Andreas Dombret: International challenges in financial regulation – the view from Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Japanese Bankers Association, Tokyo, 29 March 2018.

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1. Introduction

Ladies and gentlemen

Thank you very much for the kind introduction. On my flight here I realised that late March to early April is actually the perfect time of the year to visit Tokyo. After all, it is sakura – or cherry blossom season, which started a little early this year. I will make sure I find some spare time tomorrow to take a walk and cherish this unique natural spectacle.

I have already had some very productive meetings here in Tokyo, and I am looking forward to my discussion with you today. Thank you for the invitation, Mr Misawa.

We are here to talk about international challenges in financial regulation. To kick-start our discussion, I would like to give you my view from a European perspective.

I was asked to talk about quite a few topics, so I decided I would start at the global level in the first part of my talk and then switch to the European level. At the global level, I will talk about Basel III and its implementation. At the European level, I will focus on the European banking union and its future development.

2. Regulation at the global level: Basel III and its implementation

Let's get straight down to business. What's the global state of play in matters of banking regulation?

Not long ago, we reached a remarkable milestone. The Basel Committee on Banking Supervision – a body made up of supervisory authorities from 28 jurisdictions – worked since the onset of the financial crisis to find a global solution to the problems that brought about the crisis. In December of last year, the Committee finalised Basel III – the global minimum standard that imposes limits on the risks that internationally active banks can take.

Important and far-reaching standards like that aren't agreed upon every day – and luckily enough, many of you might be thinking. So we can rightly say that the finalisation of Basel III was a major achievement.

However, we can't rest on our laurels. Good rules have little value if they're not implemented properly. Therefore, we must now take the next step and master the implementation of Basel III.

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 Committee, including the United States and Japan, 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. Only then will we avoid regulatory conflict and arbitrage, and be able to provide a reliable framework for international banks.

Please note two important qualifications here.

The first qualification is that Basel standards are minimum standards. Therefore, countries can decide 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 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 the global players, the rules tend to overburden small institutions. The main problem is the compliance workload – that is, the work involved in meeting the requirements and demonstrating that they've been met.

Therefore, 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 this regard, the smaller financial institutions in Europe are facing much the same challenges as those in Japan. One reaction that we are seeing in the European banking sector is continued consolidation.

As supervisors, it can't 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.

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 already have less restrictive rules 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 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.

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 immediately 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 allowing lax implementation or even deregulation.

3. Regulation in Europe: building the banking union

Now that you know my take on the global state of play, let's move on to the European level.

Like in many other regions, our main focus in Europe since the onset of the financial crisis has been on improving our regulatory framework and supervisory architecture to get rid of the gaps and loopholes uncovered by the financial crisis. We did this knowing that we can never make the system entirely crisis-proof, but that we have to do all we can.

One major outcome of this process in Europe was the establishment of the European banking union. November 2014 saw the launch of the common banking supervision arrangement – the Single Supervisory Mechanism. At the beginning of 2016, it was joined by the second pillar responsible for the recovery and resolution of credit institutions – the Single Resolution Mechanism. The banking union started with a great deal of momentum, and we can say without hubris that we have built up quite a lot from scratch within a very reasonable timeframe.

However, there are still some gaps in the banking union's architecture. The banking union, and with it the euro area, requires further reform. Europe's heavy reliance on the banking sector stands out as one major reason why we need to make it more resilient still.

The most prominent proposal put forward in this context is the erection of a third pillar for the banking union, namely some form of European deposit insurance scheme – or EDIS, for short. It is a hotly debated topic these days, and rightly so. Strong deposit insurance is essential to reassure depositors and thus prevent runs and contagion. Therefore, it certainly makes sense to think about ways to shore up this backstop in Europe.

That said, you will probably be aware that the Bundesbank is one of the institutions that have been arguing against implementing EDIS prematurely. And that's not because we reject this proposal outright. The Bundesbank's position is not about blocking EDIS indefinitely. It is about sequencing the steps in the right order in order to reach the best possible solution.

And there are a number of issues which need to be addressed first. A European deposit insurance system would entail a mutualisation of liability. So before some form of European deposit insurance is introduced, we need to ensure that it is done on the basis of both more equal and significantly lower risk levels in all the countries involved.

