

## **Jens Weidmann: Stable banks for a stable Europe**

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the 20th German Banking Congress, Berlin, 7 April 2014.

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### **1. Welcome**

Mr Fitschen, ladies and gentlemen

I am honoured to have been asked to speak to you this evening at the 20th German Banking Congress.

The film we have just seen illustrates that German Banking Congresses, or bankers' congresses as they used to be called, have always mirrored our country's colourful history.

I would like to take the opportunity today to talk about the importance of stable and healthy banks for a stable currency union.

### **2. Dissecting the financial crisis**

Do you remember the Agatha Christie film "Murder on the Orient Express"?

The US businessman Mr Ratchett is murdered on the train from Istanbul to Calais. Detective Hercule Poirot, who happens to be on the same train and is asked to investigate by the director of the train company, a fellow traveller, discovers that the murder victim has twelve stab wounds and is, in reality, the criminal Cassetti. After questioning the witnesses, he ascertains that a number of passengers had a motive to murder Cassetti. He therefore comes to the conclusion that there is not one culprit for Cassetti's murder, but twelve.

I am telling you this because the chief economist of the BIS, Claudio Borio, recently said that the search for the culprit for the financial crisis brought to mind the search for the culprit in "Murder on the Orient Express". As with Cassetti's brutal murder, for which there is no one culprit, there is no monocausal explanation for the financial crisis.

In fact, the contrary is true: an analysis of the root causes of the global financial crisis, as well as the European debt crisis, shows that many are to blame, or should we say responsible.

I believe that no one here in this room will deny that there were serious aberrations in the banking sector, which contributed to the crisis. However, central banks and the regulatory authorities also made mistakes.

Although the central banks successfully combatted inflation, they provided incentives for risky investor behaviour. Regulatory authorities underestimated the resulting dangers, as did the financial markets, where risk premiums were long at extraordinarily low levels. Politicians trusted in the efficiency of the financial markets and pursued a policy of market liberalisation and deregulation and did not see, or did not wish to see, the risk potential this entailed.

Most economists were equally blind to the risks in the financial system, with just a few issuing warnings to the political decision-makers. Claudio Borio, whom I mentioned earlier, and his colleagues at the BIS were among the few to point to the potential for a setback as a result of the rapid growth in the credit securitisation and credit derivatives segments.

If financial market economists did not see the dangers, how were small investors and savers supposed to have been aware of the risks involved in some of their investments, say Lehman certificates? However, even what are referred to as "retail clients" cannot be absolved from all responsibility, when, for instance, they made deposits with virtually unknown banks and turned a blind eye to potential risks in the search for higher yields.

The financial crisis has shown just how fragile the financial system is. And it has become apparent that the financial system is the Achilles heel, as it were, of European monetary union.

A stable currency union requires a stable financial system. Banks have a central role to play in the euro area's financial system. The sovereign-bank nexus is a huge obstacle to permanently overcoming the crisis in the euro area.

In some countries, banks and governments have manoeuvred themselves into a position of mutual dependence that is a downright vicious circle: if the banks run into difficulties, this raises the risks for the government budget. Where this gives rise to doubts about the solvency of sovereigns, this in turn impacts banks, not only because they then lack a last line of defence, but because they also have large holdings of government bonds on their balance sheets and display a pronounced home bias.

During the crisis, and encouraged by crisis measures, many banks, especially in the crisis countries, even upped their holdings of high-yield bonds issued by their home state. The logic is sound as seen from the individual bank's perspective: if all goes well, the bank will pocket a sizeable yield premium, and if the state becomes insolvent, the survival of most banks in this country will be doubtful anyway.

### **3. Deleveraging unavoidable**

In order to return to balance sheet structures that are sustainable in the long term, I believe deleveraging is unavoidable. This is because banks themselves are responsible, first and foremost, for resolving the structural problems in the European banking sector.

Euro-area banks' total assets more than doubled between 1999 and mid-2012, due in large part to the exaggerations in the run-up to the financial crisis; they swelled from more than 14 trillion euro to almost 35 trillion euro.

In the euro area as a whole, banks are now reducing their assets, though this process has not yet been concluded. While the decline observed since mid-2012 is considerable, at just over 4 trillion euro to date, it reverses just a fifth of the preceding expansion.

The high level of non-performing loans as well as the losses the banks are reporting are additional indications that there is still considerable need for adjustment, especially in the periphery countries of the euro area. Moreover, looking at the experiences with debt crises in Scandinavia and Japan in the 1990s, there is much to be said for not putting off the balance sheet repair process.

