Andreas Dombret: The savings bank sector – challenges and opportunities

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Handelsblatt Annual Conference "Future strategies for savings banks and Landesbanken", Berlin, 26 February 2015.

* * *

1. Introduction

President Fahrenschon

ladies and gentlemen

Thank you for your invitation. I am delighted to be able to speak to you again today at the Handelsblatt Annual Conference, and I hope that this year's prestigious event will be as successful as those in the past.

The title of this year's Annual Conference is "Future strategies for savings banks and Landesbanken". So let's take a brief look at what the future might hold in store and discuss the key challenges that lie ahead for the savings bank sector.

Do you know Swimmy, a parable by the author and illustrator Leo Lionni? It's a story about a shoal of red fish swimming together through the vast and wide ocean. Now, I can't say for sure if the shade of red is HKS 13 – the business colour famously associated with savings banks – but I can nonetheless make out a number of clear parallels to the savings bank sector.

Leo Lionni's parable tells us that the fish can only overcome the many dangers and challenges they face on their journey through the ocean if they stick together as a shoal. It also shows us that each fish has a role to play within the shoal.

And equally, it's fair to say that the "shoal of savings banks" has navigated the choppy waters of the financial crisis pretty well – aided not least by the savings banks association's compartmentalised structure. Germany's savings banks are generally highly trusted institutions, not least on account of their strong commitment to their local area and their close, often long-term customer relations. However, some savings banks have most certainly fared better than others, and the same can indeed be said for the Landesbanken.

And in the wake of the financial and sovereign debt crisis, new challenges are already looming on the horizon for the savings bank sector, and I would like, if I may, to discuss the two most pressing issues. The first concerns the outside world – the ocean in which the shoal of fish is swimming, if you will. The other is about the internal make-up – that is to say, the structure of the shoal.

2. Impact of the low-interest-rate environment

Let us start off by looking at the ocean. The German economy is in good shape. Or, to stay with the metaphor, the economic waters are pretty calm. Enterprises in Germany have their costs under control, their debt is not particularly high, and they have an attractive range of products to offer the global markets. Moreover, German economic activity is being bolstered by consumption – unemployment is low, households are not burdened by excessive debt and real wages are rising appreciably owing to low inflation.

In the Bundesbank's December projection, we forecast that Germany's real gross domestic product would rise by 1.0% this year and 1.6% next year. However, the price of oil has continued to plummet since we prepared that forecast. If oil prices persist at their current low levels, economic growth could prove to be markedly higher this year and next. Because at the end of the day, the low oil price has the effect of a small stimulus package. So projections such as the one prepared by the European Commission which suggests that Germany's economy will expand at a rate of 1.5% in 2015 are probably pretty close to the mark.

Economic activity will naturally also be buoyed by the highly accommodative monetary policy – we are, after all, in a persistent spell of low interest rates. There's no denying that the low interest rates are very annoying for savers and a major burden for banks. And the savings banks are no exception – so in spite of the upbeat economic backdrop, the shoal of fish finds itself in rather shallow waters.

But there's one thing we need to be aware of – the task of monetary policy is to set the policy rate such that equilibrium is restored in the economy and the objective of price stability is achieved. Where exactly that point of equilibrium lies is determined not by the central bank, however, but by politicians.

At the end of the day, it is politicians who set the ground rules that determine the economy's fortunes – in their fiscal and labour market policies, say, but also in competition policy or investment in education and research. All these factors impact on economic growth and on real earnings, too, which are the source of savings.

Ultimately, the status quo mainly indicates that in a low-interest-rate setting, a savings culture which is built around savings accounts will sooner or later reach its limits. It becomes apparent that investors can benefit from diversifying their savings through greater capital market exposure – I assume that the savings banks are advising their customers accordingly.

And as for monetary policy, you can take my word that the Bundesbank, as a member of the Eurosystem, will push for interest rate hikes and an exit from the non-standard monetary policy measures as soon as the objective of price stability makes this necessary.

