Andreas Dombret: The situation in the German banking sector – challenges in striking a balance between weak profitability and the low-interest-rate environment

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the press conference to unveil the Deutsche Bundesbank's Financial Stability Review, Frankfurt am Main, 25 November 2015.

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1. Banking supervision: successful first year in the SSM

Ladies and gentlemen

Before I delve into the risk situation in the German banking sector, I would briefly like to look back with you on year one of European banking supervision.

On 4 November 2014, the ECB assumed direct responsibility for supervising the largest 120 or so banks in the euro area. Those included 21 German institutions, although the number has risen to 22 in the meantime. Given the sheer scale of the project and the very short time available for preparation, many were doubtful about whether European banking supervision could actually work.

My answer after one year of the Single Supervisory Mechanism (SSM) is: yes, it is working, and I am confident it will continue to meet the high expectations placed in it. Cooperation between the ECB and the national supervisors is running pretty smoothly, and we are indeed observing a gradual Europeanisation of banking supervision. So I'm satisfied with the first year of European banking supervision.

There are a few points we can improve on. These include, for instance, decision-making structures and processes. In this regard, I believe that an adequate distinction is still not being made between important processes and routine decisions; having said that, however, my comments are by no means intended to imply criticism.

Of course, European banking supervision has heralded a lot of changes, especially for the major banks. Communication with banking supervisors is increasingly taking place in English, cross-border peer comparisons between banks are growing more important, and the supervisory approach has taken on a more quantitative slant on the whole. These factors all entail more work for the banks, of course; but the banks, too, ultimately stand to benefit from improved supervision and a Europe-wide level playing field.

Looking to the future, another topic that's on the table right now is a European deposit guarantee scheme; indeed, the European Commission presented a plan only yesterday. I take quite a critical view indeed of this project because I don't believe that the groundwork has been laid for such a scheme yet.

We have a common currency and a single European banking supervision set-up. But to a large extent, it is still domestic fiscal and economic policymaking which determines the state of play in the banking system. As a case in point, corporate and personal insolvencies are still regulated very differently across Europe. Bearing this in mind, if a common deposit guarantee scheme were in place, the repercussions of flawed national policy decisions could be passed through to savers throughout the euro area.

And there is another point which needs to be considered. As long as banks continue to carry a large stock of sovereign bonds issued by their home country on their balance sheets, a common deposit guarantee scheme would mutualise the risks of sovereign debt. Ultimately, that would introduce Eurobonds through the back door.

Aside from that, the question can be raised as to whether the Single Resolution Board would really be the right institution to operate a European deposit guarantee scheme. And last but not least, regulatory proportionality needs to be maintained as well – would the burden be shared fairly among the large and small banks?

2. Banking regulation: nearly all items on the reform agenda ticked off

But let's return to the here and now. The first year of European banking supervision went very smoothly. But a functioning banking supervision set-up also needs a sound regulatory footing. From a regulatory perspective, we have now experienced seven years of reform.

Many of the items on the Basel Committee's reform agenda have been ticked off. Before we cast our minds to future regulatory projects, we should first observe the effect of the new rules – not just each one individually but how they interact with each other.

Ultimately, though, regulation and supervision are not the only challenges facing banks, nor are they the most pressing ones. Let us now consider the risk situation in the German banking sector.

3. The German banking sector: stability improved further ...

As far as German banks' resilience is concerned, we are seeing a gratifying development. German banks have further improved their resilience by raising new equity and retaining earnings.

The tier 1 capital ratio of the German banking system as a whole rose by 0.6 percentage points between June 2014 and June 2015, and currently stands at 15.6 %. Thus, the long-term trend towards strengthening their equity base progressed further in 2015. You will recall that at the beginning of 2008, the year of the global financial crisis, the tier 1 capital ratio averaged around 9.1 %.

Meanwhile, leverage has continued to decline and is likewise following a multi-year trend. By way of illustration: to fulfil the minimum leverage ratio requirement under the Basel regime, eight of the major German banks with an international focus would now have to raise a combined total of less than Euro1 billion of additional tier 1 capital. The corresponding figure at the end of 2013 was around Euro18.5 billion. So the gap has largely been closed.

4. ... but profitability still weak

In order to safeguard resilience on a sustained basis, however, banks will also need to be sustainably profitable. And this is where, in my view, German banks still have some catching-up to do – not least given the protracted spell of very low interest rates.

Let us begin by returning to the German major banks with an international focus. Measured as a percentage of total assets, these institutions have improved their operating income slightly in the past years – from 1.31 % in 2009 to 1.46 % in 2014.