### **4. Bank regulation as a response to the crisis**

History teaches us that banking crises and financial crises are recurring phenomena; in other words such crises can never wholly be avoided. Nonetheless, the utmost should be done to prevent such serious crises as those witnessed in recent years. Above all, we need sensible and intelligent financial market regulation.

On the subject of the lessons to be learnt from the financial crisis, there are remarkable differences in perception between representatives of the financial industry and the general public: while the prevailing impression among the public is that next to nothing has happened, industry representatives are already complaining of an excess of regulation. There has even been talk of a "tsunami of regulation".

In my opinion, neither is true. Regulation has been materially tightened in numerous instances, but there can be no question of overregulation.

Nor have all points on the regulatory agenda been put into practice. What is key is that the steps taken by regulators should always be effective and designed to combat the underlying

issues and that the interplay between the various regulatory measures should also be taken into consideration.

The stricter capital requirements and new liquidity rules under Basel III, which will be phased in by 2019, have already significantly enhanced financial institutions' internal capital adequacy. On the whole, the regulatory measures have made the financial system more secure and robust. Whether it is now sufficiently secure and robust is a different question.

According to the Basel Committee's latest Basel III impact study, the 102 large international banks that were examined had, on average, a common equity tier 1 ratio of 9.5% and the 125 other banks had a ratio of 9.1% in mid-2013. The target for 2019 of 7% common equity tier 1 capital is therefore already more than met, on average.

Of course, that does not mean that all banks have already achieved the target of 7% plus potential surcharges for global systemically important banks. However, the cumulative shortfall of the large international banks halved in the first half of 2013.

The eight large German banks with an international focus that the Bundesbank examined had an average ratio of 8.3% as at the 30 June cut-off date, while the 40 smaller banks even had a ratio of 12.8%. Large banks' capital requirements also almost halved, from 9 billion euro to 5 billion euro.

The 7% target ratio includes a new capital conservation buffer of 2.5 percentage points. This buffer will allow losses to be absorbed effectively. It thus goes some way towards resolving the problem which the British economist Charles Goodhart has described as the "regulatory paradox".

Imagine you arrive at an unknown railway station late at night and there is exactly one taxi at the station's taxi rank, which you wish to take to your hotel. The taxi driver tells you that he is sorry but he cannot take you because the city authorities demand that there must always be at least one taxi waiting in front of the station.

Metaphorically speaking, the traditional minimum requirements guarantee that there is exactly one taxi at the taxi rank. However, this capital cannot be used to absorb losses, as hard-hitting supervisory sanctions would be imposed if capital falls below requirements.

The new rules ensure that there are at least two taxis waiting. Now, taxi drivers will counter that the more taxis there are waiting for customers, the longer they stand idle, and that is expensive.

Bank representatives use a very similar argument when they say that capital is expensive and conclude that a bank's assets should be funded with as little capital as possible. However, the argument should really be that debt capital is cheaper as it currently enjoys tax privileges, which makes equity financing comparatively unattractive.

And there is, I may add, a considerable difference between whether the worst case is having to wait for a taxi or facing stability risks in the financial system. I therefore believe that it is right to create greater capital reserves than regulators are currently demanding in order to make the financial system more robust.

A problem that German and other banks have been experiencing not just since the financial crisis is weak profitability; the current low-interest-rate environment just adds to the burden. Poor profitability limits banks' ability to retain earnings and thus their ability to build capital. Measures to improve earnings in the banking sector therefore indirectly also facilitate measures to improve risk absorption.

Critics of the Basel capital rules such as Martin Hellwig complain that the risk-based approach of the Basel framework serves primarily to artificially lower capital requirements. In actual fact, the leverage ratio, ie the unweighted capital ratio, of the eight large German banks with an international focus that participated in the Basel III monitoring was just 2.2% in

mid-2013, which translates into 45 euro of debt per euro of capital. Smaller banks' leverage ratio was as much as 4.3%.

The planned introduction of a leverage ratio – the target ratio according to Basel III is 3.0% – is doubtless a sensible addition to the risk-weighted capital rules. The risk-based approach must, however, remain a key element of the capital rules. Having a leverage ratio as the sole rule would offer banks problematic incentives to take greater risks.

I therefore agree with my colleague Mark Carney of the Bank of England who has said, in this context, that it is sometimes good to wear a belt and suspenders to prevent your trousers from slipping.

## **5. Making failure an option**

Ladies and gentlemen, the journalist and professor for banking Wolfram Engels once wrote: "Bankruptcy is a part of the market economy." This self-evident truth has, to date, been inadequately implemented in the banking sector, however.

Large and very interconnected banks especially were, to date, able to count on their survival being systemically relevant and thus guaranteed. However, "too big to fail" is not compatible with the principles of a market economy, nor is "too interconnected to fail".

