Andreas Dombret: Look ahead

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bundesbank reception as part of the Euro Finance Week 2017, Frankfurt am Main, 14 November 2017.

*   *   *

1 Welcome

Dear Professor Weber

Dear fellow members of the Bundesbank's Executive Board

Ladies and gentlemen

Welcome to the Deutsche Bundesbank's reception for the Euro Finance Week. I would like to extend a sincere welcome to this evening's guest speaker, the former Bundesbank president, Axel Weber. Dear Professor Weber, we are all delighted that you have returned to your old stomping ground today and are about to speak to us. Thank you for being here.

I also wish to thank Mr Nader Malkei, who this year, too, is doing so much to make the Euro Finance Week a success. The importance of this one-week event is demonstrated, not least, by the fact that it is celebrating its 20th anniversary this year. And speaking of anniversaries, this is the tenth time the Bundesbank is holding this reception.

We also find ourselves looking at a less auspicious anniversary, namely that of the still ongoing debate on Basel III – I spoke to you at this very occasion one year ago.

Which is why I would like today to offer an answer on where we stand right now. The short version of my answer is that, technically speaking, Basel III has been finalised: a compromise is within reach.

2 The Basel III compromise is better than its reputation

The first remark I wish to make is this. The Basel III compromise we are looking at is better than its reputation.

This is the case, not least, because of the commitment of BaFin and the Bundesbank to finding a reasonable middle path. On the Basel Committee we achieved a successful outcome at two points in the negotiations. The first was last November, with what is known as the Santiago compromise. In a departure from the original draft, the most important issues for Germany were successfully anchored in that compromise. In particular, the strict German methods for calculating real estate risks are now recognised as risk-reducing, and the degrees of freedom for those calculating risk with internal models have been preserved to a considerable extent. Compared with what was originally proposed, the capital increase for German banks has been halved – this was achieved through a tough negotiation stance on our part.

The not quite finished second round of negotiations concerns the calibration of the output floor, that is the threshold below which calculations of capital requirements using internal models are not allowed to fall. European representatives on the Basel Committee wanted to set this threshold at 70% of the simple, less risk-sensitive standardised approach, whereas the United States pushed for at least 80%. The German representatives resolutely argued in favour of maintaining risk sensitivity in regulation because this is the only way to capture an institution's actual risks and to set the right incentives, thereby discouraging excessive risk-taking. Following intensive and difficult talks, a compromise to which all 28 members of the Basel Committee can probably agree has come within our grasp.

I'll put it bluntly: a possible compromise with an output floor of 72.5% is anything but the result Germany had been hoping for. But nor would there be any justification in allowing the negotiations to founder over 2.5 percentage points; BaFin and the Bundesbank see eye-to-eye on this.

All the more as the positive effects of the reform clearly outweigh the negative ones. After all, we stand to gain an international minimum standard that will apply in more than 100 countries – one that will bolster financial stability and minimise the additional regulatory work as a result of harmonisation. This standard will help to put banks' capital base on a sound and sustainable footing and so help to restore further confidence in the banking sector.

Allow me to say a few words about the impact. We as the German supervisors consider the increase in capital requirements under Basel III for German institutions to be acceptable, even though significant increases are to be expected in individual cases. At the same time, quite a number of banks will see their capital requirements decline. When applying the calculation method under Basel, we see an increase in capital requirements for Germany's major institutions of just over ten per cent, and for the small and medium-sized institutions of just under one per cent. This puts German institutions as a whole at the middle of the pack in Europe.

What is more, an output floor at the planned level means that fundamental risk sensitivity has been preserved. With an output floor of 80%, this would have been true for only a very small number of banks.

It is now time for us to accept this compromise. And by that, I mean: for all of us to accept it. It is important for us that a déjà-vu experience is avoided. You may recall that the United States was involved in the Basel II negotiations, but did not fully implement the reforms – even though the "America first" doctrine had yet to be coined ...

I therefore appeal to all the parties concerned to keep their word and to put the compromise into effect, in full. The United States, too, must implement Basel III without qualification – every part of the reform. Which is to say including the complete revision of the trading book rules. Otherwise, the German representatives on the Basel Committee will not be able to agree to what is already a difficult compromise. I personally would welcome the idea of "putting America first" – in the context of introducing Basel III, with America leading by example and being the first country worldwide to implement Basel III first.

3 Effects have to be cushioned…

For all the attention we are devoting to Basel III, the regulatory capital and liquidity requirements are only one of many challenges that face German banks and savings banks.

Other important topics are looming on the horizon in connection with the changeover to IFRS 9 and the increase in loss-absorbing capital. I am referring here to TLAC and MREL which, combined, constitute a substantial challenge for balance sheet structure and bank management.

My take on this issue, then, is that we need to make it possible for credit institutions to fulfil the new requirements gradually in order not to overburden them in the short term.

Let me say clearly that I consider each and every one of these new requirements to be necessary. But of course the banks must also be in a position to meet the challenges they pose to the liabilities side of their balance sheets overall.

IFRS 9 will very soon – as of 1 January 2018 – be replacing IAS 39, which is still in force, as the international standard for the accounting of financial instruments. One of its core elements concerns loss allowances, which will no longer have to be recognised only for actually incurred losses, but for expected losses as well. That is an extremely tall order. A study by the ECB shows that loss allowances for expected credit losses are likely to be a major driver of the drop in the equity ratio when we switch from IAS 39 to IFRS 9. For the significant institutions examined, the average decline amounts to 0.4 percentage point, and it's even higher for their less significant peers.

Put plainly, for some institutions, these tougher accounting requirements come on top of those resulting from the Basel III reforms – even if there are bound to be some overlaps. It is precisely for this reason that I believe it makes sense to introduce the IFRS 9 requirements incrementally.

