Andreas Dombret: Long-term challenges facing banks in Germany

Dinner speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bundesbank's autumn conference "Achieving Sustainable Financial Stability", Berlin, 1 October 2014.

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1. Introduction

Ladies and gentlemen

It is a pleasure for me to welcome you to this year's Bundesbank autumn conference. In my view, the topic of this conference is well chosen. The crisis and the great uncertainties it has brought on have made the pursuit of financial stability all the more urgent. For this reason I am delighted that so many of you have been able to accept the Bundesbank's invitation to discuss this sensitive issue.

This evening I would like to take a closer look, with you, at the long-term challenges facing German credit institutions.

With more than 1,800 institutions, the German financial system is the largest – in terms of sheer numbers – in the euro area. This large number reflects a special feature of the German banking system, namely that it is built on three pillars. Alongside the private banks, many regional savings banks and credit cooperatives are in operation. In the crisis, these locally important institutions played a major part in stabilising the German economy, because they were less strongly affected by the financial crisis thanks to their traditional business model.

Nonetheless, all banks have felt the effects of a great loss of confidence since the financial crisis erupted in 2008 – they have lost the confidence of the general public, of trade and industry and of the interbank community. There are two major reasons for this loss of confidence. The first is uncertainty about how sound individual institutions actually are. The second relates to wrong investment advice in connection with securitisation products and certificates. More recently, confidence suffered again as information about banks' misconduct came to light – for example, the manipulation of reference rates such as Euribor and Libor or the legal violations that have often garnered so much attention from the media.

The financial crisis and the subsequent loss of confidence have given rise to a major reform of financial regulation. Basel III is certainly the best known and most important of the measures designed to make banks more resilient by strengthening their capital and liquidity position. And many banks have indeed strengthened their capital position significantly over the past years. This elevated robustness is indispensable, as it was never possible at any point in the past to identify the specific causes of the next crisis in good time.

This means that, in future, institutions will also have to be prepared for hitherto unknown dangers, uncertainties we may not even know exist. And here, a strong capital position is the best buffer against shocks, regardless of where they come from.

However, dealing with unknown dangers requires German banks to embrace a new risk culture. The crisis made us painfully aware of just how far removed from a sound culture of risk the risk culture was at many banks in Germany.

2. Risk culture

One reason for an inadequate risk culture lies in the "too big to fail" problem, which was a central issue in the last crisis. The failure of banks that are very large or strongly interconnected might endanger the whole financial system – the failure of Lehman Brothers in 2008 was a case in point. Thus, in the eyes of the markets these banks enjoy an implicit state guarantee: in case of trouble, the state would feel compelled to step in and rescue the distressed bank.

Yet this implicit state guarantee creates flawed – and dangerous – incentives. If a bank can be sure of state support when it gets into difficulties, it will no longer see risk and return as being two sides of the same coin. Essentially, this means that profits from risky business operations remain with the bank, while the taxpayer is left to shoulder potential losses: this is an unjustifiable scenario.

For this reason, I believe that an important signal to the market and to banks is to develop mechanisms that allow even big banks to fail without destabilising the entire financial system. The possibility of a market exit, which is fundamental to any market economy, must also exist for the banking sector. The real threat of actually failing is in itself a strong incentive for banks to be more aware of risk in their actions. The long-term goal, then, must be to put risk and return back onto the same page.

One important step towards that goal is the European resolution mechanism which will start in 2016. This mechanism ensures that the owners and creditors of banks are the first in line when it comes to bearing losses. Consequently, the taxpayer will be the last in line to foot the bill. This realigns risks and rewards and will certainly have a fundamental and positive effect on the risk culture within banks.

Yet what is crucial here is not only that rules are in place for dealing with a distressed bank, but that banks don't get into financial dire straits in the first place. Banks have to improve their risk culture regardless of the "too big to fail" problem. At the spring meeting of the Financial Stability Board, recommendations for action were agreed on and subsequently announced. According to the Financial Stability Board, the foundational elements of a sound risk culture are effective risk governance, an effective risk appetite framework and, in particular, the alignment of compensation with prudent risk taking.

Four practices may help in assessing the soundness of a risk culture.

- First, the tone from the top: the board and senior management are the starting point for setting the financial institution's core values and the expectations for its risk culture, and their behaviour must reflect the values being espoused.
- Second, accountability: employees must understand the institution's core values and its approach to risk. And they have to be aware that they are responsible for their actions and risk taking.
- Third, effective communication and challenge: a sound risk culture promotes an environment of open communication and effective challenge, within which decision-making processes encourage a range of views.
- Last but not least, incentives: performance and talent management encourage and reinforce maintenance of the financial institution's desired risk management behaviour. This includes changing the banks' in-house incentive schemes. One example here would be to cap bonus payments and link them to the long-term development of institutions' profits.

We must succeed in embedding awareness of sustainable business practices more firmly in the risk culture of banks.

3. Profitability

Of course, a new risk culture has its price, which will unquestionably also have a short-term impact on the banks' profitability. What's more, the current low-interest-rate environment also remains a major challenge for the profitability of banks. German savings banks and credit cooperatives in particular rely on net interest income as the most important earnings component. Consequently, they expect a further decline in profitability in the current interest rate environment.

In addition, competitive pressure is high due to the sheer number of institutions in the marketplace, and this will no doubt increase as the integration of the banking market across Europe deepens.

Last but not least, the implementation of the new banking rules will come at a cost – to raise fresh capital, say, or to draw up recovery plans and build up a restructuring fund.

Against this backdrop, it is essential that German credit institutions recognise their weaknesses and counteract them at an early stage. This could be achieved by boosting income in fee and commission business and by taking into consideration cost-cutting measures. There is traditionally a strong branch network in Germany. Streamlining this could reduce costs. Mergers could also make sense for several credit institutions, with the focus in each case being on the sustainability of each business model.

4. Closing remarks

Ladies and gentlemen

In my speech, I have discussed three challenges that German banks currently face: regulatory reform, necessary changes in risk culture and low profitability.

Regulatory reform definitely comes at a cost for the banks. However, when we talk about the cost of regulation for the banks, we also need to talk about the cost of crises for the general public. Viewed from this perspective, I think the price we are paying for stricter regulation is entirely appropriate. Even for the banks themselves, the rising outlay for regulatory matters is not only a cost factor. They, too, benefit from a stable financial system.

The same is true of a change in risk culture. There is evidence that institutions inadequately identified and managed not just their market and credit risks but their operational risks as well: it is therefore imperative that improvements be made. Credit institutions have themselves already announced their intention to change their risk culture. However, this fundamental decision is not one that should be merely voiced at the senior management level. The banks must do more than simply talk the talk: their new values must be practised institution-wide by managers and employees alike.

In conclusion, each institution faces the major challenges of adjusting to new regulatory requirements and of improving its risk culture without completely losing sight of profitability, particularly as profitability is already challenged by the current environment of low interest rates and fierce competition in the German banking market.

However, I am confident that German credit institutions will succeed in overcoming the challenges ahead and in finding a healthy balance between risk and reward. The first steps to achieving these goals have already been taken.

Thank you for your attention.