But that point in time is still some way off. In fact, we will have to get used to the idea that low interest rates will be with us for a while yet, or, to use the ECB Governing Council's exact words, for an "extended period of time". What's more, the extensive government bond-buying programme will be kicking off shortly, putting more pressure on the German yield curve – that will present quite a challenge for domestic institutions engaged in maturity transformation.

So the big question facing savings banks and other credit institutions right now is how they can overcome the challenge posed by low interest rates, and how they intend to go about it. I would urge you to take a sober view of the interest rate situation – not with a sense of anxiety, just realistically.

It's obvious that net interest income will generally continue to diminish – the Bundesbank's analyses and projections point quite clearly in that direction, and all of you here today know that just as well as I do, if not better. While it is true that the vast majority of savings banks are comfortably capitalised and their internal capital adequacy is sound, some of them have aligned their business strategies with the prospect of interest rates climbing again relatively quickly. So I would urge you not to think purely in terms of where you stand right now, which for many of you may still appear comfortable. A strategy can't be to live off ever-diminishing resources – even if the savings banks' resources can see them through a spell of low interest rates. So I would reiterate my urgent appeal to you – consider your earnings situation realistically, from a dynamic angle.

Because there's barely any prospect of interest rates picking up again in the medium term. So the question is this – how can savings banks and other credit institutions generate a sustained flow of stable earnings under these circumstances as well?

There's no straightforward answer to that question. The answer is most certainly not to take on more and more risk in the search for yield. In the worst case, that kind of "quest for yield" can contribute to the formation of price bubbles. Looking ahead, I want to be able to count on the savings banks to run their lending business prudently and responsibly – not least in the real estate segment.

And as for the possible answer that savings banks should charge their own depositors negative interest rates – that is something which banks alone should decide at their own discretion, not banking supervisors. As supervisors, we have no intention of intruding on your decisions.

The response to the current challenges can probably be found primarily on the cost side – staff resources can be deployed even more efficiently, and operating outlay can be reduced. As a case in point, there are some savings banks which still run a relatively large branch network, and a growing number of them will probably be wondering whether that is still in keeping with customer demand, demographic change and changes in customer behaviour.

To sum up: like it or not, we will have to get used to the idea that the persistent low-interest-rate environment will take a heavy toll on savings banks' bottom line. Particularly the pressure on net interest income is likely to intensify further, pushing down savings banks' operating results.

The good news is that many savings banks do have sufficient resources to hold their own in the medium term, even amid such inclement conditions – provided they aren't hit by a huge wave of write-downs in the future.

All things considered, savings banks now need to adopt a strategic and operational stance that will guide them through these choppy waters as best they can. Incidentally, it is not just the low interest rates which are forcing credit institutions to rethink their strategic alignment – developments like the growing digitalisation of banking business also need to be considered.

3. Reforming protection schemes

Let's now turn our gaze inwards on the shoal's structure. It's clear that the structure of the savings bank sector will have to change. The reason for this is the need to comply with the requirements of the EU's new Deposit Guarantee Directive and the German Deposit Guarantee Act. These, in turn, necessitate a swift reform of the sector's institutional protection and joint liability schemes.

The new EU directive requires all credit institutions to provide their depositors with statutory deposit protection cover of €100,000 by the middle of this year. Owing to their institutional protection scheme, savings banks, Landesbanken and state building and loan associations had previously been exempted from this requirement, and thus also from mandatory membership of the statutory compensation scheme. They must therefore now adapt in order to comply with the statutory requirements, which also entails adapting their institutional protection scheme.

Incidentally, people's banks and Raiffeisen banks are required to adapt for the same reasons. However, due to their relatively centralised organisational structure, this adjustment ought to be comparatively easy.

By contrast, the decentralised organisation of the savings bank sector makes an adjustment more challenging. This has not only to do with economic and legal difficulties, but also, above all, because the savings bank sector fundamentally sees itself as a regionally-oriented grouping.

To a certain extent, savings banks must now show their true colours – and by this I mean beyond their particular shade of red. Are they a group with all the advantages of a group, and thus some centralised elements? Or are they a collection of decentralised, more or less autonomous institutions that only swim in a shoal as long as there is something in it for them?

