Andreas Dombret: Banks and the German economy – will they continue to work hand in hand?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 4th Regensburger Wirtschaftsgespräch, Industrie- und Handelskammer (IHK) Regensburg, Regensburg, 11 February 2016.

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1. Introductory remarks

Mr Witzany

President Olschok

Ladies and gentlemen

I am delighted to be here in Regensburg to speak to you today. Over the next hour, I would like to discuss with you whether banks and savings banks and enterprises will be able to continue working hand in hand in future to tackle the challenges of business life. I have learned that the forum provided by your first Wirtschaftsgespräch already discussed to what extent the sometimes complex rules of the Basel III framework might affect the supply of credit to small and medium-sized enterprises (SMEs) in particular. I would now like to revisit that debate and continue it in my speech.

2. Banks and enterprises: for or against each other?

Mark Twain once said, “A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain.” I probably don’t have to point out that bankers aren’t, of course, like that – well, at least most of them aren’t. On the contrary, banks often play a very important role for enterprises and for the economy as a whole. They act as mediators between those who invest capital and those who need it. They finance investments, they take on and manage risks, they settle payments and they play a supporting role for enterprises in IPOs. That means that businesses need banks, but that banks also need businesses. As at the end of last year, German banks and savings banks had lent a total of far over €900 billion to domestic enterprises alone – that corresponds to just under 12% of their consolidated balance sheet total. Their lending business, in particular with corporate clients, is therefore a key pillar of our domestic credit institutions’ business activity.

I am certainly not exaggerating when I say that this kind of cooperation between banks and savings banks and enterprises works well in Germany in the vast majority of cases. The traditional concept of the “house bank”, or relationship banking, has major importance in particular for the German Mittelstand. Many enterprises work together with just a single credit institution, and, in a lot of cases, have done so for many years.

Nevertheless, the recent financial crisis has not left the relationship between credit institutions and enterprises unaffected. The banks’ standing was severely damaged, a lot of trust was forfeited, and quips like that by Mark Twain started making the rounds again. The loss of trust went so far that some enterprises made enquiries at the Bundesbank during the crisis about whether they could open an account with us, because they said that they no longer had any confidence in the commercial banks. At the same time, massive government financial rescue packages were being put together – without them it is likely that there would have been a complete collapse of the financial system with even more serious consequences for the real economy.

3. Banking regulation: we'll soon be there

The financial crisis and the ensuing global financial crisis have made it abundantly clear to us how closely interlinked the financial system and the real economy are. We have learned that institutions can be so large that they can't really be removed from the market – this is known in the debate as the "too big to fail" problem. We are also aware that credit institutions' bonus systems can get out of hand and generate destabilising effects if they are geared excessively to short-term profits and ignore long-term risks. And we now know that the banks' high degree of interconnectedness and phenomena such as herding behaviour can indeed give rise to risks for the financial system, even though each individual bank is stable when viewed in isolation. Comprehensive reforms were and are therefore still necessary in order to create a secure financial system that reliably fulfils its actual purpose for the real economy.

And that is why we have seen many new regulatory initiatives over the past few years. Today, seven and a half years after the collapse of Lehman Brothers – which for many was the beginning of the financial crisis – we are significantly closer to our goal than ever before.

In response to the financial crisis, the G20 countries have worked on improving the resilience of the individual banks. Strengthening the individual banks as the smallest component part of the financial system strengthens the system itself. With this goal in mind, in 2010 the Basel Committee on Banking Supervision adopted a regulatory framework, called Basel III for short.

The first step set out in this framework was to overhaul the capital requirements in place for credit institutions. Equity capital is key to the stability of the banks as it constitutes their main buffer for absorbing losses. Under the new rules, banks have to satisfy higher capital requirements in terms of both quantity and quality. Since last year, these institutions have been required to hold CET1 capital equal to 4.5% of their risk-weighted assets. This was followed on 1 January by an additional 0.625% for the capital conservation buffer, which is set to rise to a total of 2.5% by 2019. From 2019, when it is possible for all instruments to be deployed in full, banks and savings banks will have to hold CET1 capital equal to at least 7% of risk-weighted assets. This is a significant increase compared with the 2% minimum ratio that applied until the end of 2013. What is more, the other new capital instruments, which include the countercyclical capital buffer and the additional buffers for the most significant institutions, also need to be backed by CET1 capital.