Four initiatives are needed to reduce the threats that the balance sheets of too many euro area banks still pose:

- First, we need improvements to the Single Resolution Mechanism and an increase in bail-inable capital.
- Second, we need institutional improvements concerning national insolvency regimes.
- Third, we need a reduction in non-performing loans on bank balance sheets.
- Fourth, we need adequate regulatory treatment of sovereign exposures.

All four points on this list are important, but I would like to focus on the last two today: non-performing loans, or NPLs, and sovereign exposures.

Let's start with NPLs. Although volumes have declined overall in recent years, high NPL levels are still a matter of major concern in some EU member states. On the bright side, the average ratio of NPLs on European banks' balance sheets is about one-third down on the 2014 figure. However, there are two caveats.

First, we are coming from the very high levels in the years after the financial crisis. When we compare the current ratio with the lower pre-crisis levels, there is still a long way to go. What is more, the coverage ratio of non-performing loans at European banks has not improved significantly over the last three years.

Second, the reduction in risk we have seen so far is, to a large extent, attributable only to certain countries. For example, banks in Ireland and Spain have already made noticeable inroads into their high stocks of NPLs. In other countries, we are still looking at largely unchanged and stubbornly high ratios. In about a third of all EU countries, average NPL ratios are still in the double digits. To appreciate what this means, it is instructive to compare European NPL ratios with those in the US or Japan. Here, the NPL ratio in 2016 stood at roughly 1.5 per cent on average. So the fundamental problem – the very heterogeneous distribution of NPLs across EU member countries – remains unsolved.

Therefore, we need to make further progress on this front before we can establish a European deposit insurance system. And our efforts need to go beyond preventing risks from building up in the future. We also have to cleanse balance sheets of existing stocks of NPLs. So far, the European Central Bank and the European Commission have both only presented measures aimed at improving risk provisioning for future NPL flows.

High and heterogeneous levels of NPLs are one key impediment to taking further steps towards a common deposit insurance scheme. Another stumbling block is related to sovereign exposures on banks' balance sheets.

Due to regulatory privileges, sovereign exposures are not – or only thinly – backed by regulatory capital. Furthermore, unlike other asset classes, there is no limit to the volume of sovereign bonds a bank can hold from its home country. This has forged a close link between the solvency of countries and the solvency of their domestic banking sectors. And this link is even closer today than it was before the financial crisis in 2008.

Regulatory reforms introduced since the crisis have focused on one side of this contagion channel: Measures were introduced to reduce the risk that distress in the banking sector will spread to the public sector. Contagion in the other direction – from sovereigns to banks – has not been addressed so far. As long as this remains the case, a European deposit insurance system should not be established, since it would indirectly insure sovereign default risks.

It is thus all the more important to move forward at the European level and kick-start a paradigm shift to end the regulatory privilege that sovereign exposures enjoy there.

The sooner we get this done, the sooner we can take the next step towards a common deposit insurance system in Europe. But to reiterate once more: Risk reduction needs to come first if we want to take the steps in the right order. We should not forget that we already have a system of national deposit insurance schemes in the EU which guarantees deposits up to 100,000 Euro. So there is no reason to take hasty decisions now that we might regret in the future.

I have named four areas that we need to address: NPLs, sovereign exposures, insolvency regimes, and resolution. We will get the best results if we move forward in all four of them simultaneously. Importantly, it's not enough to announce measures to tackle these issues. What we need is implementation and verifiable success. And we are just not there yet.

4. Outlook

Ladies and gentlemen, when I arrived in Tokyo yesterday, the blossoming cherry trees weren't the only thing that caught my eye. I was also pleased to see that the construction work around Tokyo Station not far from here has been completed. I think work there has been under way for something like a decade now, during which time the district has been given a major facelift. The result is quite impressive.

In about the same stretch of time, our regulatory and supervisory architecture has also been given a major facelift of its own – both globally and in Europe. We have finalised Basel III at the global level, and we have built a banking union in Europe. The result here is quite respectable as well.

Nevertheless, neither our regulatory and supervisory architecture nor Tokyo city centre is finished for good. Here in Tokyo, the next construction sites are visible here and there, and projects for new high-rises are in the making. In the global regulatory architecture, Basel III may be finished but its implementation is not. In Europe, the banking union is on its feet but some gaps remain.

Our task for the coming years is to wrap up the job we've started – which is to further improve financial stability and provide certainty for financial institutions.

Now I am looking forward to our discussion.