In extremis, banks must be able to fail. For only the possibility of failure guarantees the implementation of the principle of liability. And only the principle of liability ensures that economic agents take responsible decisions.

This is not intended to be a plea for "small is beautiful". Large international banks definitely have a place in our economic framework. Nor does the sensible ringfencing of risky, speculative business from normal customer business, as proposed by the Liikanen Group and taken up by the European Commission, change this.

However, incentives to expand to ever greater size should be reduced. Systemic risk buffers and higher capital requirements for systemically important institutions are instruments which counter this incentive. Their introduction is therefore welcome.

In other words, there should be at least three, not just two, taxis waiting at the taxi ranks of large stations, to return to the image I used earlier.

However, capital buffers are only a first line of defence to help banks weather adversity better. This is particularly important for banks that would be especially difficult to wind up. Further measures are necessary to ensure that it is, in extremis, possible for large and very interconnected banks, too, to fail.

## **6. Banking union**

### **6.1 Single Resolution Mechanism**

A vital building block in the process of making the banking system more stable is creating the regulatory framework for the orderly resolution of failed banks. To achieve this aim, procedures need to be put in place which allow the principle of liability to be implemented effectively.

The EU has made crucial progress recently, with the adoption of a harmonised bank resolution regime (the Bank Recovery and Resolution Directive) and the decision to create a Single Resolution Mechanism (SRM). Essentially, the new rules are designed to ensure that banks that run into difficulties in future can be wound up, with their owners and creditors being first in line to foot the bill.

The SRM provides expressly for a bank-financed resolution fund only being second in line, while public funds would only be used as a last resort. Despite a number of exceptions in the

fine print, which are part and parcel of the process of compromise, the resolution mechanism agreed upon allows a fundamental principle of market economics to be enforced.

The Bundesbank welcomes this agreement as an important complement to common European supervision. But we still believe that a treaty change will be needed, all the more so as the decision-making processes seem to be as complex as ever. The aim must be to set up a European resolution agency equipped with clear decision-making structures.

A matter which has yet to be decided conclusively, but one that will be of particular interest to you, is the question of which banks will need to pay into the single resolution fund, and how much. An appropriate approach would be to have different contributions depending on an institution's size and its specific risk profile.

Banks will be asked to bring the fund up to its target volume of 55 billion euro over a period of eight years, beginning in the year 2016 – an adequate timeframe, in my opinion, for mobilising these funds. It would also be right, in my view, to use the option granted by the SRM Regulation of also counting amounts which banks have already paid into national resolution funds towards their contributions.

A European deposit guarantee scheme is not being regarded as a matter of priority at the moment, and rightly so. After all, a joint deposit guarantee scheme would necessarily mean joint liability. But joint European liability would necessitate joint European control, which would require more than the creation of a Single Supervisory Mechanism.

## **6.2 Single Supervisory Mechanism**

The ECB is aiming to be ready to launch the Single Supervisory Mechanism (SSM) on 4 November. This will require a mammoth effort by all the parties involved. It is a project that is comparable to the creation of monetary union, but is to be rolled out at seven times the speed.

At the current juncture, the ECB together with the national supervisors is comprehensively assessing the balance sheets of 128 banks which, as things stand today, are candidates for direct ECB supervision.

If the asset quality review and the subsequent stress test reveal that banks need to be recapitalised, the need for capital will have occurred on the watch of the national supervisors – so you could say it is a legacy issue. It is therefore down to the member states in question to repair these legacy issues before responsibility shifts to the ECB. Private funds should be first in line to address any capital shortfalls. Failing that, it should be up to the member state to recapitalise the bank in question, assuming the latter runs a viable business model.

This asset quality review is a major undertaking for supervisors and the banks in question. Yet at the same time, it is crucial for ensuring that the Single Supervisory Mechanism gets off to a credible start in its mission to restore confidence in banks and revitalise lending in the euro area. Hence the strict and demanding standards set by the asset quality review and the subsequent stress test.

The assessment represents a huge administrative burden for the banks, so their misgivings are understandable. But if you are looking to paint a complete picture, there's simply no getting round a thorough assessment. The procedure is even being likened to a full physical examination for banks.

Before a football club signs a new player, it first subjects him to a thorough medical – and that is more than just a quick once-over.

Of course there are some physicians who carry out needless examinations, but a good medical practitioner is mindful of the proportionality of the treatment administered. Proportionality is also the watchword in the asset quality review, though we should not forget that this is the first time such a comprehensive assessment has been conducted.

## **7. Stop the preferential treatment of government bonds**

The banking union closes a vulnerable gap in monetary union by contributing to strengthening the financial system. It also helps to loosen the toxic links between sovereigns and banks to some degree.

