# Andreas Dombret: The future of the banking industry

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 60th Kreditpolitische Tagung, Frankfurt am Main, 7 November 2014.

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## 1. Introduction

Mr Otto, ladies and gentlemen

Thank you very much for inviting me to speak here at the 60th Kreditpolitische Tagung. I wish to begin by congratulating you on this landmark birthday. “The future of the banking industry” is the topic of today’s conference and also of my remarks. But please join me on a brief digression before we come to the topic of the banking industry.

Have you ever heard of the US baseball player Yogi Berra? Yogi Berra is a household name in the United States – not just for his achievements as a ballplayer, but also for his aphorisms. One of these aphorisms referred to the future: he is supposed to have once said that: “The future ain’t what it used to be.” With respect to the banking industry, probably nobody could have put it better.

We have left behind us a severe crisis, which for most of us – myself included – was, and will hopefully remain a once-only event. This crisis set in motion a process which will change the financial system from the ground up. It is therefore all the more important that we look towards the future and give some thought to where this process will take us. The topic of today’s conference is thus entirely appropriate.

I will confine my remarks to the viewpoint of supervisors and regulators, whereas the other speakers will probably take different perspectives. Regulation and supervision form the framework for the banking industry and its future – which is why I have chosen to focus on these factors.

## 2. Banking regulation: considerably stricter

Quite soon after the crisis broke out, initial steps were taken at the global level to improve banking regulation.

Without going into further detail, let me mention two extremely decisive measures. One was that the capital rules were tightened. This is an appropriate step, since capital is still the most complete buffer a bank can hold to cover losses. For globally systemically important banks, we even went a step further. These banks now have to hold additional loss-absorbing instruments above and beyond capital.

Secondly we also – for the first time ever – adopted global liquidity standards alongside the new capital regime. This is also an appropriate step, for the recent crisis was driven strongly by liquidity problems. At the end of October, the Basel Committee published its final rules, which will place banks’ funding on a more stable basis.

The regulatory reform will help make banks more stable. However, it entails effort and costs – something which particularly the banks themselves point out time and again. It is certainly true that tighter bank regulation is a cost factor. However, regulation is not an end in itself; it is there to prevent crises. So if we want to discuss the costs of regulation to banks, we also have to talk about the costs of crises to the taxpayer – and then I do believe indeed that the figures add up.

The regulatory reform will undoubtedly affect the future of the banking industry. Though it might mean more time and effort for one bank or another in the short run, for society it means more stability in the long run – which will also benefit, not least, the banks themselves.

## 3. Banking supervision: increasingly international

However, regulation only defines the rules of the game. An additional element is needed – a referee to monitor compliance with the rules.

In this regard, we in Europe set out into a new world three days ago. On 4 November, the ECB assumed responsibility for supervising the 120 largest banks in the euro area. These 120 banks represent more than 80% of the euro-area banking system's total assets. This turned the ECB overnight into one of the world's largest supervisory authorities.

The new Single Supervisory Mechanism (SSM) in Europe is getting to the root of three causes of the recent crisis. For it enables banks to be supervised at a consistently high standard throughout the euro area; it allows cross-border problems to be handled better; and it contributes to mitigating the influence of national interests, which has time and again hampered arm's-length supervision.

The step towards a European prudential supervisory regime certainly represented upheaval for the supervised banks. The supervisory culture will change: supervision will become more quantitative, and its perspective will change. Thus, in future the ECB will also inspect banks' business models. While this is standard practice in countries such as the United States or the United Kingdom, it is a first for German banks. It will certainly not be easy, but it is worth trying.

The SSM, however, will naturally follow the principle of proportionality: systemically important banks and banks with riskier business models will be supervised more closely than small banks and banks with low-risk business models.

The process of change associated with the SSM, by the way, will affect not only the banks but also us as supervisors. However, even in the new supervisory world order, the Bundesbank and BaFin will still be closely involved in off-site supervision.

The SSM will give national supervisors the opportunity to acquire new experience, which they can then transfer to supervision of the nearly 2,000 German banks for which national supervisors will remain responsible. The step towards an SSM for Europe will therefore affect all banks, and all banks will benefit.

## 4. Competition: much tougher

To sum up: we have improved regulation and supervision alike. This will make the future of the banking system more stable and less crisis-prone.

However, I already hinted at the beginning that supervision and regulation are not just for banks but particularly for society at large. Within the regulatory framework and under supervisors' watchful eye, banks will have to look out for themselves in future, too. This is all the more so as, in future, sovereigns will no longer be around to rescue banks in an emergency with taxpayers' money. This is due to the new "bail-in" rules for shareholders and creditors and to the new European resolution mechanism which will take effect in 2016.

Regulatory reform is thus putting more "market" into the financial markets – and with markets also comes the possibility of failure. In the words of economist Allan Meltzer: "Capitalism without failure is like religion without sin – it doesn't work".

In future, it will be up to the banks themselves to hold their own in the market. And for this they need two factors: stability and profitability. Regulation and supervision can at least contribute to stability; however, banks themselves are responsible for profitability.

Where does the German banking system stand with respect to stability and profitability? Not quite two weeks ago, the ECB published the results of the comprehensive assessment. In this exercise, the 130 most significant euro-area banks were subjected to a thorough health check – with regard to the quality of their assets as well as to their resilience to a possible economic downturn.