I have to admit that I have always tended to regard savings banks as a collective. It seems to me that savings banks swim in a shoal out of conviction, which is a source of their strength – yet they have decentralised decision structures that almost border on a type of grass-roots democracy. Indeed, I have never had the impression that savings banks were a "corporation".

We, as supervisors, take a neutral position on the matter. I can assure you that we will work closely and openly with the savings bank sector on this topic. However, allow me to use this opportunity today to mention a few general points that are key to an effective institutional protection scheme.

The cornerstone of any protection scheme is that it is credible. Otherwise it will be unable to fulfil its purpose. If depositors lack faith in the scheme, this could lead to a bank run in a worst case scenario, which is the very thing that the system is supposed to prevent.

In order for a protection scheme to be credible, its members must be given the right incentives to prevent an excessive build-up of risks. A balance needs to be found here between liability and control, which is what the Bundesbank is calling for in the currency union as well.

The incentives of a protection scheme are affected by the way that contributions are decided. Ideally, members should pay contributions in line with their individual burden of risk. Risk-based contributions are, incidentally, also what the EU directive and the German implementing act require.

For a joint-liability scheme such as that operated by the savings bank sector, it is essential that the contributions made by the leading institutions in the group are commensurate with their respective risk levels. In my opinion, the system of contributions proposed by the European Banking Authority gives too much weight to covered deposits, with the result that the central institutions, which have smaller deposit levels, are not adequately taken into account.

However, incentives are not affected solely by the system of contributions. Intra-group claims – in other words the lending relationships between the individual members of the protection scheme – also play a role. It can be assumed that the savings bank sector will aim to continue treating intra-group claims on a privileged basis.

This makes perfect sense for a collective, as the redistribution of liquidity is one of its central functions. However, this provides incentives to build up high levels of reciprocal claims, above all within the collective. A balance needs to be struck here between an internal redistribution of liquidity and an excessive build-up of internal financial relations, which could be a source of stability risk.

The right incentives are therefore crucial for the stability of a protection scheme. Specifically, this means that the protection system as a whole must be able to manage risks. In this vein, the Capital Requirements Regulation requires institutional protection schemes to have centralised risk management. It is only through this centralised structure that liability and control can be brought into balance.

I do, of course, understand that it is difficult to square this type of centralised approach with the regional responsibilities and decision-making channels of the savings bank sector, and, not least, its decentralised self-conception. Nevertheless, I believe that a tenable solution can be found, and I would warmly welcome it if all group partners would commit to achieving this. A balance must be found between those who benefit from a protection scheme and those who are disadvantaged by it. However, time is of the essence, as the statutory requirements must be fulfilled by July of this year.

4. Conclusion

As the philosopher Pericles said in 500 BC, "It's not a matter of predicting the future, but of being prepared for it." And this still applies today.

I am confident that the savings bank sector is adequately preparing for the future – both in terms of the continued low-interest-rate environment and the issues of deposit protection and joint liability.

The low interest rates mean that adjustments are needed at both the strategic and the operational level. However, the compartmentalised structure of the savings bank sector has been, and continues to be, its strength. At the same time, the joint-liability scheme is an important element for the savings bank sector in bolstering the confidence of depositors. Ultimately, each savings bank benefits from the trust placed in the savings bank "brand".

In order to maintain this system, the savings bank sector must adapt to the new European requirements. The challenge here is to bridge the gap between the centrality required by the directive and the sector's decentralised structure. At its most basic level, a protection scheme of any kind must first and foremost be credible, which necessitates the right incentives being set for all members.

One thing, however, is certain: with the right structure, the shoal of savings banks will continue to be able to safely navigate shallow and choppy waters. And despite our neutrality, this is of course also important for us as supervisors. After all, we have a keen interest in savings banks having a stable earnings position and an efficient protection scheme.

On this note, I would like to thank you very much for your attention and wish you a successful and productive savings bank conference 2015!