Andreas Dombret: Challenges of regulating the financial markets in Europe and Brazil

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the FGV/IBRE, Rio de Janeiro, 5 April 2018.

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1. Introduction

Ladies and gentlemen

Thank you for your kind invitation. As always, it is a pleasure to be in Rio and to keep in touch with current developments in Brazil.

I am well aware of the hot economic and financial topics here in Brazil, such as current international developments and monetary policies with interest rates at record low levels – not to mention political developments for the upcoming elections. But I must disappoint those of you who might have expected me to talk about these issues. There is an ongoing and broad upswing across advanced economies, but in contrast to the US and its interest rate policy, the euro area is still in another phase.

Instead, I would like to share with you my view on the challenges of regulating the financial markets in Europe and Brazil. Obviously I am much more of an expert for the financial sector in Europe. For this reason, I have decided to focus on those regulatory topics in Europe that are of special interest to you in Brazil as well, namely

- the finalisation of global post-crisis regulation …
- … and the regulatory challenges to be met in a digital financial world.

2. Finalising global post-crisis regulation …

Regarding banking regulation after the global financial crisis, we reached a remarkable milestone not too long ago. In December of last year, the Basel Committee on Banking Supervision finalised Basel III – the global minimum standard that imposes limits on the risks that internationally active banks can take. The body had worked since the onset of the financial crisis to find a global solution to the problems that led to the crisis.

However, good rules are of little value if they're not implemented properly. Therefore, what counts in the end is taking the next step and mastering the implementation of Basel III. And we should not blind ourselves to the fact that we will continue to experience headwinds here: from those who go against internationally agreed policies and rules, from those who think banking and the economy would profit from a looser grip, and from those in the financial sector who claim that they've been treated unfairly and that they'll have a hard time coping with the standards.

In Europe and in Germany, some have been expressing opinions along the lines of that third argument in particular. While I can see that regulatory reforms are burdensome for the European banking sector, especially in an already burdensome environment for banking – I'm thinking here of the low overall profitability, for example, or the assembly of the banking union – those different challenges, though they happen to coincide, should not be lumped together. They do not count as arguments against robust global minimum standards.

The standards of the final Basel III package are, overall, manageable for institutions in Europe and in Germany, and even more so given the generous implementation period. For example, what is known as the output floor – a very distinctive feature of the finalisation package – will not come fully into force until 2027.

Moreover, let me stress how valuable a global compromise on banking standards is. Back in 1974, it was a German bank named Herstatt Bank, which had been engaging in forex speculation far above its risk capacity and at the expense of their international counterparties, which invoked the Basel Committee and finally led to Basel I in 1988 and Basel II in 2004. We need to keep in mind that each of these sets of rules was originally designed to level the playing field for internationally active banks across the globe. And to prevent a regulatory race to the bottom among jurisdictions.

But the global financial crisis proved beyond question that the international framework still contained major weaknesses. Banks in Europe – and, to my knowledge, across the globe – have never opposed this reasoning in general. But they must also accept that it is not a shared theory that will make global banking more reliable in the future, but a workable global compromise.

That's why I am a strong supporter of swiftly implementing the standard in the European Union to make it a binding reality. And I very much expect all the members of the Basel Committee to do likewise. We all need to focus our energy on the comprehensive and consistent implementation of the Basel rules and on their rigorous application.

Please note two important qualifications here, however.

The first qualification is that Basel standards are minimum standards. This means that countries can opt to set stricter requirements if they like. Switzerland, for instance, has a higher leverage ratio. And as many of you know, the UK has ring-fencing rules in place that separate the vital basic functions of a bank from the riskier ones. Even though this policy is not of the Basel Committee's making, the UK is of course free to apply this add-on to the Basel rules in its own jurisdiction.

The second qualification is that Basel standards are intended for, and tailored to, large, complex, and internationally active financial institutions. As a result, the rules themselves have become large and extremely complex, and Basel III is certainly no exception here. Appropriate as they are for global players, the rules tend to overburden small institutions.

To demonstrate, let me refer to the German banking landscape, because it is a case in point. In Germany there are roughly 1,700 credit institutions, several of which are "big players" and many are small institutions. Some have a balance sheet worth no more than a few hundred million euros. Some institutions have only a handful of employees. These small institutions are of course having a hard time with rules that are aimed at large and complex banks.

The main problem is the compliance workload – that is, the work involved in meeting the requirements and demonstrating that they've been met.

This is to say that the rules could act as an additional handicap for small banks that are already under pressure from many sides. Take the rapid digitalisation of banking, for example, or the low-interest-rate environment in Europe. One reaction that we are seeing in the European banking sector is continued consolidation.

As supervisors, it cannot be in our interest to overburden smaller institutions with rules that were designed for their larger peers. This would effectively give an advantage to larger financial institutions and intensify the pressure to consolidate.

The argument becomes even stronger as some requirements developed for large international banks have proved ineffective for small credit institutions, simply because these enterprises are less complex, are not active in comparable business fields and are thus exposed to fewer risks. During the crisis years, small institutions proved to be more robust – not least due to their simple and less risky business models.

