Andreas Dombret: Banking sector in uncertain times - a challenge for whom?

Keynote speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the British Bankers Association, Annual International Banking Conference, London, 20 October 2016.

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1. Introduction

Ladies and gentlemen

We are facing a surplus of pressing issues at the moment, each so important and complex that I could easily devote an entire speech to every one of them. Unfortunately, I cannot do that because my time is limited. But that is not actually a problem, because with so many different matters at hand, one can easily get lost in the details. Therefore, before we start discussing the current issues in greater depth, I would first like to take a step back and look at the bigger picture.

That is, I would not only like to put the challenges we are facing into perspective, but also reflect on the role I see for the stakeholders; i.e. for banks, regulators and supervisors as well as politicians.

2. Challenging times for the banking sector

If we look at how the European banking sector has developed since the financial crisis, there has clearly been quite some improvement. Compared to 2008, European banks have strengthened their tier 1 capital position by 6 percentage points to 15% on average. Their improved resilience is also reflected in the leverage ratio. Before the financial crisis, European banks held around 3.6% of unweighted common equity; today, the average is 5.5%. Besides boosting their solvency, banks have also worked to enhance their liquidity buffers.

Yet over the course of the past year, European bank stocks have come under significant pressure. While the overall European stock market – as represented by the Euro Stoxx 50 – has more or less held steady, the Euro Stoxx Banks index has dropped by more than 30 per cent. Bank stock price volatility has soared, and CDS quotes suggest that confidence has recently declined in the creditworthiness of many listed European banks. So something is obviously worrying investors.

Complex issues can rarely be pinned on just one root cause. Indeed, banks in the UK and in the rest of Europe are being pounded by multiple headwinds. Let me briefly pick three of them.

First, we are currently seeing significant structural changes in the market environment. Two developments are decisive here. On the one hand, digitalisation is rapidly transforming the banking business. At the same time, banks and the economy face a prolonged period of very low interest rates. While net interest income hasn't been affected much so far, the pressure on margins is likely to mount over the medium term.

Second, banks operate in a still relatively new regulatory environment. And rules based on the Basel III regime are currently being finalised and phased in. The need to adapt to, and comply with, the new requirements is imposing costs on the banks and causing some headaches among bank managers. And the uncertainty about the final Basel III rules is rising, given that the last meeting of the Basel Committee is approaching at the end of November.

Third, to the surprise of most market participants and probably politicians as well, a majority of the UK citizens voted in favour of leaving the European Union. Many observers are concerned about the consequences of this process. And while many contributions to this debate are rather speculative at a time when negotiations haven't even started, there are indeed many complex problems to be solved and tough decisions to be made over the coming months and years. Nobody knows that better than you.

Allow me just one short remark: Interconnectedness between the UK andEU is significant in terms of both the real economy and the financial markets. Rearranging these complex ties will be a demanding task.

Many eyes in the banking sector are on the issue of passporting from theUK into the EU, and, closely related to that, on the question of whether, and in what form, the UK will retain access to the single market. There is also the matter of whether the City of London will be stripped of the ability to clear euro-denominated OTC derivatives after the UK has exited the EU.

These are just two of the most prominent examples of the regulatory uncertainty that is bothering the financial sector in the wake of the referendum. Further questions such as the free movement of labour, goods and services, affect the UK economy as a whole and with it all the clients of banks.

Taken together, these headwinds are placing a strain on the earnings prospects of banks. This is also reflected by the earnings-per-share forecasts for European banks, which have been in decline since the beginning of this year for almost all major institutions. Bearing this in mind, it's certainly no surprise that bank stocks have underperformed the rest of the economy.

To make matters worse, the bulk of the developments I have just outlined aren't short-term hiccups; they will continue to absorb everybody's attention for quite some time to come. And I expect them to radically change the banking sector. So if you were asking yourselves whether coming here today to discuss some of them is worth your time, I am certain you have made the right decision.

3. A challenge for whom, exactly?

When you find yourself in a challenging situation, it is usually a good idea to put all possible solutions on the table. Sometimes, it can be useful to look for ways to circumvent the problem. And it's also worthwhile examining who or what might be responsible for the problem at hand. Another tempting, but rarely fruitful response is to blame the whole sorry affair on external factors which only someone else can do anything about, and to then ask that someone to do something to make the problem go away.

Unfortunately, this is a response I have seen all too often in the debates on the situation of the European banking sector. And it can come in different shapes and forms: central banks being called upon to change their monetary policy because the current stance, it is claimed, is destroying earnings opportunities for banks; regulators being asked to revisit reforms because they're said to be driving up costs too strongly; and policymakers being asked to steer Brexit negotiations such that the financial sector doesn't suffer disadvantages during divorce proceedings.

