Andreas Dombret: The glass is half full – seven years of regulatory reform in the financial sector

Keynote address by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Euromoney Conference "The Public Sector Financing Forum", Frankfurt am Main, 30 September 2015.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak at today's Public Sector Financing Forum. It is a great pleasure to be here. The focal point you have chosen for this forum – the low-interest-rate environment – is indeed highly topical, and has been keeping us all very busy lately. A case in point is the survey that the Bundesbank and BaFin recently conducted among German banks on the challenges posed by low interest rates – more on that later.

As you all know, the financial sector still faces a truly challenging environment. While the worst aspects of the crisis and its consequences have been weathered successfully, circumstances remain difficult. In my speech today, I will be discussing these circumstances and also shedding some light on what we have to do to complete the post-crisis regulatory reforms. I will argue that we have come a long way but that we are not done yet. Nevertheless, since we have accomplished the majority of reforms, my message is this: the glass is half full, not half empty.

2. A truly challenging environment

Before I talk about regulation, let me sketch the truly challenging environment that now exists, and let me emphasise four factors. First, after the crisis, banks faced substantial deleveraging pressure. Adjusting risk taking and funding strategies was necessary in order to survive and meet new regulatory demands. As the process of phasing in the regulatory reforms will continue until 2019, many institutions still need to deleverage further.

Second, all financial institutions – but banks in particular – need to adapt to new technological demands for renewal. Digitalisation offers substantial challenges and opportunities at the same time. In any event, it has the potential to reshape the banking sector.

The third factor is the high degree of investment uncertainty. Unfortunately, in the current economic setting, there remains a high degree of uncertainty about the economic trajectory. What regulators can do, however, is pave the way for a sustainable recovery in the financial sector within a strong framework of rules – and combine this with reasonable phasing-in horizons.

The fourth factor in the difficult environment is the low interest rate setting in which you all have to do business. The recently released results of the joint BaFin-Bundesbank survey indicate that the persistence of low interest rates over a medium to long-term horizon will pose a challenge to the interest-driven business models of many German credit institutions. This is because such a persistently low interest rate environment leads to a structural erosion of interest income as higher-yielding exposures taken on in the past mature and are increasingly replaced by new positions that generate a lower rate of return.

The roughly 1,500 participating credit institutions on average expect pre-tax profits to fall by around 25% by 2019. This would amount to about 2 billion euros each year. In comparison: in 2014, the participating banks realised profits before tax of about 10 billion euros.

Should the period of low interest rates persist, profits would fall by as much as 50% – assuming that the banks leave their balance sheets unchanged. If the level of interest rates went down by another 100 basis points, profits would fall by 60% – provided the banks adjusted their balance sheets. If interest rates increased, profits would stabilise at a level slightly lower than the level realised in 2014.

Given this rather bleak outlook, banks have to act now. They must, for instance, try to increase the share of non-interest income. I have already mentioned digitalisation as a means of benefiting from new business opportunities. The adaptation of business models can generate new customers and streams of income. At the same time, banks should try to reduce costs. Again, digitalisation and the innovation of IT systems can allow significant cost reductions. Another issue on the cost side are the large branch networks of German banks. Here, consolidation might be a promising strategy.

3. What's next in financial regulation?

Against this challenging backdrop, some may argue that further regulatory reform is a problem, and that it will choke the just recently restarted engine of growth. But let me be clear: all macroeconomic studies on the impact of regulatory reforms are consistent in stressing that the overall economic benefits by far outweigh the costs. And that means that there is no way around fully implementing the reforms that have already been initiated and finalising their outstanding elements.

Having said that, policymakers are very mindful not to impose inefficient regulation and unnecessary costs. In that spirit, regulators took great care in designing the reforms that have already been implemented. And the same is true for those regulatory projects that are still in the pipeline. Some of them are currently under construction, and others are still on the drawing board. Let me outline to you the most important initiatives.

Let's begin with the completion of Basel III, which the Basel Committee is currently in the process of finalising. The new Basel framework marked a milestone in the regulation of banks. No sooner had it been put in place than the Basel Committee set about tackling the variability of risk-weighted assets in portfolios with essentially similar risk profiles. This variability makes it more difficult for investors to compare one bank with another. That is why the Basel Committee is currently overhauling the standardised approaches for credit, market and operational risks. It is also planning to introduce capital floors for internal models based on the standardised approaches. Together with enhanced disclosure formats, this will make it much easier for investors to compare and monitor banks and their risk profiles.

