Andreas Dombret: Basel III - goal within sight

Opening speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bundesbank symposium on "Banking supervision in dialogue", Frankfurt am Main, 15 March 2017.

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1. Introduction

Ladies and gentlemen

I would like to warmly welcome you to this year's Bundesbank symposium. I am delighted that this year, too, so many of you have decided to join us at Kap Europa, where our event is once again fully subscribed.

Precisely one week ago a sensational news story was making the rounds. No, the Basel Committee didn't complete the Basel III reform package just in time for our symposium. The influence of this symposium doesn't stretch quite that far, unfortunately ...

I am taking about the sensational discovery in Egypt, where archaeologists discovered a statue of Ramses II weighing seven tonnes and towering nine metres high.

So why on earth am I telling you this? What does Ramses II have to do with Basel III? After all, my speech is supposed to be about the Basel III reform. Allow me, if you will, to keep you in suspense a little longer and reveal the answer to this question at the end of my speech.

2. Are we there yet? The current status of negotiations

Ladies and gentlemen, we are very close to concluding the Basel reforms. And the closer we get to the end, the more we turn our attention to what these reforms will mean. Many institutions are worried, not least in Germany. What will the overall package look like in the end? Will the new standards be too strict? And how can the new requirements be fulfilled?

These are all questions that are being asked, and rightly so. After all, banks and savings banks have seen extensive reforms since the financial crisis, and they are afraid that the reforms will go even further and might be too much for them to cope with. This is why the reform is also often referred to as "Basel IV" ...

But how justified are these fears? This is what I want to talk about today. Let's start off by looking at the facts. What is the status of the negotiations and what can we expect?

First of all, let's just remember that a large part of Basel III has already been fully agreed on and implemented. That said, the final parts are still missing. This concerns, in particular, the new rules on calculating risk-weighted assets, and this is what the ongoing negotiations are about. The Chairman of the Basel Committee, Governor Stefan Ingves, will give you a first-hand account of this following my speech – and I would like to express my thanks to him for this already.

We have made real progress in Basel since the end of last year. We have been able to reach a consensus in nearly all of the open points while also taking into account important concerns raised by Germany.

Take, for example, real estate loans – an important business area for banks, not only in Germany. Here, German negotiators were able to secure an agreement that regional differences will be better taken into account. After all, while more lenient standards are used in most other countries, the valuation of real estate collateral in Germany is particularly conservative. We were always of the view that these different methods should not be treated equally in the Basel standards. Anything else would distort global competition and punish those institutions that assess the risks of real estate financing with particular care.

Another example are the internal models for estimating credit risk. The Bundesbank has always objected to a too severe limitation of these models. This is because the use of models is always more risk-sensitive than the standardised approach to calculating equity capital. Here, too, we were able to drive a balanced compromise. The same applies to the measurement of operational risk and the details regarding the upper borrowing limit.

When it comes to finalising Basel III, I feel it is particularly important that – for all the constraints placed on internal models – we continue to keep an eye on risk sensitivity. Because both extremes – a risk-insensitive approach to capital backing on the one hand, and the unfettered use of internal models to measure risk on the other – have undesirable side-effects.

Ladies and gentlemen, we have every right to be quite satisfied on the whole with the current status of negotiations. But I will make no secret of the fact that a number of items are still unresolved. One of these is the proposal to introduce a new output floor, as it is known, for risk-weighted assets. This output floor would need to be applied by institutions which use internal models – that is, mainly the large institutions.

I'm giving nothing away when I say that Germany's supervisors have taken a critical view of this proposal. This output floor is designed to help curb excessive variability in the calculation of risk-weighted assets. But it needs to be calibrated carefully, because setting too high a hurdle quite simply creates the wrong incentives. After all, there are good reasons why model calculations are designed such that higher risks require more capital, and lower risks less. If this straightforward principle were undermined by an excessively high output floor, it would be to the detriment of risk sensitivity. This would give institutions less of an incentive to run their businesses in a risk-oriented manner. Incidentally, fewer than 50 banks use internal models in Germany – out of just under 1,900 institutions overall under our supervision. This means that the number of institutions affected by an output floor is relatively small, particularly important though those institutions undoubtedly are.

