Joachim Wuermeling: What will pass, what will still be around, and what will come? The prospects for Germany’s banking sector

Speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the Bundesbank symposium "Banking supervision in dialogue", Frankfurt am Main, 19 March 2019.

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1 Look to the future

Ladies and gentlemen,

I, too, would like to warmly welcome you all to this year’s Bundesbank banking symposium. Today is a premiere for me, since it is the first time that I have the honour of hosting this event.

I would like to use this opportunity to tell you what I see, in my capacity as a banking supervisor, and what the Bundesbank sees as the key challenges facing Germany’s banking sector at the moment and in the medium term. Although acute problems tend to keep us busy on a day-to-day basis, I mainly want to identify prospects with you here today. Let me put the question like this: imagine we meet here again in five years’ time – which of today’s challenges will still be on our agenda?

Looking more to the future makes particular sense in 2019, because what we are currently experiencing is a turning point. The focus over the past decade has primarily been on learning the regulatory and supervisory lessons from the financial crisis. Now this ambitious set of reforms is largely drawing to a conclusion, in the shape of the European banking package and the implementation of the final piece of Basel III. It will admittedly take a few more years to put everything into practice, but there is not much more in the pipeline for the time being. That’s why, for me, 2019 is also a year for staking out new topics – or, to use business-speak, for “agenda-setting”.

And that is why I feel we now need to look more at issues which will shape the future – such as structural change in financial markets, digital transformation and the evolution of the economic and political setting for you and for us.

I would therefore like to organise my introduction in three sections.

- First, what will pass? These are the topics which are still very important today, but will probably be a thing of the past in five years’ time.
- Second, what will still be around? These are the issues which we are still some way from overcoming.
- And third, what will come? These are the topics I expect to grow in importance and to occupy us even more than they do today.

2 What will pass?

Let’s kick off with the issues that will pass – that is, the topics which are keeping us busy right now, but will hopefully be yesterday’s news at the Bundesbank’s 2024 symposium. There are three areas I see here.

First, five years from now, will we still be talking about the regulatory reforms enacted in the wake of the financial crisis? I don’t think so. I’m very confident that we will have wrapped up and implemented most of the regulatory projects and grown quite accustomed to operating within the new framework.

The final pieces are just being added to the regulatory puzzle. As things stand at present, the EU's banking package will be signed off before the elections to the European Parliament in May, thus implementing the components of the 2010 Basel III package. The leverage ratio and the net stable funding ratio, or NSFR, will be established as binding minimum requirements going forward. Another initiative which is in the process of being implemented is the Basel Committee's new rules for market risk – the Fundamental Review of the Trading Book (FRTB).

The total loss-absorbing capacity provisions incorporated into the banking package will provide tailwinds for derisking in the banking union. This doesn't mean that risk reduction has been concluded yet, of course. But it makes me optimistic that the remaining risks are also being addressed with the determination and commitment they deserve in Europe's banking union.

However, this leaves one fairly major item for the Bundesbank which we likewise need to wrap up over the coming years. I'm talking about the important subject of proportionality – that is, the matter of easing overly severe operational burdens for small, non-complex institutions.

This is an area in which we have succeeded over the past two years to forge a common understanding at the European level. For instance, the banking package now includes a definition of "small, non-complex institutions" – these are institutions with total assets of €5 billion or less which also satisfy a number of qualitative criteria.

That means we have successfully addressed the basic issue of the regulatory importance of proportionality and its implementation. The foundations have been laid for easing the burden on institutions precisely in areas where the administrative effort is disproportionate to the supervisory gains.

The second topic which is on the finishing straight is implementation of the package finalising Basel III in Europe, which has been agreed for the beginning of 2022. So the end of the "Basel marathon" is within our sights.

A comprehensive impact study is under way. Thank you to all the institutions which participated in this arduous exercise. The investment will pay off. You see, the new Commission that will be assembled after the European elections will table a draft bill based on the findings from this impact study.

