Q&A

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How to face multiple challenges at the same time

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WHAT ARE THE RISKS POSED BY THE SIGNIFICANT INCREASE IN PUBLIC AND PRIVATE DEBT IN SOME EU COUNTRIES TO FINANCIAL STABILITY IN EUROPE?

The situation in the EU paints a heterogeneous picture as far as public and private debt is concerned. In some of the countries severely affected by the pandemic, public and private debt was already high before the crisis. With the precipitous rise in debt over the course of the pandemic, the risks for financial stability are not decreasing and must be monitored continuously. But in most countries, the challenges have been identified and various measures to counter excessive debt are being discussed.

EUROPEAN BANKS HAVE BEEN SHOCK ABSORBERS OF THE HEALTH CRISIS. DO THEY HAVE SUFFICIENT EQUITY TO COPE WITH THE UPCOMING INCREASE OF NON-PERFORMING LOANS (NPLS) AND FINANCE THE RELAUNCH OF ECONOMIC ACTIVITY? WHICH MEASURES WOULD BE APPROPRIATE FOR DEALING WITH THIS DETERIORATING SITUATION (E.G.EQUITY/PARTICIPATING LOAN, EU OR NATIONAL "BAD BANKS", NETWORK OF NATIONAL " BAD BANKS" FINANCED CENTRALLY...)?

The results of the ECB's recent COVID-19 Vulnerability Analysis for the banks it supervises directly indicates that the eurozone's banking sector, taken as a whole, will likely be able to withstand the pandemic-induced stress. This can also be said for the less significant institutions in Germany that are directly supervised by BaFin. They, too, should be able to cope with the COVID-19 crisis as things currently stand.

But let's go back to the ECB's analysis: forecasting whether and how banks will be able to deal with the credit defaults caused by the crisis heavily depends on the underlying scenario. According to the central scenario, in which a sharp recession is assumed, there could be a decrease in the average CET1 ratio of the banks in question from 14.5% to 12.6%. This would mean that the economy would continue to have a sufficient supply of credit. As for the severe scenario, modelling a more drastic decline in economic activity, there could be a drop in the average CET1 ratio from 14.5% to just under 8.8%. On the whole, most of the banks would still be able to comply with the minimum capital requirements. This is in part the result of national and European supervisors repeatedly calling on institutions to keep enough capital in the system.

At this juncture, it is too early to engage in discussions relating to the creation of potential bad banks. What we need to do right now and what we are already doing is closely monitoring and stabilising the solvency and profitability situation of banks with the tools and flexibility available.

WHAT FURTHER PROGRESS IN THE BANKING UNION FRAMEWORK WOULD OVERCOME THE FRAGMENTATION OF THE EU BANKING SECTOR, ADDRESS THE INCREASED SOVEREIGN BANK-LOOP AND THE ROOT CAUSES OF RING-FENCING PRACTICES, REMOVE THE OBSTACLES FOR NON-VIABLE BANKS TO EXIT AND FOSTER CONSOLIDATION IN THE EURO AREA?

Further improving and expanding the EU's resolution and liquidation toolkit is currently very important for the banking union. We need further harmonisation here – and we must broaden this toolkit so that we can use it for medium-sized institutions, too. The Federal Ministry of Finance and BaFin are actively involved in discussions.

We could also consider EDIS in relation to a reform of the resolution and insolvency regime – and less as a stand-alone solution as in recent years. And as we have stressed many times, we also need to place negotiations on EDIS into the context of actually further reducing risk in the European banking sector. Germany's Finance Minister addressed this topic in November 2019 to reignite the debate.

In addition, things haven't really moved forward as regards the regulatory treatment of sovereign exposures. Work in the Basel Committee on Banking Supervision and at EU level – which was practically inconclusive – has been put on the back burner. There are profound differences of opinion internationally, but we should make every effort to break the sovereign-bank nexus.

