

Andreas Dombret: Banks navigating uncharted waters

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Instituto de Estudos de Política Económica, Rio de Janeiro, 2 December 2016.

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1. The world in uncharted territory

Ladies and gentlemen

Do you remember where you were on the evening of November 8, 2016? It was a Tuesday, and judging by the headlines in literally every major newspaper in the world on the day after, the world was in a state of shock. The sentiment that dominated the greater part of media coverage of the US presidential election was also apparent in social media and in personal conversations probably everyone in this room had in the days that followed.

The outcome of the US election has caused a great deal of uncertainty. How will the change of government affect the foreign and security policy of the United States of America? What influence will it have on trade, regulatory and environmental issues? What will it mean for US relations with other regions, in particular Europe and Latin America?

As you know, the US presidential election was not the first vote that took markets and the public by surprise. In June this year, UK voters left Europe astonished as they voted to leave the European Union. Both decisions were taken in an already agitated situation in which the world is facing terrorism and tension over security in several parts of the world. On a different front, it is still fighting the after-effects of the worst financial and economic crisis since the Great Depression.

Looking ahead, we see more potential stumbling blocks. The Italian constitutional referendum will be held next Sunday and the French presidential election in about five months from now, just to name two of them.

All those past and future events have two things in common.

First, they actually change our world, or they have the potential to do so. Many expect this change in society, politics and economics to be for the worse. While we can try to predict how exactly the change will affect us, we have learned that such predictions are doomed to fail. In the end, we have to cope with a certain degree of uncertainty – and at the moment, there is plenty of it.

Second, these various events can tempt us to look for easy answers. Being confronted with multiple issues simultaneously, each complex enough in itself, can be overwhelming. The prevalence of over-simplification, polarisation and populism in recent political campaigns is a reflection of this desire for a simple solution.

2. Parallels to the financial world

Ladies and gentlemen, I hope you are not wondering by now if you accidentally ended up in the wrong room, listening to a talk about contemporary history, political science or sociology.

Because of what I have just described is also very relevant for my field of expertise – the banking and financial sector. It is my impression that, like the world as a whole, the financial world is currently going through its very own period of change and uncertainty, that it is struggling just as much to cope with it, and that we are just as prone to the lure of easy answers.

In this context, you may already have come across the term “the new normal of banking”. It suggests that the sector has reached some kind of new equilibrium and that we have understood what it characterises. First of all, I doubt that this is true. And second, to be honest, whenever I hear this phrase I don’t even know exactly what is meant by it.

Therefore, I want to dedicate the remainder of my remarks to an overview of what I believe to be the major developments in and challenges for the banking sector. I will also discuss possible answers to these challenges. Coming from Deutsche Bundesbank, I will of course be doing this from a European perspective. But in our discussion later on, I am eager to hear your views on, and to learn from your experiences in the financial sector in Brazil and Latin America.

3. Challenges for (European) banks

Let me start with a challenge I have already mentioned: the pending divorce of the UK and the EU. I have mentioned it because of its political impact. But as you know, it has strong implications for the financial sector as well and will continue to do so. Many eyes are on the question of whether, and in what form, the UK will retain access to the single market. In the financial realm, the related question is whether financial firms in the UK will continue to benefit from what we call “passporting”. Currently, many international banks use London as a hub to conduct business within the European Economic Area. But depending on the deal that will be struck between the UK and the EU, passporting in its current form might end – and with it the possibility to enter the European market through the UK. Another open question is whether the City of London will still be in a position to clear euro-denominated swaps and other euro-denominated transactions once the UK has formally exited the EU.

These are just two of the most prominent examples of the regulatory uncertainty that is troubling the financial sector in the wake of the UK 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.

Given that formal negotiations have not even started yet between the EU and the UK, there are still plenty of plausible scenarios for their future relations, and thus for the environment banks will have to operate in. This uncertainty surrounding Brexit will stay with the financial sector for some time to come, and there is no easy way around it.

Let’s move on to the second issue, which concerns regulation more generally. Earlier this week, I was in Santiago de Chile to meet with my colleagues from the Basel Committee, where we discussed details for completing Basel III. The rules based on this regulatory regime are currently being finalised and phased in. Important aspects of the current negotiations are the revisions made to the level and the calculation of capital requirements.

The need to adapt to, and comply with these new requirements is imposing costs on banks and causing headaches among bank managers. This holds for European financial institutions in particular. In comparison to Brazil, for example, the use of internal models for calculating risk-weighted assets and thus capital requirements is widespread in Europe. Consequently, any changes to this approach – as currently discussed – have much stronger implications for European banks than for their counterparts elsewhere.

It is therefore crucial that the final result of our current negotiations will be regionally balanced and does not undermine the risk-oriented approach of the Basel framework. The Committee was not able to reach such an agreement yet. We will continue our negotiations with the goal of ending regulatory uncertainty as soon as possible. And we will work towards finding a compromise before the Committee’s oversight body – the Group of Governors and Heads of Supervision – will meet in January.

In parallel with reforming Basel III, in Europe we have established the banking union with a whole new supervisory architecture at its core – the Single Supervisory Mechanism. This supervisory mechanism is still relatively new territory for banks, as it has just recently celebrated its second anniversary.

As you can see, the regulatory and supervisory world is changing significantly and rapidly for banks. Keeping up with these developments is a challenging task.

