Andreas Dombret: Where do we go from here? The future of US-EU financial relations following the finalisation of Basel III

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Institute of International Bankers, Annual Washington Conference, Washington DC, 5 March 2018.

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1 Introduction

Ladies and gentlemen

Thank you for the kind introduction. It is a pleasure to be in Washington and at the IIB’s annual conference. Let me use this opportunity to give you my perspective on the future of US-EU financial relations at this well-suited moment, given that the most important post-crisis global reforms have now been finalised.

When I was going to prepare this speech, I asked myself: “What do all of us in this room have in common?” Do bankers and supervisors across the atlantic share the same convictions? Do we have the same ideas on financial policy? Honestly, I am not perfectly sure on this. So I assume there is at least one major area of common ground, and that is the uncertainty we feel with respect to how things will proceed.

Take global banking regulation – and Basel III, in particular. On the one hand, we have just finalised Basel III, the global minimum standard for international banks. On the other hand, parliaments and governments in the United States and the European Union are debating regulatory changes that seem to diverge from this global compromise. Banks remain uncertain about precisely what the regulatory future holds.

Moreover, this uncertainty does not stop at finance. The US administration’s economic policy announcements, as well as Brexit and other elections, are causing many to call into question the extent to which nations will actually coordinate their future economic policies.

This tension between the global and national level creates political uncertainty. For example, many enterprises feel insecure about the economic policies under which they will have to do business in the future. Likewise, bankers are asking how much of Basel III will be implemented in their jurisdictions and wondering about the individual paths that some countries will take.

This tension between global harmonisation and cooperation, on the one hand, and countries’ demands for individual approaches, on the other, will be one of the main fault lines – if not the crucial one – in future US-EU financial relations. Let me elaborate on this challenge.

2 What we should – and should not – expect from international harmonisation

Recent years have made us confident – perhaps a little overconfident – with respect to global harmonisation. It would be fair to assume that the global financial crisis and its aftermath played a considerable role in that respect. In the wake of the crisis, we have witnessed a resolute international response led by the world’s twenty heavyweight economies. The international community has put on a truly remarkable display of determination. While the G20 was founded quite some time before the crisis, its members’ resolve to take common action was unprecedented in the US city of Pittsburgh in 2009 and at subsequent summits. Key milestones were achieved in international banking regulation. And this will to reform continued until recently, when the new international minimum standards for banking regulation, also known as Basel III, were finalised.

The international response to the crisis was necessary to make the architecture of the global banking system both credible and acceptable to society at large.

But let's not get carried away by global thinking, and we should not fall into the trap of global harmonisation as a cure-all – by which I mean the idea that, if some global rules are good, more global rules would always be better. Instead, we have to live with the fact that, in today's world, international agreements are still made with national and regional interests in mind. And even though there are strong arguments in favour of harmonisation, we have to respect that, in some areas, there are also strong arguments against common approaches and reasons as to why countries should set their own distinct sets of rules.

A key topic nowadays is that of nations striving for greater sovereignty. In Europe, the most striking example of this was when the United Kingdom decided in a national referendum in 2016 to withdraw from the European Union. On both sides of the Atlantic, too, we have also experienced it in the form of drawn-out negotiations for trade agreements. Just think about the criticism levelled against CETA, the comprehensive Canada-EU trade deal, and TTIP, the corresponding US-EU project, which slowed these projects down or even brought them to a halt.

Proponents of greater national sovereignty have a point: sovereignty provides scope to deal with issues in a national way. A regulatory landscape that is aligned to national particularities requires, to some extent, that there are national instruments and policies on hand. Fully harmonised rules take away that leeway.

We can even observe this with respect to banking regulation. Currently, global standards that are aimed at large and internationally active banks also have an impact on small community banks. These institutions do not inherently require the same rules as international banks. On the contrary, these rules may interfere with the important role that they play in the economy. I will come back to this subject later on.

For now, my point is a general one. When thinking about the future of international relations, ignoring national political constraints does us no favours. Instead, we will need to tolerate some degree of international diversity. The first consequence is to take note of the ongoing necessity to balance national and international goals. The second consequence is to identify those instruments that serve these goals most effectively. Today – and across policy fields – we are still figuring out how this can be achieved.

But what does this mean in practice? Going beyond political speeches, redefining the balance of global cooperation and national sovereignty will be a demanding process involving many technical and political decisions, where it may make sense to opt for greater harmonisation in some cases and for greater divergence in others.

That's why we do not have a simple, universal blueprint. Let me outline some of the developments in three crucial areas of future cooperation: the breadth and depth of financial globalisation and cross-border banking, global regulatory standards, and supervisory cooperation.

3 Implementing Basel III: the limits of global regulatory standards

Let me start out with the task of balancing global regulatory banking standards and regional peculiarities.

In December of last year, the Basel Committee on Banking Supervision finalised the Basel III agreement after eight years of global cooperation to devise the complex set of rules.

As I am a strong supporter of implementing this standard in the European Union on a binding basis, I very much expect that the US authorities will take a similar view. Only if both the United

States and the European Union keep their word and implement Basel III faithfully – and in its entirety, which means including the Fundamental Review of the Trading Book – we will avoid regulatory conflict or arbitrage and be able to provide a reliable framework for international banks.

However, please note two qualifications: these are minimum standards for internationally active banks.

Since Basel standards are minimum standards, a country may decide to set stricter requirements. For example, Switzerland has a higher leverage ratio. And the United Kingdom has ring-fencing rules in place that separate a bank's vital basic functions from its riskier ones. This policy is not of the Basel Committee's making, and the United Kingdom is free to apply it in its jurisdiction.

