Andreas Dombret: Shared challenges, different perspectives, shared solutions?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 13th High-level Meeting for the Arab Region "Banking Standards and Regulatory and Supervisory Priorities", Abu Dhabi, 14 December 2017.

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1. Shared challenges, different perspectives

Ladies and gentlemen,

Let me start by asking a question: Why are we here?

Don't worry, I won't get too philosophical. Of course, it only takes a quick glance at this meeting's programme to find the answer. We are here to talk about "Global Banking Standards and Regulatory and Supervisory Priorities".

But if you compare the economies, the financial sectors and the supervisory institutional set-ups of different countries in the Arab region, Europe or elsewhere, you realise how different they are in many respects. Yet about 150 people from 20 to 30 countries that apparently have little in common travelled all the way to Abu Dhabi for this conference.

So why are we here? The reason is that, despite all the differences between our financial sectors and supervisory set-ups, the challenges financial institutions and supervisors face are surprisingly similar. I am convinced that when faced with complex challenges – some of them familiar, others entirely new – it helps to work together and take different perspectives into account. And given that all of you travelled here for this meeting, you and I clearly share this belief.

Over the next couple of minutes I will offer you my perspective on our shared supervisory challenges. First, I want to quickly remind us all how we got here – what lessons were learned from the global financial crisis and what has been done since then. I'll also give you, of course, my own take on the finalisation of Basel III just last week in Frankfurt. And last, I will touch upon current and future challenges we face, and how I think we should tackle them.

2. Lessons learned and the post-crisis agenda

The global financial crisis that erupted in 2007 has helped us to understand – better than ever before – that markets are not always efficient.

On the contrary, financial markets have a tendency to exaggerate and so experience cyclical instability. You could say that tomorrow's downturn builds up during today's upturn, when optimistic market participants are deaf to sceptics' warnings. Financial crises, we have to acknowledge, are an inherent part of the financial system.

For regulators and supervisors this means that our work must aim to do the following: (1) make crises less likely, and (2) – given that we cannot prevent every crisis – make banks as crisis-proof as possible and feasible.

Over the last decade, we have gone to great lengths to cast these lessons learned into an improved regulatory framework. Our post-crisis reform agenda had many boxes to tick:

- increasing the quality and level of capital;
- enhancing risk capture;

- constraining leverage and excessive concentration;
- adding a macroprudential dimension to the regulatory framework;
- addressing liquidity risk;
- ensuring the resolvability of banks to allow them to fail without putting the entire system at risk.

3.The “grand finale”: Basel III

The “grand finale” of these efforts, you could say, was the finalisation of Basel III just one week ago – despite all the prophecies of doom. Large parts of the reform had already been agreed upon as early as 2010. At that point in time, the Basel framework had already made a huge leap compared to its earlier versions. And some on-lookers back then probably felt that the finalisation of the reform package was imminent.

But in the end, it took us about seven more years to finalise Basel III. Why did it take so long? In my view, the answer is twofold.

First, we had to balance multiple, intertwined goals – and we didn’t shun the details. There were plenty of open questions. Do the new rules distort risk-taking behaviour? Do they truly resolve threats – or simply shift problems? How can we level the playing field for a diverse global banking sector? And so on.

All the members of the Basel Committee knew that if we didn’t genuinely address all of these questions, we would risk seeing unintended consequences sooner or later.

So the finalisation package was about achieving a balanced overall set of rules. This required us to review every single rule with great thoroughness. And this is basically what we did in the past years until we arrived at the final result unveiled last week.

I don’t intend to bore you with the details of the reform package, so let me mention just one aspect. The most hotly debated topic around the finalisation package was its effect on minimum capital requirements. The result is that, for individual financial institutions, there will be some changes in minimum capital requirements. But at the global level, the finalisation package will not significantly increase capital requirements: we expect to see a slight increase of 0.7 percent for large institutions. This is because we did not have a mandate for tighter rules in general, but for more risk-adequate rules. And I think that, in the end, we fulfilled this mandate.

The second reason why finalisation took so long are the differences I mentioned earlier. Across the globe, you can find various kinds of financial sectors with plenty of regional disparities. Add to this different supervisory cultures and policy traditions and you have a mix of opposing views that are, by nature, difficult to reconcile.

Financial sectors differ in that some are bank-based while others are more capital market-based. They also differ in terms of how high their standards for collateralization are. Supervisory cultures differ in the emphasis they put on short- or long-term developments. And they differ in that they are more open or more sceptical towards model-based solutions.

This obviously means it takes longer to achieve a common ruleset. Tough compromises had to be found. For example, the way we combine risk modelling with standard approaches and the leverage ratio proved to be a tough issue. German authorities were strongly advocating the principle of risk sensitivity, which we saw threatened by potentially overarching limitations on internal risk modelling. For this reason, we opposed an excessively high output floor. And let me be completely honest: in this respect, the final result is not what we had advocated.

But there comes a point where it isn’t worth jeopardising an overall agreement over strongly held convictions. Even if reaching compromise sometimes hurts, there is great value to it. Other members of the committee and I were convinced that having common global rules is a crucial long-term investment in financial stability at both the global and regional level. This is what unified us.

The final agreement restricts the use of internal risk models while preserving the principle of risk sensitivity. I welcome this from a German point of view. Due to the long transitional periods, banks have plenty of time to adapt to the new regulatory framework. For German banks I can say that adaption will be a challenge but nevertheless feasible in face of their solid capital base and the long transition periods. Now it is of utmost importance that all member states of the Basel Committee implement the new framework.