But in my view, further steps will be needed if we are to permanently and effectively sever this nexus. In particular, the preferential regulatory treatment afforded to government bonds and other exposures to the public sector needs to be brought to an end.

If government bonds had to be backed by an amount of capital that adequately reflects the inherent risk, and limits were defined for public sector exposures, as is commonplace for loans to private debtors, banks would have much less of an incentive to increase their leverage by investing in sovereign debt. That would also play a key part in improving the stability of our banking system because it would remove an incentive for taking on excessive leverage.

It is gratifying and encouraging to hear that Martin Blessing, a leading figure in the German banking industry, recently put forward a similar suggestion, because it indicates that support is on the increase. Finance Minister Wolfgang Schäuble recently also called for this issue to be added to the political agenda.

It goes without saying that like Basel III, the appropriate legal framework would need to be phased in incrementally over an extended period of time.

## **8. The role of central banks**

As I highlighted at the beginning of today's speech, only structural measures can overcome the structural problems afflicting Europe's banking sector.

Monetary policy – and this is something I would like to be quite clear about – cannot resolve these structural problems in the financial sector, for we have neither the tools nor the mandate to do so.

Being a central bank we cannot rectify the solvency problems of distressed institutions. But what we can do is combat temporary liquidity shortages.

Back in November 2013, the ECB Governing Council, of which I am a member, agreed to continue the full allotment policy at least until the middle of 2015. What this means is that for the time being, banks can continue to draw as much liquidity as they wish, provided they can furnish sufficient collateral. After all, we should not forget that Europe's financial system is centred around banks, and that state of affairs is not about to change any time soon.

Successful monetary policy is based on preconditions which it cannot entirely create on its own. A functioning banking system is one of them; sound public finances another.

Ladies and gentlemen, the euro area is currently experiencing very low inflation rates that are well below our definition of price stability, which is below, but close to 2%. Our projections suggest that the spell of low inflation rates will persist for a time before rates gradually head back towards 2%.

Given the low inflation pressure, the expansionary monetary policy stance is appropriate.

At the same time, I would like to stress that the risk of a self-reinforcing deflationary spiral driven by shrinking wages and prices – a scenario which some people are prophesying – is equally remote, despite the current very low inflation rates in the euro area. These are largely explained by diminishing energy prices and the adjustment processes in the crisis countries. As the crisis countries gradually return to economic health, price pressures there are also likely to see renewed momentum.

The ECB Governing Council, expecting inflation rates to rise gradually, decided not to loosen the monetary policy reins any further at its last meeting. We are, however, monitoring

developments very closely and are potentially prepared to take further measures in order to cope effectively with risks of a too-prolonged period of low inflation.

Consideration should also be given to the fact that all the monetary policy measures that are currently on the table would set us on a course into uncharted waters. This raises questions as to the effectiveness of such measures and to the risks and side-effects they might entail. Moreover, the Governing Council members need to respect the boundaries of our monetary policy mandate and the provisions of the European treaties.

Another issue about which I have no doubt is that the longer the low-interest-rate policy persists, the greater the risk and the less effective its positive stimulus. This point was also raised by the Association of German Banks recently, and rightly so.

Sticking to the low-interest-rate policy for longer than would be needed to safeguard price stability – something which the German Institute for Economic Research inter alia called for recently as a way of making the sovereign debt burden in the euro area more sustainable – should not be an option for us. This would get us into the realm of fiscal dominance and breach our mandate.

Above all, we would run the risk of losing the general public's confidence in central banks. They rely on monetary policymakers to focus unswervingly on achieving and maintaining price stability. At the end of the day, we would throw away our most valuable asset, for money without trust is not worth the paper it is printed on.

## **9. Conclusion**

Ladies and gentlemen, I began my speech today by drawing your attention to the film "Murder on the Orient Express". And as I have already mentioned, Hercule Poirot discovered that there was not one culprit but twelve. It was a case of lynching – the dead man was guilty of killing a small girl, and each of the twelve was connected to the girl in some way.

But Poirot also came up with another possible explanation – that a stranger had boarded the train, committed the crime and then escaped unnoticed. This was the account which the director of the company operating the Orient Express presented to the police, meaning that the true culprits ultimately escaped punishment.

Turning to the financial and debt crisis, it would be wrong to put the blame on an ominous stranger. The objective should be to learn the right lessons from the crisis and make sure that similar crises can be avoided in the future.

The lessons that need to be learnt for the financial sector are substantial ones, but much has already been achieved.

Without stable and healthy banks, there cannot be a stable monetary union.

Thank you for your attention.