The second qualification of the Basel III standard is that it is for internationally active banks. As a result, jurisdictions are free to apply a different set of rules to smaller, only nationally active banks that pose no threat to international financial stability. The majority of countries already have less restrictive rules in place for smaller banks in order to reduce the operational burden imposed on them. I am a strong proponent of extending this proportionality further, because the highly complex regulatory reforms introduced in the wake of the financial crisis were intended for global banks and overburden smaller, regional banks.

In sum, then, we ought to focus on truly global aspects, like regulating globally active banks, while leaving it to individual countries to carry out those tasks that they are better placed to take care of, such as regulating locally active banks.

4 The challenge of supervisory cooperation

The second area in which we will see a re-balancing of global cooperation is supervisory cooperation.

Here, like with regulation, we should reassess where a global approach is sensible, and in which cases national approaches are better suited. As a result, we are likely to see more divergence in some areas, but hopefully some more cooperation in other areas.

An example for more divergence is likely to be higher demands for licensing foreign bank branches and subsidiaries. Take, for example, the discussion about introducing an EU intermediate holding company, or IHC for short, equivalent regime. The European Union has been debating a draft law proposing the establishment of what are referred to as intermediate parent undertakings, or IPUs for short: similar to the US IHCs, foreign banks would have to bring their EU operations under a single holding company. This will most likely become law; and for good reason, because we need to have a better, consolidated understanding of what is going on in international banks doing business in Europe. What's more, we need to be able to act reliably in times of turmoil. Otherwise, we would not be able to fulfil our mandate of ensuring financial stability. But to be clear, this instrument is by no means intended to make market entry more difficult for foreign banks – and the Bundesbank will continue to advocate fair access for foreign banks.

As a result, we will move further away from the idea of serving the world from one spot with the need for only one licence. This is frustrating in a way, but it's a realistic approach.

This must, however, not come at the expense of less cooperation. The opposite is true. It's not a coincidence that my last meeting before this conference was with Randal Quarles. Trilateral cooperation – between US, UK and EU authorities – will become crucial if we are to get a full picture of what is going on at global banks. And, while this applies when times are good, it applies all the more so in times of crisis – winding up a global bank would still be a nightmare, the progress that the Financial Stability Board has made on this notwithstanding. And Brexit will contribute to a growing need for cooperation between supervisory authorities. Semi-formal supervisory colleges of internationally active banks will gain in importance when the United Kingdom leaves the European Union. This will be all the more true if and when regulatory standards diverge.

I have no blueprint for you. In a first step, I think it is vital to acknowledge that, even with some degree of divergence, we should not forget how important it is to remember the repercussions for global and national financial stability if we do not cooperate. This sometimes means that we should accept solutions that are not in our immediate interest.

This concerns, not least, the issue of protectionism. Naturally, structural change poses a daunting challenge to the industrialised world, too. However, protective tariffs are not the right answer, as they harbour the threat of countermeasures that could spiral into a trade war – one that would ultimately only produce losers and one that I give an urgent warning of. While going it alone may seem like a particularly sophisticated approach for some countries, it will ultimately turn out to be rather short-sighted. I am confident that the new German government will strengthen the rule-based, fair approach to trade policy in the European Union and globally.

5 The future of financial globalisation and cross-border banking

When looking at international banking regulation and supervisory cooperation across borders, we can see that rebalancing is still on the horizon. These instances of rebalancing should not take existing regimes to new “black or white” extremes but rather bring them to a mature state. This is what we can also see when it comes to the evolution of cross-border banking.

We have seen tremendous shifts, but I do not believe that they are bringing about the end of global finance. Let’s briefly look at some facts – two trends stand out.

First, while flows have been receding since 2007, their build-up since 2000 had been far too extreme. From the 1990s to the 2000s, they more than doubled relative to GDP; if you look at the absolute numbers, cross-border capital flows rose more than five-fold between the early 2000s and 2007. By 2016, flows had returned to their levels at the turn of the millennium. If we remember the freezing of funds during the financial crisis, and the instability that this brought about, the decline constitutes a reasonable trend of de-risking to risk-appropriate levels.

The second major trend is that the composition of global finance has changed significantly since 2007. While all types of capital flows have declined, more than half of the drop came from cross-border lending.

IMF and McKinsey analyses reveal that the decline stems mostly from a move away from overseas business and a shift away from cross-border wholesale funding by major European and some US banks. At the same time, stable capital flows, such as foreign direct investment and portfolio lending, have grown since the crisis.

Overall, we should not make too much of the drop in cross-border flows since 2007, especially in the light of the severe bubble before the crisis. Moreover, cross-border banking has become more stable in terms of not only volume but also composition since the financial crisis.

That means that firms seem to have become less reliant on the idea of a fully global market. They acknowledge that crossing national borders entails risks, and they see that overreliance on short-term wholesale financing is quite problematic.

These are not signs of a global financial recession, but rather of a maturing process.

6 Conclusion

Ladies and gentlemen,

I was born in the United States, grew up in Germany and have worked throughout Europe. I have US, German, and European citizenship.

To end the close cooperation between our two nations would necessitate a split personality on my part. But I accept that my two homes have distinct preferences and rules. That we have overcome some of these differences is a remarkable achievement, but we should not try to make everything equal when it’s not.

It is our duty to rebalance global economic policy cooperation with the demand for national sovereignty. We should value the maturing of cross-border finance at a hopefully more sustainable level and composition; we should honour the commitment made in the context of finalising Basel III while nevertheless accepting its limitations for non-international banks; and we should overcome our reservations about close supervisory coordination, as this will become more important in the future.

The future of US-EU financial relations will be more complicated. But this complication could prove beneficial – rather than leading us into an ice age, it could help our relationship mature.

Thank you for your attention.