The exercise identified capital shortfalls at a total of 25 banks in Europe. Twelve of these banks already closed the capital shortfalls this year, while the other 13 now have nine months to remedy their shortfalls. This should take place primarily through genuine capital increases, ie not by reducing their risk-weighted assets and especially not using public funds – a particularly important point, in my book.

The 25 German banks passed the comprehensive assessment, with one exception. The bank that failed has already closed the identified capital shortfall, however. Incidentally, a total of five German banks would have failed the test if the Basel III capital definitions which enter into force from 2018 had been applied.

Like with any test, among those banks which passed the test, some passed with good marks and others only just scraped through. It is above all those banks which just barely passed which can expect to be monitored particularly closely in future – by supervisors and by the markets. Ultimately, however, for all banks, this is absolutely not the time for complacency. The real work is only just beginning.

For investors and supervisors are, of course, looking beyond the results of the comprehensive assessment. Take, for example, the unweighted capital ratio, that is to say, banks' leverage ratio. Despite improvements of late, it is still well below the European average – and this goes particularly for the large, internationally active German banks. There is thus a need to catch up.

The same also applies to German banks' profitability. Competition for customers and investors will become much tougher in future, and at the same time more international. Global regulation and European supervision will level the playing field on an international scale. German banks are therefore increasingly being forced to face international competition. And an international comparison shows that German banks do indeed have catching-up to do with respect to profitability.

Their return on equity and return on assets were both well below the European average in 2013. One driver of German banks' sluggish earnings is that their business models depend relatively heavily on interest income.

In a protracted period of low interest rates, this naturally weighs on earnings. In the first half of this year, the large German banks' operating income was down roughly 8% from the previous year – a decline driven by falling net interest income. The problem we are dealing with here is ultimately structural: one can see that interest rate margins have been on a continuous slide since the mid-1980s. This has been affecting, in particular, the major banks in Germany, including the Landesbanken.

Therefore, in order to be ready for the future, banks should rethink their business models and orient them to sustainable profitability. The need to reorient business models is not specific to Germany: however, here, too, German banks are performing somewhat below par by international standards. At least this is what the IMF has diagnosed in its recent Global Financial Stability Report.

It would make sense for the banks to pursue a strategy of diversifying sources of income and, in particular, of expanding sources of non-interest income. The good news is that in terms of costs, German banks are still performing relatively well by international standards. However, many areas remain where banks' profitability could be enhanced indirectly.

The branch networks of cooperative sector banks are still quite extensive. Although it serves to acquire and maintain customers, it is also a large cost component when compared with competing direct banks. Although the total number of banks in Germany has already been declining for some time, the German banking market continues to be relatively dense and has room for consolidation.

Against this background, all ideas need to be considered. Mergers must not be off-limits, either – provided these are between strong partners and preserve sustainable business models. Incidentally, as I mentioned earlier, supervisors will also be keeping an eye on business models. However, supervisors are, of course, not the better bankers. The final decision on business models should ultimately be taken by those who are being paid to do it and ultimately bear the risk.

Ladies and gentlemen, each bank has the power to shape its future. However, each bank is dependent on its economic environment. At the outbreak of the crisis, US banks suffered much more greatly than European banks, but they then also made a much faster recovery. This is not least because the US economy also stabilised relatively quickly. Looking at Europe, politicians are now called upon to undertake the necessary reforms: reforms for growth and reforms for stability. For only in a healthy economy can banks generate sustainable profits. This has always been so, and it will always be that way in future.

## 5. And the culture?

However, not only are banks dependent on the economy – but also, of course, vice versa. A modern economy depends on a functioning banking system.

I have spent the past 20 minutes talking about the challenges for the future – but the future is naturally also open to wishes, especially now with Christmas approaching. My greatest wish is for the banking industry to return to its inherent role: as a provider of services to the real economy.

What we need is genuine cultural change which will re-ingrain this image in the minds of bankers. A culture in which anything goes unless explicitly forbidden must not be allowed to be part of the future but should instead be banished to the past. We need a culture based on a quote from Seneca: "Shame may restrain what the law does not prohibit."

Of course it was, in the end, only a few black sheep who gave an entire industry a bad name. However, we need a culture that transcends short-term yields to look at the bigger picture. Banks have a responsibility to the economy and to society. Once they fulfil this responsibility, they will regain public confidence.

## 6. Conclusion

Ladies and gentlemen, the world of banks is changing. In my remarks, I have discussed various factors affecting the German banking industry's path to the future. These include stricter regulation and European supervision, but also tougher competition.

And it is not just competition within the banking market which is playing a role. Technological progress is also creating competition entering the banking market from without. Take, for instance, new electronic payment systems or crowdfunding. These are putting external pressure on banks' traditional business models. Banks need to respond and to adapt their business models and IT systems to the new environment.

It is ultimately up to the banking industry to decide how far they wish to go in this situation. I am convinced that German banks have what it takes to prevail in future, as well, but they already have to begin today to address the challenges of tomorrow. We cannot regulate the banking industry's path to a golden future; this is where banks must assume a great deal of individual responsibility.

Let me close my remarks by quoting, alongside Yogi Berra, another famous American: “Change is the law of life. And those who look only to the past or the present are certain to miss the future.” These words were spoken by John F Kennedy.

Thank you very much!