This is why jurisdictions are free to apply a different set of rules to smaller banks which operate solely within their national market and pose no threat to international financial stability. Most countries – including Brazil – already have less restrictive rules in place for smaller banks in order to ease the operational burden on them. And I am a strong proponent of extending this proportionality further.

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

So what's the global state of play in matters of banking regulation? One major step forward – the finalisation of Basel III – has already been taken. The next, equally important step lies directly ahead of us – full implementation of these rules. During implementation, we should bear in mind that Basel standards are minimum, not maximum standards. Nevertheless, they are designed for the global players, and simpler rules are called for where small and regional institutions are concerned. Importantly, this principle of proportionality must not be mistaken for a loophole that allows lax implementation or even deregulation.

3. … and setting the route for digitalisation

Ladies and gentlemen

As regards the road towards a more resilient global financial system after the financial crisis, we're in the driving seat – and what's more, we also know the general direction in which we're headed. But where digitalisation is concerned, this is not the case: we still cannot know for certain where the digitalisation of the financial sector will lead us, even though we are currently right in the middle of it. And for those of us in the driving seat of banking regulation and supervision, this makes us feel uneasy. Let me elaborate on that.

It is not that we are unable to cope with changes and uncertainty per se. In fact, change and sectoral adjustments have been constants in the banking sector in Germany and in Europe. Market environment, customer habits and technologies in banks have been evolving constantly. In Germany today, in the middle of a low-interest-rate environment, many are adjusting their business models. Since the early 1990s, the total number of banks and savings banks in Germany has more than halved. For regulators and supervisors, those changes in the business environment mostly haven't challenged the way we work. With regard to the digitalisation of the banking sector, we should likewise not get nervous about innovations and new competitors, as they are welcome as part of a healthy market environment.

Of greater concern for us is that the digitalisation of the banking sector may possibly change the gameplay as well. Consider, for example, the speed of transformation. In a digital world, it is likely to increase. For instance, customer fluctuation is expected to rise, as competitors are available at their fingertips. Worldwide rivalry is likely to increase through online competition. Time to market has become crucial for some business, which is again likely to influence product development. All of these dynamics may well feed into the risk landscape. There are numerous consequences that are worth pondering from a stability perspective – think, for instance, of the threat of a rapid disruption of business models, or systemic operational risks.

Now I am well aware that the whole digitalisation trend has produced a host of buzzwords and metaphysical theories, some of which might never materialise. No major disruption has occurred to date. If you look at the German banking sector, there are segments such as internet payments where new market entrants have taken incumbent banks by surprise. But these developments have had limited effects outside of those segments. Also, while new market entrants initially took an aggressive approach towards incumbents, different forms of cooperation are usual today – we observe a blend of competition and cooperation as well as a widening of services. An abundance of new business ideas have turned up, from white label banking to digital ecosystem strategies. So, as a preliminary summary of digitalisation, I can say that, as of today, digital revolution fantasies have waned.

What is more, if we look at regulation, earlier narratives about the end of banks have ceased. Not long ago, the so-called fintechs were presented as opponents to classical banks. Today, some fintechs have even acquired a banking licence, meaning that they have to fulfil exactly the same requirements as other, age-old institutions.

But have we seen all that digitalisation has to offer? Not at all, if you ask me. At the present point in time, the transformation is only gaining momentum. From other sectors of the economy, we have learned time and again how digitalisation has transformed business. In the music industry, where selling individual pieces of music on demand online seemed like the end of the narrative of cut-throat competition, music streaming services suddenly appeared and quickly gained market shares. In banking, business changes and changes in customer habits are likely to reinforce each other. We simply cannot predict where this will lead us.

But regarding regulation, I guess it's fair to say that we have already learned a valuable lesson. If we want to find good regulation for a digital financial world, we cannot build it on superficial distinctions: we have to look closely at each and every case. Be it crypto currencies, robo advice or payment services – whether it constitutes a risky financial business or merely an additional service may depend on details. When advancing regulation, we should not be blinded by the catchy terminology and the innovative technologies applied, but instead look for the concrete business models.

Regulating financial business in a digital era has become a topic that engages entire continents – and rightly so. Because, simply speaking, if you create a superior algorithm once, you can distribute it across the globe and scale its use at virtually no cost. And like good business ideas, there are various threats out there that may transgress borders all too easily. That is why I'm convinced that we will benefit greatly from cross-border exchange in these matters. Today, we are already exchanging experiences and views on regulating and supervising financial technology in several international bodies, for example in the Basel Committee. I am certain that these interactions will intensify in the months and years ahead.

It's true that some countries are more reluctant than others to embrace digital finance. And interpretations of an acceptable scope in promoting innovation differ across jurisdictions.

But as with the Basel minimum standards for banks, we need to take the long-term perspective when assessing the reason for rules for the digital financial sector. Because with digital innovations, as with the traditional risks of banking, we all have to unite in ensuring that digital innovation now will not be the origin of the next crisis. This should motivate us even more to keep in touch.

Thank you very much for your attention.