The new rules will help make the banking system more stable as a whole. At the same time, however, it goes without saying that the new rules also place a cost burden on the banks. This is by no means unintentional in the case of buffers for the most significant institutions: as their systemic importance puts them at an advantage in terms of funding costs, this burden levels the playing field at least in part. However, some observers fear that this is also detrimental to the real economy. They argue that the new rules are making it more expensive for banks to lend and are therefore concerned that the institutions will be forced to reduce their lending activities in the future.

The Basel Committee was well aware of the impact that the new rules would have. It was for this reason that the Committee also established transitional periods with the aim of rendering it easier for banks and savings banks to make the necessary adjustments. These apply to both the qualitative and the quantitative aspects of the new capital requirements. For example, the capital instruments that are no longer eligible for inclusion in CET1 capital will not be excluded in one fell swoop; instead, they will be phased out over a period of several years. Furthermore, increasing requirements regarding the level of capital to be held will be introduced only gradually.

But the Basel Committee has also come in for criticism in response to these transitional periods – in the eyes of some government representatives and market observers, they appeared to constitute too great a concession to the banks. Personally, however, I believe that the Committee has served the interests of the real economy, in particular, without having to compromise on in its efforts to increase the resilience of the banking system.

Of course, the development of Basel III has and will continue to be accompanied by impact studies that assess the effects of the new rules on financial institutions and the real economy. These studies have thus far come to the conclusion that the short-term economic impact is rather low and are therefore consistent with numerous earlier findings that were able to demonstrate, for instance, that credit institutions' borrowing costs would only rise marginally if additional capital requirements were imposed. According to these findings, increasing capital requirements by 100 basis points would, on average, cause institutions' overall capital costs to rise by less than ten basis points.

Turning our attention to the future, tighter regulation actually promotes prosperity because it lessens the likelihood of financial crises. This is a very important point! When talking about the implications of regulation, we cannot focus solely on the short-term costs that the banks are facing – we must also pay attention to the long-term benefits. Just think of the many billions of euros of public money that had to be spent in Germany alone over recent years to stabilise the banks. In some countries, taking this measure has even plunged governments themselves into significant financial difficulties. Viewed from this perspective, I think the price we are paying for stricter regulation is entirely appropriate. Of course, the impact that reforms have on the real economy must, nevertheless, always be taken into account.

Our objective, not just within the Basel Committee, is to make banks safer and thus minimise the likelihood of financial crises. At the same time, we want to ensure two things in the event of an institution running into trouble: that the taxpayer will not immediately be called upon once again to foot the bill for failings on the part of the bank's management, and that the institution can be resolved without causing any major disruptions.

Aside from this, the regulation seeks to accommodate those enterprises that rely on bank loans. Take, for instance, the Basel framework's "SME package", which was introduced under Basel II and updated under Basel III. As part of this package, the capital that has to be held against loans to small and medium-sized enterprises is cut by as much as half depending on probability of default and collateral. As a result, capital costs for loans to small and medium-sized enterprises are significantly cheaper than those for loans to larger enterprises. It will come as no surprise to you that it was the Bundesbank that campaigned so hard for this SME-friendly regulation. Notably, the Basel framework's SME package creates significant incentives for lending to small and medium-sized enterprises. Thanks to this regulation, I believe that we have been able to sensibly exert a positive influence on the relationship between banks and enterprises.

4. Regulation calls for a sense of proportion

If we are to discuss the impact of banking regulation on small and medium-sized enterprises, I believe we must also consider the regulatory implications for small and medium-sized banks and savings banks. The global regulatory reform of the banking sector in the past few years was intended to tighten the regulation of internationally active credit institutions whilst also creating a fair and level playing field worldwide. As a result, however, almost all regulatory measures are essentially aimed at internationally active large banks. This makes absolute sense in the context of the crisis. But here and there, there is a feeling that in applying the rules we may have thrown the baby out with the bathwater; in other words, we have made the rules so complex that they are overwhelming small and medium-sized institutions.

As a result, the debate about the proportionality of regulation is heating up. Of course, tighter regulation means a considerable workload for banks and savings banks, as well as for supervisors. But it is also very important to weigh this against the cost to society of financial crises. Size is only one of several important criteria that determine whether an institution is "systemically important". Other major factors are substitutability, interconnectedness and exposure to similar risks, which is why we cannot simply apply a less complex set of rules to small banks than to their large competitors. Instead, these institutions must be regulated in relation to the risk they pose.

