Andreas Dombret: The challenges currently facing the German banking sector

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the annual reception of the Regional Office in Bremen, Lower Saxony and Saxony-Anhalt, Hanover, 6 March 2017.

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1. Introduction

Ladies and gentlemen

Mr von Stenglin

As well as the chance to eat, drink and be merry, a reception such as this is always a good opportunity to take stock of events and to look ahead at what the future might hold. Today, I would like to do just that, with a specific focus on the German banking sector.

Nine years on from the outbreak of the financial crisis, the overall economic situation in Germany is relatively positive. Activity is robust, and the German economy recorded growth of almost 2 % last year – its best performance since 2012.[1] Germany's unemployment rate has also fallen every year since 2010.

Many sectors in Germany are feeling the benefit of the economic recovery, not least the banking industry. Lending to the real economy has been back on the rise since 2013. And in any case, German banks and savings banks weathered the crisis comparatively well, owing, among other things, to the highly diverse nature of the German banking sector. What is more, the post-crisis period has seen credit institutions strengthen their capital base and scale back the risks on their balance sheets.

Things are looking pretty rosy, you might think. But a glance at the current sentiment within the industry reveals that things most certainly are not rosy. Banks and savings banks are facing momentous challenges. The reasons for this vary from one institution to the next. But there are some challenges that affect them all in equal measure.

As I see it, three key factors are at play here.

First, the persistent low-interest-rate environment, which is bringing to light the weak profitability afflicting many German institutions.

Second, the global regulatory efforts embraced after the crisis, which still haven't been wrapped up and will force us to make substantial adjustments here in Germany, too.

And last but not least, the advance of digitalisation, which, perhaps more than any other factor, represents both a challenge and an opportunity.

These three challenges deserve particularly close attention because if institutions are to overcome them, they will have to start taking decisive action today. But to do so, they first need to get a sound grasp of the situation. So let's take a closer look at what exactly these challenges consist of.

2. Low interest rates mean additional provisioning

Let's start with the first major challenge – the low-interest-rate environment. This is felt to be a burden among credit institutions and savers alike. And the pressure is mounting by the day. The public debate surrounding this topic can be broadly summarised as follows: while banks' earnings shrivel, savers have no choice but to accept practically no interest on their savings. This view is certainly not entirely off the mark, and I think that we need to take the debate and the widely-held concerns it articulates very seriously. But in some respects, this viewpoint is overblown and not always completely accurate. Let us therefore delve deeper into the issue.

Shrinking earnings from interest business are a fundamental problem for banks and savings banks. In prolonged periods of low interest rates, maturing loans with high rates of interest are replaced with new, lower-yielding loans. To counteract a decline in interest income, banks tend to increase the average maturity of the loans they issue. But this only goes so far to remedy the malaise in the current environment because longer-term interest rates are very low, too. So to continue earning money from interest business, banks need to cut back on their interest expenditure. Until now, however, the de facto deposit rate floor for retail investors has been 0 %. This is making classic deposit business increasingly unattractive for many banks and savings banks, and for many of them it would be cheaper to raise funding in the money and capital markets.

In a recently published discussion paper, we examined the impact of a prolonged period of low interest rates on German credit institutions' interest business. Our analysis indicates that, if interest rates remain constant for the next four years, net interest income will fall by a total of 16 %[2] - a huge cut given the key importance of interest business.

You might therefore be forgiven for thinking that nothing could be better for institutions right now than a rapid return to higher interest rates. And even though that's probably right in the long term, rising interest rates create significant risks in the short and medium term.

What happens if interest rates climb sharply within a short space of time? Persistently low interest rates have driven up what is known as maturity transformation business at German banks and savings banks. The narrow spread between short and long-term interest rates means that institutions are now seeing stronger inflows of short-term deposits. If, at the same time, they originate more long-term, fixed-interest loans, they increase their exposure to the liquidity and rate interest risk accordingly.

Persistent low rates are a particular challenge for institutions whose business models are driven primarily by deposit and lending business - and there's quite simply a particularly high number of them in Germany. In 2014, German banks and savings banks derived almost three-quarters of their operating income from net interest income.[3] Smaller institutions face an extra hurdle in that they can only hedge against unexpected changes in interest rates to a very limited extent in the capital market. Thus, we have seen a clear increase in interest rate risk at savings banks and cooperative banks, in particular, since 2011.

Those of you who watched the presentation of our annual financial statements for 2016 will know that the DeutscheBundesbank, too, is readying itself to face the risk of an interest rate reversal. This was the reason why we significant increased our general risk provisions last year. Central banks use different accounting standards than banks and savings banks, of course, but they, too, need to act today and equip themselves to deal with the risks stemming from a turnaround in interest rates.

Having a sound capital base is one good way of achieving this. It is gratifying to note that German institutions have substantially increased their tier 1 capital over the last few years. We have seen the tier 1 capital ratio rise from 9.1 % in 2008 - the year that marked the start of the global financial crisis - to as much as 15.8 % in September last year. But in the face of mounting risks, banks would do well to strengthen their capital base further, by setting aside reserves from taxed profits, for instance.

It is vital for banking supervisors to keep a close eye on institutions' profitability, which is why we will again be conducting a survey on low-interest-rate and stress scenarios this year.[4]

3. New regulation - a challenge for banks and banking supervisors alike

But it is not just lower earnings and higher risks stemming from the current low-interest-rate environment that are weighing on institutions - changes in the regulatory landscape are also posing a challenge.

