Andreas Dombret: Big Bang banking union – what can we expect?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Euro Finance Week, Frankfurt am Main, 18 November 2014.

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1. Introduction

Ladies and gentlemen

Thank you for the invitation and the opportunity to speak again at the Euro Finance Week. It is a pleasure to be here today. Let us briefly discuss physics before we turn to a topic that is more related to the Euro Finance Week.

The British astronomer Martin Rees once said: “We can trace things back to the earlier stages of the Big Bang, but we still don’t know what banged and why it banged. That’s a challenge for 21st century science.”

Well, the euro area had its own “Big Bang” two weeks ago, and in this case we know pretty well what banged – and why. On 4 November, the ECB became the direct supervisor for the 120 largest banks in the euro area which, in terms of assets, represent more than 80% of the euro area’s banking system. Thus, with a big bang, the ECB became one of the largest banking supervisors in the world.

Taking banking supervision from the national to the European level has been the biggest step of financial integration in Europe since the introduction of the euro in 1999. This big bang created a new universe for the banks and the financial markets.

But what exactly can we expect from the new European banking supervision? And probably even more importantly: what is it that we cannot expect from it? In the following I would like to discuss both questions.

2. The Single Supervisory Mechanism – just the first step

Taking banking supervision from the national level to the European level addresses three problems that became apparent during the recent crisis.

First, European banking supervision will allow banks in the entire euro area to be supervised according to the same high standards. These standards will emerge from sharing experience across borders and taking the best parts from every national approach towards banking supervision. Germany, for instance, could benefit from a more quantitative-oriented approach towards banking supervision which other countries already follow.

Second, European banking supervision will make it possible to effectively identify and manage cross-border problems. This is essential because today, large banks are usually active in more than one country. The failure of the Franco-Belgian bank Dexia in 2011 is a classic example in which banking supervision with a cross-border focus could have improved crisis management. Another example is the case of German Hypo Real Estate, which failed in 2009.

Third, taking banking supervision from the national to the European level will add a degree of separation between supervisors and the banks they supervise. This will prevent supervisors from treating their banks with kid-gloves out of national interest. Nevertheless, we can expect European banking supervision to draw upon the experience and resources of national supervisors. Supervision itself will take place in so-called joint supervisory teams. These teams are headed by ECB staff but are composed of national supervisors.

To sum up: there is a lot we can expect from European banking supervision, and now it has to deliver. In this regard, we should remember one thing: European banking supervision is an

immensely complex operation that has been put together in a very short time. Thus, it would probably be unrealistic to expect everything to run smoothly from day one. It will certainly take some time before every detail is sorted out deep down in the engine room of actual banking supervision. Nevertheless, I am confident that we will get there and that our expectations will be fulfilled.

3. The Single Resolution Mechanism – the necessary second step

But we should not let unrealistic expectations become the roots of complacency and, consequently, disappointment. European banking supervision is not the holy grail of financial stability. It certainly contributes to making banks more stable, but it is no panacea. Thus, we have to supplement it with other measures. Let me elaborate on one point in that regard.

Banking supervision cannot prevent individual banks from failing – not at the national level and not at the European level. Is this a problem? Not at all: the possibility of failure is an essential element of a market economy.

Nevertheless, banks are special in that respect. Just remember the 15th of September 2008, when the failure of a single investment bank pushed the financial system to the brink of collapse. The lesson is that the failure of very large or interconnected banks can lead to a systemic crisis. Thus, these banks are perceived as being “too big to fail”: when push comes to shove, the government might be compelled to step in to prevent disaster.

Consequently, “too big to fail” banks operate with an implicit and cost-free insurance. Apart from the costs this insurance imposes on taxpayers, it most definitely sets the wrong incentives for the risk-conscious behaviour of banks. Thus, solving the “too big to fail” problem is paramount for making the financial system more stable and saving taxpayers’ money.

Can European banking supervision solve that problem? Well, it can certainly contribute by putting “too big to fail” banks under close observation. And yet it has to be supplemented with other measures. And here, we recently made some progress – at the global level and at the European level.

At the global level, the G20 Heads of Governments and States have just this Sunday decided on international criteria that global systemically important banks will have to fulfil in future regarding their capital structure. In particular, these banks will need a minimum amount of Total Loss Absorbing Capacity – in short TLAC. This approach combines the existing minimum capital requirements with new requirements to ensure that large banks have sufficient capacity to absorb losses, both before and during resolution.

TLAC therefore, in my view, represents a watershed in ending “too big to fail”. It will allow for the orderly resolution of those banks without disrupting the financial system and while protecting taxpayers from having to foot the bill. For the TLAC-concept, I wish to signal my strong support.

To achieve these worthy goals, I suggest agreeing upon a figure at the upper end of the range of 16% – 20% proposed by the FSB. However, reaching an agreement on TLAC is not the finish line of the regulatory agenda. The next months need to be used for in-depth public consultation as well as an impact study of the new rules. I hope that this study will lend support to a figure at the upper end of the proposed range. Finally, after both the impact study and the public consultation, implementation is the next step, and this should not be underestimated.