The resolvability of institutions represents yet another challenge. Following the first few resolution cases this summer, there was justifiably much talk of the lessons to be learnt from them. Indeed, these are important. However, we must not lose sight of challenges elsewhere; for, in a resolution case, there absolutely needs to be a sufficient capital buffer for a bail-in. The resolution authorities are currently in the process of setting such requirements, known as the minimum requirement for own funds and eligible liabilities (MREL), for European banks. Some banks and savings banks will have to expand their holdings of MREL liabilities in future in order to satisfy these requirements.

And clearly, this is a further challenge for integrated performance and risk management which cannot be met overnight. Institutions should therefore be given sufficient time to build up their MREL ratios. Sufficient account needs to be taken of the markets' absorptive capacity and the burden on institutions, on the one hand; on the other, we must not lose sight of the aim of building up sufficient loss-absorbing capital in a timely manner.

4 ... and make relief a possibility

Given the challenges implied by the transitional period, we supervisors must generally look for ways to ease the burden on banks and savings banks without neglecting our mission.

These are the things I advocate:

- First, that we should further strengthen the principle of proportionality in regulation and relieve small and medium-sized institutions. We already put forward specific proposals for a "small banking box" back in the spring together with the Federal Finance Ministry and BaFin.
- Second, that we ask ourselves for each ad hoc inspection whether this is actually truly necessary, or whether it can perhaps be postponed to a future date.
- Third, that the targeted review of internal models (TRIM) project under the SSM be conducted in a responsible and considered manner. We will also rigorously advocate the retention of risk sensitivity going forward.

5 Time for a regulatory break

The next assertion I wish to present to you is this. I am convinced that the current projects should be followed by a sort of regulatory break, for we will have then covered the main areas.

For you, the banks, this means that you need at the earliest possible opportunity the clearest possible target you can plan towards. After all, even if regulators are taking a break, banks and savings banks still need to continue implementing the decisions taken.

For supervisors, this means that we ought to take the time that's needed to review thoroughly the impact of the reforms. And, wherever we find gaps, duplication of work or errors, these will have to be corrected.

6 Don't look back, look ahead

A regulatory break, however, must not mean simply managing the status quo. My fourth assertion, then, is this. Don't look back, look ahead. The future challenges, as well as the opportunities, are immense.

The banking sector is already compelled to proactively address structural change. Now Brexit has come along, too. I see this as the greatest medium-term challenge facing the European economy and thus, not least, the financial sector as well.

For we also have to be prepared for a worst-case scenario – a hard Brexit – that is, the United Kingdom leaving the EU on 19 March 2019 without any transitory agreement in place. That would mean interrupting established production, service and supply chains, thus massively impairing the European division of labour and trade.

Credit institutions and all other enterprises have to be conscientious in taking provisional measures – perform a sort of internal Brexit stress test, if you will. Should a hard Brexit materialise, for instance, they will need to figure out what that means – for customer relationships, for foreign services and supervisory licences. Such a conscientious analysis then needs to be followed by equally meticulous preparations. That is the only possible protection from unexpected consequences.

What Brexit means for policymakers, in turn, is that they must create structures which reflect the new realities. This is especially the case for Frankfurt, where Brexit represents an opportunity for the city and surrounding region. The influx of many financial institutions will bring with it major economic potential; this would be amplified by the possibility of the European Banking Authority (EBA) relocating to Frankfurt am Main – something which I am in favour of because this city is excellently well-suited.

I cannot say this clearly enough: although it might not quite be five minutes to twelve yet, the minute hand is relentlessly approaching the 12, as these preparations are time-consuming and should already be well-advanced. Institutions in Frankfurt in particular should, and must, be on guard against banks from London massively "poaching" their staff.

Success will not come by itself. This means the infrastructure for the post-Brexit world needs to be strengthened – international schools are just one case in point.

Government agencies must, in addition, show proactively how competitive the German economy is. We banking supervisors, for instance, regard ourselves as a point of contact for foreign banks. We explain the requirements and help with procedures without relaxing our standards.

One thing must be unmistakably clear: relaxing regulatory standards as an instrument of regional economic policy is not an option. Competitive deregulation through tax or supervisory policy would erode the foundation of our future cooperation.

7 Conclusions

Ladies and gentlemen, following the severe financial crisis, we have succeeded in creating a new architecture for a resilient and at the same time high-performance financial system.

We should therefore not quibble about the details in what is, on the whole, a good reform compromise, even if we are not equally happy about every single detail.

To conclude, allow me to again say something of a fundamental nature. For some time now, I have been seeing a hardening of the battle lines between supervisors and the central associations of the German banking industry. Banks and savings banks criticise any new banking regulation – per se and with almost no regard for how much or how little sense it makes. Supervisors, in turn, respond to criticism from the associations by defending every new rule, often out of principle and sometimes in a broad-brush manner.

Such confrontation serves nobody, least of all our economy. Both sides need to engage in an issues-based dialogue which pursues a clear, ideology-free objective: namely rules that make the financial system more stable.

I am therefore calling on all of us to remember the things that unite us, such as a shared vision of what monetary policy is the right policy, and how a European deposit protection scheme should be designed – and how things should not be done. How banks should be resolved, in Italy or here – that is something we likewise all agree on. In fact, the list of things we see eye-to-eye on is long. Although Germany’s banking supervisors and credit institutions are in different camps, in many respects we are allies. That is why we – the German banking industry and banking supervisors – should all pull together more in future – and all at the same end of the rope.

And we must seize the moment before it is lost. This moment is the economic upswing which Germany and Europe are currently experiencing. If we want this moment to be a basis for future success and not just disappear in a puff of smoke, we have to look ahead and rise to the great challenges of the future. And this we can do best together.