The major banks' return on total assets rose last year for the third time in succession. At a mere 0.2 %, their return on total assets is still low by international standards, however. And also in terms of their return on equity – which still stands at less than 5 % – German banks still have some catching-up to do relative to the rest of the world.

Which brings us to the biggest challenge facing the German banking sector: it appears to be suffering from weak profitability. Supervisors also have a problem with this, as banks' low profitability limits their ability to retain earnings and build up equity.

Nor is the persistent spell of very low interest rates helping to remedy the German banking sector's weak profitability – quite the contrary, in fact. Particularly for credit institutions with a heavily interest-driven business model, the ongoing low-interest-rate environment could pose a serious threat in the medium to long term. The longer the low interest rate levels persist, the likelier it is that net interest income will come under pressure.

Looking to the present, however, there is some good news which expressly also applies to small and medium-sized institutions. At the moment, the effects of low interest rates on the aggregate profitability and the stability of the German banking system are still limited. All told, the operating income of all German banks rose moderately in 2014, to Euro121.5 billion, against the backdrop of declining total assets. Even aggregate net interest income in 2014, at Euro90.4 billion, was Euro4.1 billion up on the year.

And even the credit cooperatives and savings banks, which depend comparatively heavily on interest business, were able last year to increase further both operating income and net interest income. This they succeeded in doing by expanding credit business on the asset side of the balance sheet and by shifting financing on the liability side to transferable deposits bearing a lower rate of interest.

Yet both measures could easily lead to risks for the financial system. With regard to credit business, we do not currently see the savings banks and credit cooperatives loosening their lending standards, which would engender greater risk. Nevertheless, banks' interest rate risk has increased significantly because loan maturities were expanded at the same time as lending was increased. We have seen the so-called Basel coefficient, which is a measure of a bank's interest rate risk, rise almost continuously since 2011.

With regard to German banks, I see three dangers. First, the currently good net measurement gains and losses could return to more normal levels if the economy falters. Second, banks could be forced to correct their optimistic projections of administrative spending. Third, plans to increase net fee and commission income could prove unfeasible. These three things could additionally weigh on the net profits of all banks and savings banks.

And of course no look at the future would be complete without a stress test. To avoid any confusion, let my begin by saying that we calculated this stress test for our Financial Stability Review (FSR) on the basis of figures available to us; the banks themselves were not involved. It is therefore not to be compared with the stress test carried out in 2014 as part of the comprehensive assessment, nor is it to be compared with the pan-European stress test which the European Banking Authority (EBA) will carry out in 2016. In addition, a number of aspects were not taken into consideration in our FSR stress test – banks' liquidity risks and negative feedback loops between the banking sector and the real economy, to name but two.

However, this "small" stress test, too, produced a couple of interesting findings. We analysed how the simultaneous occurrence of various macroeconomic shocks over the next three years might affect the German banking system. To this end, we assumed a sudden rise in short-term interest rates and a sharp fall in stock prices, the real economy and real estate prices: all things considered, an exceedingly severe scenario.

As far as German institutions' profits are concerned, this extreme scenario would have a considerable impact. Pre-tax results would fall into negative territory for almost half of the small and medium-sized banks. The average annual profit of the small and medium-sized institutions would drop by 91 % at its most extreme. The big banks would be affected, too: in particular, they would suffer losses in their trading business and need to increase risk provisioning in their lending business. Owing to good capitalisation, however, none of the large institutions would run into difficulties. In light of the extreme scenario, that's a gratifying outcome for the stability of Germany's banking sector.

5. Conclusion

Ladies and gentlemen, allow me to conclude by reiterating the four main points of my speech.

> First, the first year of European banking supervision went smoothly. Of course there are still a few things that we can improve upon, but we're working on them.

Second, many of the items on the Basel Committee's reform agenda have been ticked off, and the entire list is expected to be finished by the end of next year. The Bundesbank is committed to regulatory certainty, since it enables banks to plan for the long term on a robust basis.

Third, German banks have further increased their stability – capital ratios have continued to climb; leveraging is down further.

Fourth, German banks are suffering from persistent low earnings. Although the low-interest-rate environment is not yet making itself felt in this regard, looking to the medium to long-term future, however, small and medium-sized institutions in particular look set to feel the pinch.

Ladies and gentlemen, Germany's banking sector has become much more stable since the crisis, but some major challenges still need to be tackled – the low-interest-rate environment and weak earnings, to name but two. These are challenges that banks must overcome in order to assure their stability and profitability.

Thank you very much.