The ECB has addressed consolidation in its "Guide on the supervisory approach to consolidation in the banking sector", which I very much welcome. The ECB's guide shows that it is not seeking to punish credible and sustainable consolidation projects based on a plausible business model by imposing higher capital requirements. It is key that the ECB sets high standards: e.g. such projects must meet strict requirements in the areas of governance and risk management. Only then can further consolidation help banks achieve economies of scale and make them more efficient and robust. We all know that two ugly ducklings do not automatically turn into a beautiful swan. On the other hand, the ECB's guide makes clear that, in principle, we accept the concept of badwill and will not burden M&A activities with overly strict supervisory requirements. But ultimately – and this should be very clear – it is not supervisors but market participants who need to decide on the benefit of M&As.

WHAT ARE THE KEY PRIORITIES OF THE CMU INITIATIVE GOING FORWARD AND WHAT ARE THE MAIN FACTORS OF SUCCESS?

The stock market capitalisation-to-GDP ratio alone shows how significant the need for action is. It is still much higher in the UK and the US than in the EU. In Germany, it is roughly 50%; in the UK, it is about twice as high. In the US, it is even three times higher. Brexit has put even more pressure on the EU 27 to remain competitive internationally. The pandemic has made this even more necessary – despite extensive state aid.

I expect considerable impetus for the development of the CMU to come from a roadmap that the European Commission intends to release in the autumn. The road map is likely to address parts of the proposals that an expert group commissioned by the European Commission presented in mid-June.

The group has shown what is important now: building a truly integrated CMU, creating a more vibrant and competitive business environment and more efficient market infrastructure and making the capital market accessible for retail investors, too. More transparency and more homogeneity in the area of regulation is needed here – not just for financial supervisory purposes. Germany will promote this approach during its presidency of the Council of the European Union.

Here, I believe it is key that we seek more "U" – i.e. more of a union or – to be more specific – more uniformity for Europe's markets. But we also need more "M" – in other words: larger and deeper markets. We still have a buy-side that is far too weakly developed compared to other capital markets in the world; and we are still lacking a genuinely European investor structure. That applies in particular to the heavyweight EU countries of Germany and France.

I believe that the development of funded pensions is an ideal starting point to counter this. I am therefore pleased that the expert group has dedicated an entire chapter to this aspect. The group has made various proposals, including the establishment of a pan-European dashboard that should help increase transparency. This is a step in the right direction but it still needs to be supplemented with additional European and national initiatives. Some of the proposals to strengthen occupational pension schemes come to mind here; a topic which legislators, for instance in Germany, have already been discussing for a while.

IS AI LIKELY TO BE A "GAME CHANGER" IN THE FINANCIAL SECTOR OR IS IT A SOURCE OF OPTIMISATION AMONG OTHERS? WHAT ARE THE MAIN POLICY PRIORITIES FOR ENSURING AN APPROPRIATE DEVELOPMENT OF AI IN THE FINANCIAL SECTOR AND WHICH CHALLENGES DOES AI RAISE IN TERMS OF SUPERVISION?

Beyond the possibilities of mere automation, AI is definitely a game changer. Ever-growing data volumes and ever-improving analytical possibilities support disruptive developments, whether this be new products, services or entire business models in a self-reinforcing cycle of innovation.

We are undergoing a period of radical change, prompting many new questions for both market participants and supervisors and regulators, too. One question is: who will bear responsibility for business decisions? Humans or machines? Companies will, to the extent that AI is finding its way into the financial industry, be very tempted to outsource entire processes – or even decisions – from humans to machines. But what happens if something goes wrong? How do supervisors respond when managers say: "It wasn't me, it was the algorithm"? This is something we cannot accept! The principle that humans must at least bear ultimate responsibility must be upheld at all times.

Another aspect: how long will supervisory approvals remain valid in times of AI and machine learning? For instance, to what extent can a model used to determine regulatory capital requirements via self-learning systems evolve independently before we are faced with a model change that requires a new approval? Regulators and supervisors need to be prepared for such developments and be able to set standards. AI raises many more questions, e.g. regarding consumer protection or cyber security and the explainability of highly complex solutions.

Whatever the specific issues that need to be addressed, as regulators and supervisors, it would be wise to bear in mind two key ideas: Firstly, international phenomena require international answers. Same business, same risk, same rules – this applies across the EU and ideally worldwide. Secondly, in times of ever-shorter innovation cycles, regulation and supervision should be designed in a forward-looking, technology-neutral and principle-based manner. By not spelling out everything to the last detail, we are promoting both legal certainty and innovation. ●