Andreas Dombret: The risk situation in the German financial system

Opening statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the unveiling of the Deutsche Bundesbank's Financial Stability Review, Frankfurt am Main, 25 November 2014.

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1. Introduction

Ladies and Gentlemen

I am delighted to present the 2014 Financial Stability Review, which I am doing for the first time together with Deputy President Professor Buch. This press conference also marks a personal first for me, as, in this context, it is my first in my new role as the Executive Board member responsible for banking supervision. In addition to my previous experience in the private sector, my move from the field of financial stability to banking supervision in May 2014 means that I can see things from many different perspectives – something for which I am thankful.

And we have another premiere: this is the first Financial Stability Review to be published since the Single Supervisory Mechanism (SSM) was launched. Under the new European supervisory structure, the ECB assumed direct supervision of the 120 most significant euro-area banks on 4 November.

Ms Buch has already discussed many important aspects of the Financial Stability Review, which I will now expand upon by taking a look at the current risk situation of the German banking sector.

2. German banks under the new supervisory structure

The comprehensive assessment began just one year ago. This involved subjecting the major German institutions to closer scrutiny and testing their ability to withstand stress in a crisis situation. The objective was to create transparency and to detect any legacy problems and capital shortfalls. Elke König, President of BaFin, and I gave a detailed account of the results back at the end of October.

You will recall that 24 of the 25 German institutions that participated in the comprehensive assessment passed, with the only bank to fail having already closed the capital shortfall identified in the comprehensive assessment.

From a German perspective, we can therefore state that the ECB's prelude to the SSM in the form of the comprehensive assessment was an overall success. Much the same as a play or an opera, however, it takes more than one successful overture to secure a bank's long-term success.

Therefore, banks cannot afford to rest on their laurels based on this positive outcome, as several banks barely cleared the 5.5% capital hurdle in the stress test's adverse scenario.

Furthermore, five German banks would not have passed the stress test if it had been based on full implementation of the Basel III rules, which will apply from 2018 onwards. What this shows not least is: German banks cannot afford to stand still.

Last but not least, Germany also has a some catching-up to do with regard to the leverage ratio. Although this non-risk-weighted capital ratio has improved in recent months – 20 of the German banks that participated in the comprehensive assessment are already compliant with the 3% leverage ratio figure, which will be in effect from 2018 onwards – German banks are still performing relatively poorly by international standards.

3. Low-interest-rate environment and weak earnings: the situation of Germany's banks

Let us now analyse the current situation of the German banking sector.

In addition to a high level of resilience – as confirmed by the comprehensive assessment – banks also need, not least, to be successful in terms of sustainable profitability in order to be able to hold their own in the market in the long run.

So what can we ascertain from banks' earnings situation? Let us take a look at something of vital importance to German banks: interest income. This continues to be characterised by the ongoing phase of low interest rates.

German banks' business models rely strongly on interest income, relatively speaking. When interest rates are low, this naturally puts pressure on earnings. For instance, in the first half of this year, the operating income of 11 German banks with an international focus was roughly 8% down year-on-year. This decline was largely driven by falling net interest income and a drop in net trading income.

Viewed in relation to the German banking system as a whole, the impact of low interest rates currently remains limited. Savings banks and credit cooperatives, in particular, managed to bolster net interest income by increasing lending business volumes.

However, if interest rates remain at current levels for the foreseeable future, the pressure on earnings will intensify further: maturing higher-yielding loans would then have to be rolled over into lower-yielding loans. As it is almost impossible to lower deposit rates any further in many cases, it could be worth considering expanding lending business to counter the fall in net interest income. A protracted period of low interest rates, moreover, could spark a greater risk appetite among low-earning institutions, in particular.

Furthermore, a cross-sectional analysis of German institutions reveals a high degree of synchronisation with regard to interest rate risk. The Bundesbank has addressed this point as part of a macro stress test conducted on small and medium-sized institutions, which simulated various paths of interest rate movement.

An abrupt interest rate increase and a flattening of the yield curve are the scenarios which would weigh most heavily on banks' net interest income. This is attributable to term transformation.

The strains caused by a rise in interest rate would particularly lead to a stability problem if other macroeconomic risks were to materialise simultaneously. Banks need to equip themselves to deal with this by ensuring they have adequate capital buffers.

Developments in this regard are positive. For instance, German banks have improved their resilience by raising new equity and retaining earnings. The visible overall drop in the Tier 1 capital ratio is attributable to the stricter regulatory requirements of CRD IV and the CRR. Since we began carrying out our Basel III impact study in 2011, the average Common Equity Tier 1 capital ratio of the largest German banks has risen to 9.3%, almost doubling.

Please allow me to outline an additional aspect of the banking system's current situation. Global regulation and European supervision are contributing to the level playing field that has been called for and which is necessary. But this also means that German banks are increasingly facing up to international comparison.

In its most recent Global Financial Stability Report, the IMF warns that, in terms of return on equity and return on total assets, German banks languish well below average in both an international and a European comparison. German banks lag far behind their foreign competitors in terms of the diversification of their earnings, in particular. Effectively, this means that the German banking sector needs to press ahead with the expansion of non-interest income as a percentage of total earnings in order to be able to hold its own when competing for clients and investors in the long run.

In the past months, banks have cleansed their balance sheets of many legacy issues and strengthened their capital base. The measures taken thus far to strengthen resilience are very much to be welcomed. However, German banks are by no means “out of the woods” yet.

So where should the focus of such efforts be placed? On the one hand, with regard to improving resilience, risk provisioning always needs to be brought into line with the prevailing economic environment. On the other, methods of further increasing capital levels, for example by retaining profits, need to be explored. German banks need to review their business models – not least given overcapacity in the banking market.

4. The Bundesbank’s role in the supervisory structure

There are perhaps some people who are wondering what the Bundesbank’s role will be in the new supervisory structure. Will it be the ECB that, together with Ms Buch, presents the banking chapter of the Financial Stability Review in future?

Take it from me, everything will remain in experienced hands in this regard. We will – naturally – lose a little bit of our influence on the 21 banks which will be supervised by the ECB in future. On the other hand, we will gain some influence among the 99 foreign banks, as the President of the Bundesbank will also have a say in decisions, even those concerning other European banks, on the ECB’s Governing Council.

Through our direct involvement in the off-site supervision of SSM banks as well as our continuing responsibility for the off-site supervision of small and medium-sized banks, the Bundesbank’s involvement in the supervision of banks will continue undiminished – in the framework of our tried and tested cooperation with BaFin.

And our cooperation with BaFin was particularly good during the comprehensive assessment, for which I would like to thank our colleagues at BaFin very much.

Although we at the Bundesbank would have wished for a somewhat different legal basis for the future division of European supervisory tasks with BaFin, we naturally repsect the compromise that has been reached and, in future, will cooperate as closely and harmoniously with BaFin as we have in the past – and the same goes for our cooperation with the ECB.

In this strong role, we will continue to deliver clear assessments of the risk situation of the German banking sector, but also, I expect, increasingly of the European banking sector as well. Today’s first Financial Stability Review following the inauguration of the SSM is therefore certainly anything but a curtain call.

Thank you.