Another fundamental change to the regulatory framework for banks, as I see it, is a revision of the privileged treatment of sovereign bonds. This is another item currently on the Basel Committee's agenda. There is no regulatory or economic justification for such preferential treatment. The sovereign debt crisis that swept across the euro area made it crystal clear just how risky the nexus between sovereigns and national banks can be. That is why the Bundesbank is pushing for government bonds to be backed with a risk-appropriate amount of capital and for large exposure limits, just as they exist for claims on private debtors. We also need to make sure that adequate rules are introduced in the area of liquidity requirements. While I'm certain that tough "political" negotiations still lie ahead, I'm nonetheless confident that the preferential regulatory treatment afforded to sovereign debt will be revised in future. And this will realign incentives and risk premiums to prudent levels.

A third new element is the recovery and resolution regime that has been agreed globally and implemented across Europe. It was created to solve the problem of "too big to fail" banks and to keep taxpayers from having to bear the brunt in a crisis. This new core element of the banking regulation and supervisory framework is currently being finalised on the basis of the guiding principles issued by the international Financial Stability Board, or FSB for short. This resolution regime is a vital step forward in learning one of the key lessons of the financial crisis: the much discussed issue of moral hazard – a problem that arises because institutions that up to now were "too big to fail" could not be held accountable for their actions.

Looking ahead, there won't just be recovery and resolution plans for credit institutions; clearly defined liability cascades will be established, too, so as to ensure that the taxpayer really is last in line to foot the bill – that is to say, after shareholders and creditors have been bailed in, and then only in absolutely exceptional cases. But, to put this theoretical resolution model into practice, institutions will need to hold a certain amount of additional debt which, should the need arise, will be transformed into loss-absorbing capital.

For global systemically important financial institutions, this will be achieved by way of the TLAC standard, which the FSB will finalise this autumn. The same principle applies to the European institutions, but implementation here is based on what is known as the MREL standard, which differs in some respects from the TLAC requirement. One difference is that all institutions will be required to satisfy the MREL requirements, not just the systemically important ones. Another is that the minimum requirements will be set individually for each institution by the competent resolution authority.

These new standards will have a transformative impact on the market for loss-absorbing debt capital. They will introduce attractive new instruments that offer high returns for investors, particularly for those outside the banking sector. And the disclosure requirements under these standards will give investors the transparency they need to make well-founded decisions.

These reforms together with those that have already been accomplished will strengthen institutions' stability and systemic resilience. Nevertheless, when speaking about regulatory reforms, we have to bear in mind that most of those which I have mentioned only affect the regulated banking sector. In the context of low interest rates and tougher regulation, there are incentives for regulatory arbitrage through the shifting of assets from the regulated banking sector to somewhere outside the regulatory perimeter. And we are seeing significant movement in this direction.

That is why the G20 has agreed on a roadmap for regulating the shadow banking sector. Work is being conducted simultaneously by the FSB, the Basel Committee and IOSCO. The objective is to ensure that shadow bank-like risks to financial stability emerging outside the regular banking system are subject to appropriate oversight and regulation. Yet, we are careful not to inhibit sustainable market-based financing models that do not pose such risks.

One good example of a well-designed instrument is the Basel Committee's standard for measuring and controlling large exposures. While Europe had similar rules in place before the Basel framework was published in April 2014, this new standard provides a global approach to regulate relations between banks and other financial institutions. The framework was designed to protect banks from significant losses caused by the sudden default of an individual counterparty. By extending the scope of coverage beyond banks to exposures to funds, securitisation structures and collective investment undertakings, the framework has also become a useful tool in helping to strengthen the oversight and regulation of the shadow banking system.

4. Conclusion

Ladies and Gentlemen, unfortunately all of us here will have to work in this challenging environment for some time to come – ultra-low interest rates, digitalisation, deleveraging, and a high degree of investment uncertainty will continue to frame our decisions.

Yet, as I have outlined, we are seeing a considerable improvement in the condition of the banking and financial sector. Such developments and the regulatory reforms around Basel III have made the financial system more stable.

Nevertheless, further reform efforts are needed, and the momentum for reform cannot be lost. A resilient resolution regime with sufficient bail-in capital, prudent regulatory treatment of sovereign exposures, and the regulation of shadow banking activities are necessary to make the financial system more resilient.

I think this is good news for investors, because it promises to boost transparency, enhance stability, and generate new investment products.

My talking a lot about outstanding regulatory reforms might give you the impression that most of the work lies ahead of us. Nevertheless, as the title of my speech suggests, we have already achieved a great deal – more than is still ahead of us. As a supervisor, I am happy to say that, while we still have a lot of work to do, the glass is half full, not half empty!

Ladies and gentlemen, that concludes my speech – thank you very much for your attention.