What is more, a robust line of defence is already in place today, in the shape of the leverage ratio, which sets additional minimum capital requirements to prevent internal models from being abused by those looking to understate the capital they need to set aside. This leverage ratio offers sound protection, and it improves on the current provisions under the European regulatory regime.

We will therefore stick to our position in negotiations that any output floor should not be too high. There is no need for that – and it would even be damaging. To put it in no uncertain terms: an excessively high output floor is out of the question as long as we're involved.

Ladies and gentlemen, as you can see, negotiations are on the right path, by and large. So what happens next?

There is a general consensus on the Basel Committee that we shall continue to work towards creating the clarity and certainty that market participants need to plan for the future. And do so as quickly as we can. I do not intend to commit to a time schedule today, not least because the United States, a major negotiating partner, is recalibrating its position. But as far as the Bundesbank is concerned, we will stay at the negotiating table and are always ready to stake out common ground. We naturally need to take into account the differences between the European and US banking systems and the fact that the new rules will need to be palatable to all the negotiating partners. These are, after all, global minimum standards we are talking about – no more and no less.

The pace of negotiations isn’t decisive, either. It’s the outcome that counts. And I believe we will have achieved a good outcome if it reduces excessive variability in the calculation of risk-weighted assets without relinquishing the principle of risk sensitivity.

3. Don’t overstate the case: effects on German institutions are limited

But success is also about the ability of banks and savings banks to absorb the impact of the reform and pass into a new world of regulation. I’ve now reached the section of my speech where even the biggest regulatory gripers will probably prick up their ears ...

Our internal impact studies show quite clearly that the future requirements from Basel are manageable for German institutions as long as we conclude the reform in its intended shape. Speaking from a German perspective, I consider it a successful outcome that a set of rules which has to take into account the idiosyncrasies of 28 countries and communities achieves such a high degree of regional balance.

What will the impact on German banks and savings banks look like, exactly? To provide a reliable answer to that question we have taken the Basel Committee’s latest figures and added a number of calculations of our own. Our scenarios thus reflect the current status of negotiations.

On balance, we do not see any material increase in risk-weighted assets, and thus in capital requirements, for the bulk of participating institutions. What this means specifically for many banks in Germany is minimal increases of less than 5% on average. We even find instances where capital requirements decline. Fears of a strong upturn in capital requirements across the entire German financial system are unfounded, in my eyes – quite the opposite, in fact. So the sense of panic observed in some quarters is no longer warranted. Let’s not beat around the bush here: it’s time critics came down from their barricades over Basel III and started to look ahead.

There is, however, one thing which I do not wish to play down: the need for action is, of course, different for each institution. Certain institutions will almost certainly be affected by the Basel proposals. Those institutions affected the most could very well be confronted with higher capital requirements, in a few exceptional cases by more than 20%. Above all, this is due to the proposed output floor. This output floor will be binding for the majority of the large German banks, although to very differing extents. However, this also means that particularly the savings banks and cooperative banks, which primarily use the standardised approach, will barely be affected and will even benefit from Basel III to a certain extent.

For those institutions that are the most heavily affected, fulfilling the Basel III requirements will undoubtedly present a challenge that should not be underestimated. Yet for them as well – and let’s remember there is just a relatively small number of such institutions – I consider the consequences of the reforms to be acceptable. Past experience teaches us that preliminary calculations tend to overestimate rather than underestimate the actual requirements. This is due, among other things, to the fact that we look at bank balance sheets as at a specific reporting date and do not take the banks’ reactions, such as restructuring operations on the asset side, into account. However, this is where I do see considerable leeway for a number of institutions. The equity ratio of German banks and savings banks has risen by more than half a percentage point to currently 16.2% since September last year, which was due primarily to the reduction in risk-weighted assets.

Furthermore, the new rules will not come into play overnight. It is planned that all institutions shall be given longer implementation deadlines to give them enough preparation time for the transition. This will extend the period in which institutions can, for example, retain profits in order to strengthen their capital base. It may also make it easier to raise fresh capital if a favourable market environment can be expected. Not least, the transitional periods also provide institutions with sufficient time to thoroughly check their business models. As the German representative in the Basel Committee, I will do everything I can to ensure that the transitional arrangements are adequate.

While some institutions will have their work cut out for them, the majority of German credit institutions will barely need to take any action. This applies, in particular, to small and medium-sized institutions. As I mentioned earlier, some of you in this room can probably even expect to see lower capital requirements in future. With a bit of luck, we will be able to create the first Basel III fan base here tonight.