But if we really want to put this reform agenda to bed once and for all, we will have to implement all the global agreements, without exception. Two thoughts spring to mind here. First, this opportunity to strengthen banking sector resilience is one we should not squander. Second, by unrestrictedly implementing the Basel standards (which are, of course, non-binding in legal terms) we need to rule out for ourselves any pretext which allows others to deviate from the rules. Otherwise, a project that has been achieved with a great deal of time and effort – and is unique in terms of global economic regulation – will be at stake. Particularly in light of the dangers to multilateralism, we need to be committed advocates of global standard-setting – in our own interests and for the common good – including in the way we put these standards into practice.

I'll be the first to concede that for some institutions, these reforms will put more work on their plates. Just take the output floor, which is having a clear impact on a number of larger institutions running riskier business models. That said, the necessary adjustments are doable, and they're warranted, too, in light of these institutions' risk profiles.

And for many institutions, the additional capital requirements introduced by the reforms are in any case on the low side – for smaller and medium-sized banks they come to 5.7% on average. Some institutions will even see their capital requirements decline.

Let's turn to the third topic that will pass. In all likelihood, the United Kingdom will, at least in five years' time, no longer be a member of the European Union; and London – this is something I

firmly believe, unlike others – will no longer perform the role it plays today for the EU as a financial centre.

On the continent, credit institutions and other financial agents will have expanded their operations and interconnected their activities to such an extent that they will be taking on essential functions currently performed out of the City – from wholesale banking to clearing operations. You will need to be ready for this.

The new capabilities and the new agents will drive another wave of structural change in markets and competition in the German financial markets, above all here in Frankfurt. That's something you will need to prepare for.

The transition won't be easy – but as a financial market we're better prepared than other sectors. You, just like the legislators in Berlin, Brussels and Strasbourg, and we, the European and national supervisors, have seen to that. Five years from now, we will hopefully no longer be tearing our hair out over short-term transitional problems.

3 What's here to stay?

Ladies and gentlemen, in my view, three major issues will still be with us five years hence:

- Robust earnings in competitive markets;
- Consolidation and cooperation;
- Digital financial technology (fintech).

Let's begin with earnings. Fierce competition in Germany's banking sector combined with slim margins have been a perennial topic for many years now – particularly given the low interest rates. And things are not going to change in a hurry. That, too, is something you will need to prepare for.

Let me be totally frank here: your business model also needs to function when interest rates are low. Judging by your 2018 balance sheets, I can see that many of you, though not all, have been diligently doing your homework.

You can expect monetary policy – which came under intense fire again recently due to the repercussions for banks – to remain geared exclusively to the goal of price stability. Forgive me for saying it, but you cannot expect policymakers to take account of the earnings prospects of certain economic agents, even if we do see the side effects, of course.

Altogether, though, there's no reason to constantly speak ill of Germany's banking market. The institutions are robust, their portfolios are solid, and they are well capitalised. Or, as "The Banker" wrote recently, Germany's market is characterised by "liquidity strength [and] strong asset and funding structures".

These qualities make us the envy of others, and that's something we can even be a little proud of. As a supervisor, let me say that as long as enough capital can be built up, earnings aren't everything.

If I may say so as a Bundesbanker taking a bird's eye view, diversity – and thus the fierce competition – provides rich rewards for the economy as a whole, even if it is making life difficult for you. "The three-pillar system has served the country pretty well," is how "The Economist" recently summarised Germany's situation.

It is thanks to you that the supply of credit and other bank products and services to the real economy has run smoothly ever since the upswing started in 2009. To put an even finer point on it, you could say that although Germany's banking sector gets funny looks in some quarters, it

has been a veritable godsend for the country's economy.

But still, profitability remains a perennial challenge. Not every institution has sound earnings potential – and this needs to be improved. No one should pretend they can't challenge key aspects of their business model.

And that's why consolidation – which is my second point in this section – will also remain on the agenda. Mergers can be a powerful tool for absorbing hefty administrative expenses. And they have been deployed, frequently, for decades now. The number of credit institutions in Germany has been declining steadily since the early 1990s, dropping from nearly 4,500 in 1991 to around 1,800 today. And that number will dwindle further still. But mergers are not the only consolidation tool. Far too little attention is paid to the efficiency gains that have already been tapped in Germany by centralising individual elements of the value-added chain – and are still there to be tapped. This can be done within institutions, in groups of institutions, by forging cooperations or outsourcing operations to third parties, and even across borders.