Another major step towards solving the “too big to fail” problem has been taken with regard to cross-border resolution. In October, 18 global banks and the International Swaps and Derivatives Association agreed to implement new rules on derivatives trading. Whenever a large bank fails, these rules will allow authorities to temporarily suspend the right of other banks to terminate derivatives contracts. This will buy precious time to organise an orderly

resolution of the failed bank. However, it is paramount that we not only have the necessary procedures in place to wind down a failed bank, but the political will to go through with it. This political will exists in Germany and is a universal pre-condition for ending "too big to fail".

We have also made progress at the European level. The Bank Recovery and Resolution Directive spells out clear rules on who has to bear the costs when a bank fails. In a nutshell: bail-out is out and bail-in is in. In future, shareholders and creditors will be first in line when it comes to bearing losses; taxpayers will be last in line. This directive will be implemented in Germany in early 2015; the latest possible date for implementation in other countries is 2016.

Also from 2016 onwards, European banking supervision will be supplemented with a European resolution mechanism for banks. From then on, the banking union will rest on two pillars and provide a stable framework for European financial markets.

4. What about the banks?

What does all that mean for the banks? In essence, regulators and supervisors are working towards strengthening the principles of a market economy. Naturally, this puts more weight on the shoulders of market participants, that is, the banks. In future, there will be no public lifeguard standing by to bail banks out when things go wrong. Failure has become a real possibility and banks have to acknowledge that.

They should have an interest in safeguarding their stability and strengthening their profitability. Regarding the stability of banks, the comprehensive assessment provided a deep insight into the state of the European system. So let us take a closer look at the German banks that were subjected to that assessment.

All in all, German banks did rather well. Of the 25 German banks that were examined, there was only one "technical" failure, since the bank in question has already remedied its capital shortfall. Over all, it could be concluded that German banks are stable enough from a capital point of view to cope with severe economic stress.

But again, no bank should give in to complacency. And neither should supervisors. We should, for instance, be aware that the comprehensive assessment focused on risk-weighted capital ratios. Markets and supervisors, however, also cast an eye on unweighted capital ratios. And with regard to these leverage ratios, German banks are below average compared to other euro-area countries. Thus, there is ample room to catch-up and improve stability even further.

Nevertheless, while stability is necessary for a bank, it is not sufficient. Banks have to be profitable as well. And in this regard, too, German banks need to catch up. Their return on assets and their return on equity are also relatively low compared to other euro-area countries. A recent study even comes to the conclusion that only 6% of German banks earned their cost of capital last year.

What can explain these weak earnings? Well, the main culprit in Germany seems to be a business model that is relatively dependent on interest income. Such a business model poses a major challenge in the current environment of low interest rates. Consequently, in the first six months of this year, the operative results of the large German banks were about 8% below their 2013 levels – a result which was largely driven by a contracting interest margin. Nonetheless, banks are also faced with a structural problem in this context: the interest margin has been declining constantly since the mid-1980s.

The banks should therefore reconsider their business models and gear them towards sustainable profitability. To be sure, the need to adapt business models is not only relevant for German banks. However, in its recent Financial Stability Report, the IMF finds that German banks are again below average in terms of reforming their business models. Again, there is room to catch up with international peers.

An obvious strategy for the German banks would be to diversify their sources of income away from interest income. Looking at the cost-side, German banks fare rather well compared to other countries. That is the good news. But there are still options to reduce costs. In this regard, mergers may well be a potential strategy. The German banking market still offers scope for further consolidation – the focus here should, of course, always remain on arriving at a sustainable business model.

As a side note: in future, European banking supervision will also keep a close watch on the business models of banks. However, we should not expect supervisors to be the better bankers. At the end of the day, management decisions have to be taken by those who bear the risks and reap the rewards. What the supervisors could do is impose additional capital or liquidity requirements whenever they have doubts about the sustainability of a bank's business model.

5. Conclusion

Ladies and gentlemen

There is no doubt: European banking supervision is an important step forward in ensuring financial stability in the euro area. Nevertheless, as I said earlier, unrealistic expectations are the roots of complacency and, consequently, of disappointment.

European banking supervision is just the first pillar of the envisaged banking union. It has to be supplemented with the European resolution mechanism for banks. This second pillar of the banking union will be erected in 2016. Eventually, the banking union will provide a stable framework for the banking system and strengthen market forces.

This, in turn, puts more responsibility into the hands of banks. It is up to each individual bank to ensure its own stability and profitability. This requires the banks to rethink their business models and to rethink their culture. Regulatory measures like TLAC that will abolish implicit guarantees for banks will also necessitate changes in banks' behaviour for the better.

The original role of banks is to service the real economy. Putting this idea back into the heads of bankers would contribute greatly to making the financial system more stable. We have to do away with a culture in which everything is allowed that is not explicitly forbidden. We need a culture which encourages bankers to look beyond the horizon of short-term returns.

If banks succeed in creating such a culture, they will eventually regain the trust of the people that got lost in the crisis. Regulation and supervision can play a supporting role, but the burden ultimately lies with the banks.

Thank you.