4. Don't lose sight of the objective: Basel III in context

With this in mind, I would now like to steer your attention away from the immediate towards the longer-term implications of the Basel III reforms. After all, this set of rules has the demanding task of laying down global standards for the banking system – possibly for many years to come.

You will, of course, experience this first hand in a variety of different ways. Credit institutions will, after all, either be subject to additional strain or may even see some relief. And that is not an undesirable side-effect of the reform, but its main achievement. The idea behind the Basel reforms is ultimately to create incentives to encourage responsible bank governance. And the best way to do this is by means of risk weighting. These incentives do, of course, work in both directions: they make certain activities more expensive and make others more attractive. On the whole, I am convinced that all banks will benefit in future from a fairer distribution of the capital requirements within the banking sector.

Furthermore, the successful implementation of the reform package can help to further calm the markets. It will certainly pay off; last year we did, after all, see growing fears that European banks were undercapitalised, which meant that their risk premiums continued to climb.

Ladies and gentlemen, Basel III is not designed to make life difficult for you and your institutions. On the contrary: in the long term, I am convinced that that the entire banking sector will benefit from better rules.

That is why the current debate about deregulation in the United States gives me cause for concern. If the Americans do not implement the Basel III framework, we Europeans will certainly not introduce the new rules unilaterally – and the whole world will suffer the consequences. We learned this lesson from Basel II. Of course, I understand that the many regulatory changes over the last few years involve a great deal of effort and that smaller institutions, in particular, are finding them cumbersome. And I am firmly convinced that the Basel III rules do not need to be applied wholesale to small, regional banks.

That's why I am pleased to see that the debate about greater proportionality in banking regulation is gaining momentum in Europe. We should therefore take an unbiased look at whether the Basel III framework really should apply in full to all banks and savings banks in Germany, or whether a less strict approach, in the form of exemptions for smaller institutions, would make sense. By this, I mainly mean exemptions relating to operational requirements. Exemptions from capital and liquidity requirements, on the other hand, cannot and must not be made, in the future as in the past.

But that's the subject of a different debate. And that debate must not be used as a pretext to do away with Basel III. Because today's financial system is not constrained by borders, we need strict global regulatory and supervisory standards. They are crucial to ensuring global financial stability. We should bear in mind the lessons we learned from the crisis in this regard.

5. Conclusion

Ladies and gentlemen, in conclusion, allow me to revisit three points and draw a few parallels with the story of our ancient Pharaoh.

First – and this is perhaps the most important message of my speech today – if in the coming days we can reach a compromise in Basel that sufficiently addresses Germany's concerns, then German institutions will be able to deal with the implications. I mentioned earlier that we do not want to substantially increase capital requirements in Germany. On average, we are talking about small increases of under 5% in Germany. And from Germany's perspective, we are advocating for things to stay that way. For the small number of banks for which we have calculated increases of more than 20%, in some cases, the transitional arrangements will provide enough time to respond to the new requirements.

Second, the statue of Ramses is not only a work of art; it is also testament to the highest quality of craftsmanship, which is one major reason it has survived for three thousand years. Figuratively speaking, this is how we, too, must approach the Basel reform package. It's not just about developing uniform, consistent rules – risk sensitivity is another of our guiding principles. During the negotiations, we will therefore call for higher risk to go hand in hand with higher capital requirements.

Third, like the unearthing of the Ramses statue, the completion of the Basel reform package will take place in several stages. Some of these are very delicate and thus require a concerted effort from all those involved. Acceptable compromises must be made on all sides. While the final part of the Ramses statue is being carefully excavated with a crane over the next few days, we should now focus all our efforts on bringing Basel III to a successful conclusion. Although we are not under time pressure here, we are all aware of the importance of global standards and will benefit from reaching an agreement. Both supervisors and institutions need clearly defined regulation. But it goes without saying that we cannot and will not come to an agreement at any price – any compromise we make must be one we can live with.

I was – and still am – confident that we can reach a successful outcome in Basel and secure a well-rounded package of reforms that can then be used to achieve the desired effect in the banking sector. Because it is in nobody's interest for archaeologists to be unearthing unused parts of the Basel III framework three thousand years from now.

Thank you very much.