There remain a great many opportunities for you to seize here, especially if you put innovative technologies to use. Innovative forms of collaboration among standalone institutions are often more worthwhile than mergers between traditional institutions. This is a trend which we supervisors want to support by designing our outsourcing rules accordingly.

Like other sectors of the economy, the banking sector also experiences waves of structural change. Mergers and acquisitions are one manifestation of such processes. Last year alone, 53 banks merged in Germany. Many of you will have initiated and implemented transactions of this kind and can report from your own experience on how much effort and skill is needed to produce a successful outcome. Further mergers are probably on the cards, and the options are currently the subject of intense public debate.

Owing to recent events, I feel it is important today to say that we supervisors are neutral when it comes to bank mergers. We may monitor such processes, but we certainly do not initiate them. You are aware of that, but perhaps there are some sections of the public arena which are not.

The initiatives for mergers and acquisitions and their design are matters for the management of the institutions and their owners. Supervisors only come into play when we are presented with a plan. The law states that mergers require the approval of the supervisory authorities, whose job it is to check whether the new institution satisfies the regulatory requirements now and in the future. That calls for a sound and sustainable business model. The assumptions and projections made in the business plans presented to us will therefore be subjected to thorough analysis.

As in all banking supervisory matters, you and, of course, the direct stakeholders in particular can count on our constructive and critical involvement. You see, banking supervisors can only play a constructive role if they are inquisitive and analytical – in keeping with their duty towards the institutions and society as a whole.

We have a commitment to society and the general public to preserve stability, solidity and security in the consolidation process. As in the past, this is a commitment we will also take very seriously in future mergers.

However, what mergers cannot resolve is a more deeply seated challenge facing the German banking market: the liquidity surplus. A bank needs to invest these funds it is unwilling to pay us the negative interest rate of 0.4%. Competition is therefore fierce, and it wouldn't get any easier with only half as many institutions in the marketplace.

Ladies and gentlemen,

Let me move on to my third topic, which is not digitalisation but digital transformation. Because

what lies ahead of us over the next few years is more than just a few fancy apps. We can barely grasp the sheer momentum of the digital change which will transform the world, and it's certainly impossible to overstate its impact.

Five years from now, fintech players won't be like creatures from outer space, but linked organically with traditional institutions. Furthermore, whole new dimensions look set to open up. Who today can predict the possibilities that blockchain, BigTech and changes in customer behaviour can bring?

This has a consequence which is not at all new but can blow up into something dramatic: business models not only have to be revised and updated, but sometimes have to be taken back to the drawing board. And they have to be capable of being constantly retooled.

Transformation impacts on us as well, in our function as supervisors. If you, the supervised institutions, fundamentally overhaul your business model, working methods and thus your risk profile, we need to ask ourselves whether our prudential toolkit and practices are still fit for purpose. Not to block, or slow the pace of, transformation. In fact, the opposite is true. We want to enable you to harness the opportunities offered by the innovative technologies without endangering the hard-won stability. To achieve this, we need to engage in greater dialogue so that we can better grasp what's happening in the digital world and thus respond to developments in a more purposeful manner.

4 What lies ahead?

Let us now look a bit further into the future. What concern me now are topics that are certainly well known today, but whose medium and long-term importance, I feel, will be greater than many anticipate, and will still be making smoke come out of our ears in 2024. Allow me to cite three topics from a wide range of areas.

The first topic is actually more of a textbook example, but it always tends to be brushed under the carpet when times are good: cyclical risk. A long period of strong growth and low interest rates is behind us. It doesn't take a prophet of doom to tell you: this won't last.

The problem is this, though: it is precisely in times when the economy is booming that the probability of things turning sour in future is cast aside all too easily. However, there is no doubt that in these years where the economy has been “fat” and interest rates have been “lean”, vulnerabilities have been accumulating in the German financial system.

An unexpected – or unexpectedly strong – economic downturn could simultaneously expose vulnerabilities in multiple areas. Rising losses from credit defaults and heightened risk provisioning would mean falling values of assets and loan collateral. Losses would eat into banks' available capital buffers. Banks would also have to hold more capital in order to meet regulatory or market requirements. Over the short term, banks would attempt to achieve these goals by constraining lending. This could further amplify a cyclical downswing.

