Andreas Dombret: Banks – allowing them to fail

Statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Euromoney Conference on Germany, Berlin, 29 April 2015.

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1. Introduction

Ladies and gentlemen,

Thank you for the invitation to speak at the Euromoney conference on Germany. It is a pleasure to be here today.

Shortly after the financial crisis broke out in 2008, regulators around the world embarked on a regulatory reform in order to prevent such a crisis from happening again. This regulatory reform is as complex and multi-layered as the crisis itself. Still, many observers wish there was a silver bullet that would solve the crisis with one clean shot. I shall begin my speech with a disappointing message: there is no such silver bullet.

However, if we dig deep enough we uncover a problem that lies at the heart of the crisis and relates to one of the core characteristics of any well-functioning market economy. Despite the ongoing regulatory reform, this problem has not yet been entirely solved.

2. Capitalism, religion and the banks

So which problem am I talking about? It is usually labelled the “too big to fail” problem. It refers to banks that are so big, so interconnected or so important that their failure might bring down the entire financial system. Consequently, the government has an incentive to step in and bail out these banks in order to prevent a systemic meltdown.

Banks that were deemed “too big to fail” therefore operated with implicit government support that was provided free of charge. Such support, however, can induce banks to engage in risky transactions. If things go well they take the profit, but if things go wrong the taxpayer foots the bill. Obviously, this is a less than optimal situation from any point of view but the banks’.

How can we solve this problem? The first step is to reduce the likelihood of a large bank failing. To this end, regulation has, among other things, imposed stricter capital requirements in general and introduced surcharges for systemically important banks. But capital can only shield against losses up to a point. A system that entirely prevents the failure of banks is neither possible nor desirable.

We have to remind ourselves that the risk of failure is a core feature of any well-functioning market economy. It not only encourages competition, but also leads to a situation in which the best ultimately prevail. This is what Joseph Schumpeter famously called “creative destruction”. Allan Meltzer put an even finer point on it when he said: “Capitalism without failure is like religion without sin. It doesn’t work.”

With regard to banks that are deemed “too big to fail”, we therefore have to do away with the system that shields them at the taxpayer’s expense from the forces of “creative destruction”. To be clear, this by no means implies that we actually want banks to fail per se. But the threat of failure is a huge incentive for owners, creditors and other stakeholders to act prudently and with foresight.

3. From “too big to fail” to a well-functioning market economy

To allow even large banks to fail we have to build a viable resolution regime. Such a regime would allow these banks to fail without disrupting the entire financial system. They would be able to fail in line with market principles and in an orderly and predictable fashion. The ultimate ‘entrepreneurial burden’ would be shifted from the taxpayer to banks – and that is the right thing to do.

At the European level, a common legal framework for resolution has been established by the Bank Recovery and Resolution Directive, or BRRD for short. Authorities now have a coherent set of instruments at their disposal for a smooth banking resolution process. The BRRD also sets out a clear hierarchy for the bailing-in of owners and creditors. Starting in 2016, bail-ins will become mandatory for failing institutions in the EU. Bail-ins are in and bail-outs are out, so to speak.

However, given the global scope of the financial system, we ultimately need a global approach. Consequently, the G20 have just agreed to a proposal on capital structure requirements for global systemically important banks. In particular, these banks will need to ensure a minimum amount of total loss-absorbing capacity, or TLAC for short. This requirement may be as high as 20% of risk weighted assets and must be at least 6% of unweighted assets, which is twice the Basel III leverage ratio.

It is essential that the TLAC requirements are finalised on schedule by the end of this year so that they can enter into force by 2019. Until then, much remains to be done. Among other things, we have to develop rules on how to allocate internal TLAC between local subsidiaries of banks in order to prevent ring-fencing.

Of course, the proposal should not be watered down in the process. For instance, TLAC instruments should be strictly subordinated to instruments not included in TLAC in order to ensure transparency and legal certainty. We also need clear rules that restrict the holdings of TLAC instruments by other banks in order to limit the risk of contagion. Here, a number of potential approaches are currently under discussion. These include deductions from total capital, punitive risk weights and large exposure limits.

4. Conclusion

To sum up: many people blame untamed market forces for the financial crisis of 2008. I argue that it was, in fact, not too much market but too little that contributed to the near-collapse of the financial system. A core characteristic of any well-functioning market economy was absent from the financial sector, namely the threat of failure. Large banks operated with implicit government support that distorted their incentives for prudent behaviour and eventually cost taxpayers billions of euros.

Therefore, the regulatory reforms aim to reintroduce the principle of individual failure into the financial system. To reach this objective we have to establish mechanisms that allow banks to fail without disrupting the entire financial system. We have made significant progress both at the European and at the global level. And although we have not yet reached our objective, I am confident that we will eventually do so.

Thank you.