On top of that, we are currently seeing significant structural changes in the market environment for banks. Two developments are decisive here.

On the one hand, digitalisation is rapidly transforming the banking business. While technology has always played a prominent role in banking, the speed and force of the current wave of digitalisation is unprecedented for European banks. Small FinTech start-ups as well as major tech giants are forcing their way into the market, for example by providing instant payment services with a speed and convenience unmatched by the traditional services that banks have on offer. In parallel, technologies with the potential to disrupt individual business models are being honed and refined, and made ready for the market.

In contrast to some banks in Europe, most Brazilian banks are already well-advanced in digitalising their business. Ironically, this is due to the fact that they mostly set up their IT later than their European counterparts. This observation is very much at the heart of the challenge posed by digitalisation: in the field of IT and digital services, it is not sufficient to put up a high upfront investment in order to ensure quality that will last for years. Instead, you need to do both: move early on and then continuously keep up with the pace of digital innovation. Only then can you ensure both – IT and cyber security as well as the quality necessary to satisfy an increasingly elusive customer base.

The impact of digitalisation on the financial world – and the world as a whole – cannot be overestimated. But there is a second structural challenge that is even more pressing for many financial institutions. I am, of course, talking about the prolonged period of very low interest rates.

The low-interest-rate environment is a prime candidate for the lure of the easy answer. And the seemingly easy answer is that low interest rates are the result of misguided monetary policy. But this answer reflects a common misperception as to the root causes of the low rates.

The downward trend in long-term nominal and real interest rates across the world has been visible since the 1990s. This trend accelerated after 2007 with the financial crisis. The macroeconomic literature currently discusses a number of structural causes as potential explanations. Without going into details on the research, there are indications that show that a slowdown in global growth together with shifts in savings and investment behaviour, partly driven by demographic change in industrial countries, have led to a fall in the price of capital. With the financial crisis and the recession that followed, the fall in the desired levels of investment together with expansionary monetary policy have pushed down rates even further.

In summary, not only are the very low interest rates influenced by central banks: they also reflect an economic malaise in the global and in the euro-area economies.

Irrespective of their origin, the very low interest rates pose a serious challenge for profitability in the financial sector. This is particularly the case for banks whose business model depends heavily on net interest income. First of all, the margins derived from maturity transformation are declining because of the very flat yield curve. And second, deposit-based refinancing which we have always regarded as highly desirable as a stable source of funding, even in crisis periods, becomes less attractive. This is because it is difficult to pass on negative rates to small private depositors in a very competitive market and when depositors always have the alternative of hoarding cash.

Despite the low rates, net interest income hasn't been affected much so far. But the pressure on margins is going to mount over the medium term as outstanding loans are repaid and replaced by lower-yielding ones.

A major risk associated with a low-interest-rate environment materialises when that spell comes to an end. In this scenario, pre-tax net income would probably suffer a short-term slump, especially if interest rates were to climb abruptly following a long period of low rates. In the short term, this would lead to present-value losses. More importantly, as banks are by their very nature engaged in the business of maturity transformation, a rise in interest rates will force them to roll over their liabilities at higher interest rates. But the yields on their assets will still reflect the low-rate environment.

Moreover, the longer banks have to cope with low interest rates, the more they are likely to take risky assets onto their books. We can observe that banks are extending the average maturity on the asset side, which is exposing them to more credit default and market risk.

At the same time, European banks are still holding significant amounts of non-performing loans in their books. For the euro area as a whole, the stock of NPLs amounts to roughly 9% of euro-area GDP, more than double the level in 2009, and is only declining slowly. If we instead measure the amount of NPLs relative to total loans, we get the so-called NPL ratio. This ratio stands at 5.5% on average for European banks. However, we can see a strong dispersion of NPL ratios across countries. The highest NPL ratios are present in those member states that were hit hardest by the economic crisis that followed the financial crisis after 2007.

The high stock of NPLs ties up operational capacity of the affected banks, it involves legal as well as administrative costs, and it weighs on the capacity of those banks to extend new loans to realise profits and to support economic recovery.

4. How to cope

Ladies and gentleman, the financial world is clearly confronted with significant change and uncertainty. And many in the financial world perceive this to be a change for the worse.

There are no easy solutions. The Brexit negotiations will take time and uncertainty will be with us just as long. Turning back regulatory achievements to provide relief from a perceived burden is not an option. As for the challenges posed by digitalisation, sticking to business as usual will not suffice. The same is true for the low-interest-rate environment: hoping for relief from a change in monetary policy won't be enough.

Clearly, banks need to adapt, and indeed they have already begun. Any long-term strategy for profitable banking needs to be built on its value added for customers, business partners and society.

In times like these, supervisors need to be especially vigilant in monitoring financial institutions and ensuring that they do not take on excessive risks. What supervisors will not do is attempt to be management consultants for banks.

Difficult though the times may be, and however numerous and complex the problems may seem, it's important to keep a clear mind and a steady hand.

Having a holistic and encompassing understanding of the current challenges does not mean that there are broad encompassing solutions available. We will succeed only if we refrain from falling for sweeping answers that promise to solve all the issues at once. That's why it's so important to have institutes like the IEPE that enable us to get together and thoroughly discuss both the

challenges and the strategies needed to overcome them. And I am looking forward to having this conversation with you now.

If we approach and tackle our current problems one by one, we will see that any change is manageable – both in the financial and in the real world.

Thank you for your attention.