Notwithstanding the important question of how much truth there is in the economic mechanisms thought to be behind these statements, they do convey a false impression of who exactly is responsible for what. Contrary to what such statements suggest, it is not the task of central bankers, regulators or policymakers to avert or resolve difficult situations for the banking sector. To put it bluntly, no one can expect a comfortable environment for the financial industry. Nor a certain level of interest rates. Nor a certain market environment. Nor a certain kind or degree of regulation.

Now please don't get me wrong. I know very well that the current challenges are a Herculean task for many banks. And I understand that banks are struggling with them.

And I also believe that banks can expect a lot from their supervisors, regulators and policymakers. Let me give you some examples.

With respect to structural changes in the market environment, banks can expect supervisors to closely monitor the introduction of new technologies and the entry of new competitors, and to ensure that the playing field remains level by assessing both technologies and financial institutions solely according to the risk they pose to financial stability.

Banks can also be confident that central banks are aware of the challenges posed by low interest rates. That being said, it should also be clear that safeguarding an institution's net interest income is not the objective of monetary policy.

As far as the perceived burden of regulation is concerned, banks can expect regulators and supervisors to listen to their arguments and continuously explore areas where they can do better. For example, one area where I see room for improvement is proportionality, that is, tailoring supervision and regulation to better fit differently sized banks.

As a proponent of a free market economy, I also agree with most industry representatives that we should not regulate more than necessary to achieve a stable and effective financial system. Furthermore, the regulation that exists should be as bearable as possible – as long as it remains as tough as necessary.

What we cannot do, though, is hold back on regulation simply because the sector is having a hard time. After all, taxpayers didn't have an easy ride with banks in the years that followed 2007, either. Improving regulation was and remains necessary to restore trust in the banking sector. And any costs that it might involve must be weighed against the benefits of a stable banking system.

Lastly, with respect to the future relations between the UK and the EU, you can expect supervisors to work to preserve the cooperative culture between authorities on both sides of the Channel and to keep regulation synchronised as a way of maintaining a level playing field. A politically induced uneven playing field that is skewed to favour certain financial centres over others would inevitably prove counterproductive in the medium to long term, as that would open loopholes and opportunities for regulatory arbitrage. Furthermore, banks are right to insist that Brexit negotiations should not be dragged out for too long and that there should be as much planning security as possible.

What neither supervisors nor policymakers can promise is that Brexit will not affect the rules for banks, or leave the sector unscathed. On this score, it is often argued that if Brexit hampered the banking sector, it might impair the financing of the European economy. I don't share those fears. Brexit and its possible repercussions for the City of London are unlikely to be an issue for financial stability or the financing of the EU's real economy. The financial sector has proven to be flexible in the past, and I am in no doubt that it will adapt and come to terms with any changes the negotiations might bring.

4. Importance and boundaries of politics

Ladies and gentlemen, I have given you an impression of the role I see for supervisors and central banks. Of course, there is another party from the public sector that plays a role: politicians.

And the importance of politicians can't be overestimated when it comes to the future relations between the UK and the EU. How these turn out can only be determined by the elected representatives of the people."

But there are also areas where politicians have, for very good reasons, restricted their own influence. I am talking about the realm of monetary policy and, to some degree, banking and financial supervision. As Governor Carney put it: "The objectives are what are set by the politicians; the policies are done by technocrats."

Nevertheless, we have seen some criticism of central banks and their policies from politicians lately. This concerned, for example, the handling of Brexit as well as conducting monetary policy and setting interest rates more generally.

In light of this criticism, it may be time for a friendly reminder that central bank independence is not debatable. Experience shows that political influence over central banks always leads into disorder. At the end of the day, independent central banks best guarantee price stability. Calling central bank independence into question, even only implicitly, can confuse markets as well as the public about who is in charge when it comes to monetary policy and supervisory decisions.

In summary, politicians are well advised not to exert influence in the wrong place or with the wrong measures. In this context, I am also worried about some rather protectionist tones in recent economic and legal debates. Politicians as well as public authorities must resist any temptation to give preferential treatment to domestic companies and banks – or to exert excessively tough action on foreign businesses. As Barack Obama recently said: "A nation ringed by walls would only imprison itself."

5. Conclusion

Ladies and gentleman, over the past few minutes I offered you an overview of what I believe the banking sector can expect from supervisors, regulators and politicians – and what not. It turned out to be quite a long list.

If, as a bank representative, you were to ask me what I expect from banks in return, I would say just one thing: I expect you to take up the challenge.

In a market economy, coping with multiple challenges and an adverse business environment is the core responsibility of a business's management. No one else's.

At the beginning of my speech today, I spoke about an imminent and profound change in the banking sector. After the dust has settled, there will not only be winners. But if we honour the division of responsibility between banks, supervisors and policymakers, we can open up the path towards a banking sector that is both stable and profitable.

Of course, this is not to say that there shouldn't be communication or even cooperation among the parties involved – quite the contrary, in fact. That's why it's so important to have opportunities, like today's conference, to get together and discuss not just the challenges, but also the strategies needed to overcome them. I am looking forward to having this conversation with you now.

Thank you very much for your attention.