I'll be the first to concede that the interrelationships I've just described are “old hat” to you. Yet I still believe it's important to highlight the vulnerabilities. After all, even though the medium-term outlook for economic growth is currently not all that bad, that can change sometime. Now is therefore the time to take precautions.

It helps that banks have already built up buffers – thanks in no small part to stricter regulation. Currently, the low interest rate environment is creating competitive incentives, particularly in commercial banking and commercial real estate finance, to ease credit standards. I expect market participants, for all the investment pressure they are facing, to show a certain degree of discipline so as not to worsen the quality of their portfolios as a whole.

It is important, then, for you not to let up in your efforts to keep strengthening your buffers and thus to boost the financial system's overall immune system.

We at the Bundesbank have our eyes clearly trained on the outcome of these efforts, including where the regular review of the deployment of macroprudential buffers is concerned.

Ladies and gentlemen, when looking into the future, we should also detect entirely new sources of risk as early as possible – those that do not show up in historical data. One example I am thinking of is the risks of climate change.

Such risks were at the core of last year's symposium. The topics of green finance and sustainable finance have picked up an enormous amount of steam at all levels since then. I would particularly like to draw your attention to the report of the Network for Greening the Financial System (NGFS) group, which will be published on 17 April 2019. You might be aware that the Bundesbank is one of the NGFS's founding members. The topic is not a "flash in the pan", and now is the time for you to take it seriously.

As a risk, for one thing. For physical and transitory risk can be the source of credit risk, market risk and operational risk. To a point, this is uncharted territory, and I am aware of the difficulties relating to data and methodology. There is still a lot of knowledge and methodological expertise that needs to be collected. However, that is no excuse for putting off addressing climate risk.

For another, you should view green finance as an opportunity. It is also about acquiring market share – about who is able to meet the growing demand for sustainable financial services. Some countries are making great strides – examples I am thinking of include China and the United Kingdom. The EU needs to make sure it doesn't fall behind on this score.

That's why we expressly welcome the initiatives which Brussels has put forward here, and why the Bundesbank is an active participant in this debate. We are, however, keeping a very close eye on ensuring compliance with the principle of risk orientation. This is a test that any new regulation in the field of sustainable finance has to pass.

But another thing is clear: not every proposal floated at the European level in the past few months is fully baked and ready to be served up to the real world. For this reason, institutions and associations also need to play their part in greening Europe's financial sector.

Shaping, and taking the long view, are also at the heart of my third and last point: designing the European financial centre post-Brexit.

I am convinced that we need a European strategy to deepen and modernise the internal market for financial services. Our objective should be an interconnected European financial market which not only spurs competition internally but is also a global force to be reckoned with. I'm hoping for a financial ecosystem which is spread out over several sites and in which national, regional and local specialisation is possible, yet where actors and services are part of a single, interconnected market.

Such an internal market would be able not only to close the gaps created by London's departure: such a joint financial centre would also help keep significant financial flows under European supervision and enable us to ensure the protection of financial stability thanks to our high supervisory standards.

All these considerations on what comes beyond the capital markets union during the next European legislative period need to be priority issues which the second panel will discuss after lunch.

5 Moulding the future

Ladies and gentlemen,

Albert Einstein is credited with saying that “I’m more interested in the future than in the past, because the future is where I intend to live.”

A change of perspective towards the future can help us to put into perspective the numerous challenges facing banks and savings banks now. Out of the many pertinent topics, I have touched upon nine.

Some topics that are still the subject of lively debate today might be self-evident five years down the road – think of Basel III.

Other topics which are already on the agenda today will not be nearly as easy to consign to history – think of structural change and digital transformation.

And other topics, in turn, deserve even more attention than they have been getting thus far – think of climate change and the design of the European financial centre.

As Willy Brandt put it: “The best way to predict the future is to create it.” The future won’t just happen – all of us in this room can shape it if we confront it at an early stage.

I am expecting this day to provide much impetus for dealing with the future. In closing, let me say that I am looking forward to a rich and rewarding symposium and to many inspiring discussions here in the auditorium and outside in the lobby about how, through common action and joint dialogue, we can shape the future of banking and finance in a way that benefits everyone here and in the wider community.