We should not forget that the Basel agreements are implemented not only by the members of the committee, but by over a hundred countries worldwide. In the Arab region, for example, only Saudi Arabia is a member of the Basel Committee, but countries from the whole Arab region have adopted the Basel rules to varying degrees.

All in all, I am convinced that the effort we have put into the post-crisis reforms and the compromises we have made will pay off for all of us. They will contribute to a healthier and more sustainable global financial order.

4. No turning back

Considering the many differences between the countries involved – their economies, their financial sectors, their institutional set-ups – we have made remarkable progress over the last couple of years. But what's next?

In my view, we're not done yet. We now need to cement the reform's success. This requires two things. First, we need to take a "constructive break", in which we protect the reform from sceptics and evaluate it. Second, we need to ensure its consistent and comprehensive implementation, while at the same time acknowledging regional differences.

Let me start with that I dubbed a "constructive break". Some voices are already calling for us to turn back the regulatory clock. Take the debate about deregulation in the US, or about competitive deregulation after Brexit. Often, the argument is that capital requirements and regulation in general have become too harsh and that they prevent the financial sector from supporting the real economy.

To put it bluntly: these claims are misleading. They are exaggerated and not backed by empirical evidence. We must not repeat the mistakes made before the financial crisis and deregulate just because we think this would fuel economic growth, while in reality it actually fuels the next crisis. Empirical studies suggest that tighter capital requirements are in fact beneficial, and not just for stability reasons. For example, they reveal that higher levels of equity capital are correlated with higher lending volumes.[1]

This is why I am in favour of a regulatory break. Neither must we give in to calls for yet another wave of deregulation, nor should we tighten the screws of regulation further. There are a few notable areas where action is called for, such as the regulatory treatment of sovereign bonds. But apart from these, we should now wait and see how the new rules play out.

We should use this break to thoroughly evaluate the impact of our recent reforms, and to amend and improve them where gaps and errors are found.

In parallel, we need to focus our energy on the comprehensive and consistent implementation of the Basel rules as well as on the rigorous application of the new rules. This latter point was actually an important precondition for our approval of the agreement.

5. Challenges ahead

But I have also said that no two economies or financial sectors are alike. In that respect, Europe is different from the Arab region. Each individual European or Arab country is different from its neighbours. And each individual bank is different from its competitors.

Cooperation and shared rules can only be successful if we acknowledge these differences.

Let me give you an example. In Germany, the banking system is very diverse – in particular, there are a large number of small banks. If you compare Germany to its neighbour France, you will find that the banking sectors of the two countries are more or less of the same size in terms of total assets. But at the same time, Germany has about 1,700 credit institutions and foreign branches while France has less than 500. Germany has one global systemically important bank while France has three.

As regulators and supervisors, our task is to remain neutral towards such differences, but nevertheless to acknowledge them. Our regulation and supervision must respect them and not put a particular sector, a particular business model or a particular size at a disadvantage.

At this point, I see room to improve our current regulatory framework in Europe. More precisely, we need to strengthen the principle of proportionality in banking regulation. Right now, proportionality is a hotly debated topic in Europe, and it will be debated right here as well in just a moment.

The key issue arises when the Basel rules are – more or less – applied across the board. This is because originally they were made for large, complex, internationally active banks. As a result, the rules themselves have become extremely complex, especially with Basel III. While appropriate for the global players, the rules tend to overburden small institutions. The main problem is the compliance workload – that is, the effort associated with meeting the requirements as well as demonstrating that they've been met.

In Europe, we are currently busy fine-tuning our regulatory framework by providing some relief for small, low-risk institutions. Importantly, capital requirements will remain untouched. But we are aiming to reduce disclosure requirements, simplify reporting and exempt some institutions from recovery and resolution planning, among other things.

Proportionality is one task for the near future. But there are many more challenges for the near and for the more distant future.

For example, I expect fundamental structural changes in the global financial sector driven by digitalisation, both with respect to internal processes and distribution channels. Digital multinational companies currently active in other sectors are already exploring their opportunities in banking. Cyber-risks are on the rise. And we are only beginning to understand an entirely new set of financial risks that are driven by climate change.

My point is: these and other developments don't stop at borders, so that in many respects we share the same challenges.

6. Shared solutions: the role of cooperation

Ladies and gentlemen, I started this talk by pointing out how different our economies, financial sectors and supervisory architectures are. I consider this an extremely valuable asset. We share the challenges, but we have very different perspectives on them. If we work together and bring our different perspectives to one table, we will be able to arrive at better solutions.

To me, this is what the work of the Financial Stability Institute (FSI) is about. By promoting knowledge-sharing and cooperation, the FSI helps supervisors worldwide to keep pace with the ever-evolving challenges of our job. The Bundesbank is also playing its part. The cooperation with other supervisors and central bankers worldwide – at the Bundesbank, we call it “technical central bank cooperation” – is one of my areas of responsibility as Executive Board member.

In the fall of 2015, we signed a Memorandum of Understanding with the Arab Monetary Fund (AMF) that forms the basis of our cooperation with the Arab region. We conducted three seminars this year, and this work will continue in February next year. In fact, we have been working with the AMF since back in 2010, exchanging knowledge, experiences and ideas on issues in the triangle of monetary policy, banking supervision, and financial stability. In many cases, professional contacts have led to reliable personal relations.

It is very important to me personally that we continue and strengthen the fruitful cooperation with the AMF and worldwide.

Ladies and gentlemen, shared challenges, different perspectives, shared solutions: to me, this is also what today’s conference is about. I wish you all an insightful day, and I’m looking forward to hearing your perspectives now.