we also need them in Europe, and as soon as possible.

Regarding the second objective, we also have to revert to regulation. We have to adapt regulatory requirements in order to protect banks from government finances running into difficulties.

If we are looking to offer banks greater protection against distressed public finances, it is government bonds we must target. From the perspective of regulation, there are two factors which play a role here.

The first factor concerns banks' capital. Under the current regime, banks do not need to hold capital against the risks of loans to sovereigns – unlike other loans. This regime is based on the assumption that loans to governments are risk-free because states cannot default. And, if no losses can develop, it is not necessary to establish capital buffers.

All those who had trouble following this line of argument saw their doubts confirmed by the sovereign debt crisis in Europe. Whether we like it or not, we obviously need to rethink the assumption that loans to governments are risk-free.

Consequently, it appears urgently necessary to change the rules. If banks were required to hold capital against the risks of their government bond portfolios, this would make them more resilient to fiscal distress. At the same time, banks would have an incentive not to buy such large volumes of government bonds.

And this brings us to the second issue: capital alone is insufficient. A crucial tool of risk management is diversification. The rule of thumb is "never put all your eggs in one basket". A cap on loans to an individual sovereign should therefore also be introduced.

Such caps have already been a fact of life for loans to the private sector for some time. They prevent banks from becoming overexposed to a single borrower. This makes them less vulnerable to the default of that borrower – and this is needed not just for private borrowers but for government borrowers as well.

4 Beyond the banks

Ladies and gentlemen, I have talked about banks and I have talked about states. But to reshape the world of finance we have to reach further than that. The world of finance comprises more than just banks.

Consider the insurance sector. Just one day after Lehman Brothers collapsed, the US government had to invest more than $180 billion to bail out the insurer AIG – another institution that was deemed "too big to fail". Five years later, the regulation of systemically relevant insurers is far less advanced than it is for banks. A relevant framework is slowly emerging, but some of the groundwork has only recently been prepared.

And there are other sectors we have to look out for. There are areas of bank-like business that are still outside the perimeter of banking regulation. These areas are usually referred to as the shadow banking system. In my view, this term is somewhat misleading and unfair. It implies that institutions operating in the shadow banking system are somewhat shady in character – and that is definitely not the case.

In general, the shadow banking system provides an alternative source of funding and is therefore associated with diversification and specialisation benefits. Their funds are, in principle, very much welcomed in the context of the Comprehensive Assessment.

Nevertheless, institutions in the shadow banking system perform bank-like activities and incur bank-like risks without being subject to bank regulation. And these risks can certainly be systemic because of unregulated liquidity and maturity transformation, because of the build-up of leverage, and because of pro-cyclicality.

We therefore will have to make sure that such entities and activities are adequately monitored and regulated. This objective is high on the agenda of the G20, and we have already made good progress. Nevertheless, quite some work still lies ahead.

5 Conclusion

Ladies and gentlemen, reshaping the world of finance is certainly an ambitious objective. And it is an objective that can only be reached if we all work together. The world of finance is a global issue, and reshaping it requires global cooperation.

Against this backdrop, recent regulatory initiatives in the US such as the enhanced standards for bank holding companies and foreign banking organisations worry me. They seem to contradict the need for international cooperation. Balkanisation of regulation is a real risk and any regulatory decision should be taken with that consideration in mind – in Europe as well as in the United States.

But not only do we need cooperation between authorities of different countries. In my speech, I have mainly discussed how to reform regulation. But there is one thing we should be aware of: we cannot solve all of our problems through regulation. In order to reshape the world of finance, change has also to come from within.

Financial stability begins in the hearts and minds of those who work in finance: investment bankers, stock market brokers, hedge fund managers and everyone who invests other people's money. What we need is a change of culture. The times of "greed is good" should be left far behind us. I am not at all against ambition, but short-termism and greed need to be stopped. We should see the financial system for what it is: a service provider for the real economy.

And again we have to look beyond the banks. Especially in Europe, companies tend to rely on bank loans as a source of funding. Here, it would be beneficial to diversify by turning more to the capital markets as an alternative source of funds. A more diversified funding mix would improve companies' access to funding in normal times as well as in crisis times.

Reshaping the world of finance is certainly a big step towards a stable financial system and a prosperous real economy. In a more European context, it is an equally big step towards our common goals of a stable monetary union and a stable euro.

And the economic advantages of a single currency will benefit all the member states – including Germany. But I urge you not to think about the euro only in economic categories. As long ago as 1950, the French economist Jacques Rueff noted that Europe will be made through the currency or not at all. The euro is not only an economic project. It is also a political project. It is an important building block of a united Europe.

Thus, the issues I have raised in my speech tonight serve a range of objectives; and each of them is worth pursuing with ambition.

Thank you very much for your attention.