At this point, I feel it is very important to emphasise that the current regulatory and supervisory frameworks are already largely proportionate. For example, at present, risk-weighted capital requirements are calculated differently under standardised approaches and internal ratings-based approaches. Furthermore, a portfolio has been introduced to help determine regulatory capital requirements in retail banking. And last but not least, small and medium-sized institutions are benefiting from greater regulatory leeway for business with corporate customers from the SME sector, which are an important client group for these banks.

So as you can see, the implications of the sometimes complex new rules of the Basel III framework affect credit institutions and enterprises in similar ways. Small and medium-sized market participants, in particular – both in the financial sector and in the real economy – are concerned about the new regulation. However, I think many of their worries are unfounded. The Basel framework creates active incentives to lend to SMEs, which play an important role in employment and economic activity – especially in Germany. In addition, the new rules will provide relief for credit institutions that are less significant in terms of their impact on financial stability. In my opinion, Basel III will bring us a balanced framework that lays the foundations for sustainable economic growth.

5. Capital markets union will broaden the funding base

As I mentioned earlier, the cooperation between banks and enterprises is hugely important for both parties. Whilst banks provide financing to enterprises, they are themselves dependent on enterprises to generate their income. I am firmly convinced that this symbiotic relationship in Germany functions well. But the financial crisis also showed that this symbiosis can very quickly evolve into a destructive relationship, specifically when individual banks conduct business of rather limited use to the real economy, the repercussions of which cause everyone to suffer in the end. Enterprises suffer when a crisis in the financial system snowballs into an economic crisis. Taxpayers suffer when the state has to rescue ailing banks. And banks suffer when their reputations are ruined in the wake of a crisis and both enterprises and the general public lose their trust in them. Against this backdrop, it is crucial that banks remember their true role: to finance the real economy.

So how might the future relationship between banks and enterprises look? You may be familiar with the concept of the “capital markets union”, which is currently the subject of much debate and which aims to bring about deeper integration of Europe’s financial markets – and not just the debt markets, but also the equity capital markets. I am assuming that this will also trigger further changes to the structure of the European financial system. But we mustn’t overlook the fact that much has already changed in recent years. In 1999, bank loans still made up 22% of German enterprises’ liabilities; in the third quarter of 2015, this figure fell to just over 14% – and this was despite the healthy economic situation in Germany. Following their experiences in the financial crisis, when a number of banks drastically reduced their credit supply, enterprises have started seeking alternatives to the traditional bank loan and, where possible, have increasingly turned to the capital market. The scale of capital market financing nonetheless remains low in Germany – especially when compared to the United States or the United Kingdom.

All the same, I am confident that the cooperation between banks and enterprises will still be of great importance going forward. For SMEs, in particular, the relationship with their principal bank continues to play a vital role – not least because trust is built on past experience. A principal bank thus has an information advantage over another investor, which is highly likely to benefit enterprises.

But besides market-based funding, other lenders such as insurers, other financial intermediaries or trade credits from other enterprises are also increasingly taking the place of traditional bank loans. The use of own funds has also risen, primarily among SMEs. In short, the funding options for German enterprises are becoming more varied.

At this point, one might worry that this development will have a negative impact on banks' earnings, but I would like to put something into perspective here. Diversification of funding sources can surely contribute to the stability and efficiency of the financial system – and that ultimately benefits the banks, too. There is still a great deal of potential in this respect in Germany especially, but also other European countries, compared with the English-speaking world. For this reason, I take a thoroughly positive view of the increased importance of bonds, securitisations and borrowers' notes, even in the SME sector. It is particularly important, however, to pay attention to the quality of these instruments, especially in such a young market segment. Thus, even SME bonds do not provide a real way out of the funding problems of weak enterprises, but instead are a suitable instrument for larger SMEs with high credit quality.

6. Conclusion

Let me sum up by saying that banks and enterprises are closely interconnected. They play a crucial role in the functioning of our economy, both individually and together.

Yet to a great extent, banks and enterprises shape their relationship themselves: banks decide which enterprises to lend to at which conditions, and enterprises return this trust with their demand for loans. I am therefore firmly convinced that credit institutions and enterprises, working hand in hand, will still be able to overcome the future challenges of business life. Even so, their relationship will certainly experience further change in the coming years and incorporate additional participants, mainly in the capital market. I consider this a positive development, as the next rainstorm is sure to come, and when it does, it will be a good thing that enterprises are able to procure their umbrellas both on the capital market and in the shape of loans.

Thank you for your attention. I now look forward to a lively discussion.