My colleague Sam Woods, Deputy Governor for Prudential Regulation at the Bank of England, recently described the overhaul of global regulatory standards in the wake of the financial crisis as a revolution,[5] which I think hits the nail on the head. Through the Capital Requirements Directive implemented in 2013 and the associated Regulation, we are setting new capital and liquidity standards in Europe. The most recent reforms, which implement major aspects of the Basel III framework already agreed upon, have made a major contribution to boosting the long-term stability of the European financial system.

The banking lobby never tires of saying that additional regulatory requirements put considerable pressure on their institutions. I'd like to say two things here.

First, the reforms are not an end in themselves – and they are certainly not the result of blindly taking action for the sake of it. Quite the opposite: they are necessary and consistent. Necessary because the global financial crisis cast serious doubt on the functional viability of our financial system. "Carrying on" as we were is simply not an option. And the reforms are consistent in that they specifically address the aspects that were exposed as being particular vulnerabilities by the crisis. This is why we cannot and will not water down fundamental regulatory principles and requirements.

But on the other hand, the following point is equally important in my eyes. Supervisors are keeping a very close eye on the effects that changes in regulatory requirements are having on banks and savings banks. And, indeed, we are seeing a considerable need for adjustment for many institutions, particularly in terms of their IT infrastructure. This poses a challenge for smaller institutions, in particular, as they cannot exploit economies of scale to the same extent as their larger competitors. At the same time, the staff involved in implementing regulatory tasks are being asked to meet ever higher qualitative and quantitative requirements.

To name just one example, let's take a look at a study carried out by the Federal Reserve Bank in Minneapolis on the effects of regulation on small American banks. The thrust of this study was to find out the extent to which these institutions could cope with rising personnel costs resulting from stricter regulation. The results are sobering. An additional requirement of just two full-time positions would send around 25 % of these small institutions into the red.[6] This example shows that we, as supervisors, also need to be careful that regulation does not fundamentally overwhelm any group of institutions - either in the United States or here in Germany. For one thing is very clear: a healthy system of banks and savings banks depends in part on its diversity – and this includes smaller institutions just as much as the large ones.

This is quite simply why regulatory reform is not just a challenge for the banking industry, but also for supervisors. And we supervisors should examine, where it is possible and prudent to do so, whether we can implement targeted relief measures for small banks. Regulatory proportionality is the name of the game here. It's something we already apply today in some respects, such as in the distinction between standard and model approaches. Nevertheless, we should urgently put more thought into how we can embed the principle of proportionality even more firmly in future. The development of a dedicated regulatory regime for smaller banks and savings banks is another conceivable option. And even if this is still far off, no topics should be off-limits to us at this stage.

4. Digitalisation - a challenge and an opportunity

Ladies and gentlemen, as you can see, low interest rates and new prudential standards are making life anything but easy for institutions at the moment. Of course, these repercussions ripple out into the real economy as well. And if that weren't enough, there has been a peculiar shadow lingering over the German banking landscape for many years, with no one really being able to tell if it will ultimately prove to be a blessing or a curse.

The shadow I am referring to is digitalisation. I am aware that this topic could easily fill a whole lecture series - but I wouldn't wish to impose this burden on our annual reception today. That said, there are a few key points I would like to mention.

In contrast to the other challenges I've mentioned today, digitalisation is, from the perspective of credit institutions, also an opportunity, as it provides a wealth of potential for driving down costs and tapping into new sources of income. Banks and savings banks must, nevertheless, always keep an eye on the risks presented by this brave new world.

Let's look, first of all, at the possible cost savings. These can mainly be harnessed in two ways. The first is by automating processes. Take, for example, lending and the scoring methods this requires. Automating these processes promises to drive down staffing costs substantially. The second way of cutting costs is through virtualisation. For banks and savings banks, this could mean no longer having to produce and sell services in the same place. Think of a virtual branch, for example. Thanks to net-based applications, an employee in Braunschweig can now advise customers across the whole of Germany – and, in principle, he or she can do so around the clock. Across the industry, this opens up a wealth of potential to cut material costs.

In both cases, this raises the question of whether services and the infrastructure that these require need to be provided and operated in-house, or whether these should be hived off to external providers. Even though outsourcing can deliver considerable cost advantages, it's a decision that should always be carefully considered. This is because responsibility for all processes always remains with the outsourcing institution.

What about the income side, meanwhile? Here, too, digitalisation opens up new possibilities. Virtualisation, which I have already touched upon, provides more than just cost benefits. It also allows banking services to be adapted to suit the changed expectations of customers. Customers nowadays are accustomed to banking whenever and wherever they want and expect their bank to be highly flexible. And German institutions have already responded to this. With banking apps on their smartphones, the younger generation, especially, are effectively carrying a bank branch around with them in their pockets. In other areas, too, such as wholesale banking, digitalisation has already opened up new possibilities. And it's safe to say that a lot more will change in the foreseeable future.

Nor, when it comes to developing new services, should banks shy away per se from cooperating with external service providers. Enterprises specialised in IT-based financial services, known as fintechs, are no longer seen by established institutions solely as rivals, which was their original concern. On the contrary, I think there is still considerable potential for reaping efficiency gains here. It is now a question of bringing together digital know-how and innovative power, on the one hand, and established brands and mature customer bases, on the other.

But let's not forget the risks presented by digitalisation. What happens, say, when IT systems are down for a time? If this disrupts automated processes, the losses can be substantial; for example, if payment systems come to a standstill because individual payments cannot be executed. But also because news of such incidents now travels around the world in a matter of minutes, leading to a considerable reputational risk. The same is true in the case of cybercrime, where criminals target vulnerabilities in IT infrastructure for personal gain or to inflict damage. As you can see, in the area of digitalisation, too, adequate risk provisioning is absolutely essential.

5. Tackle reforms decisively

Ladies and gentlemen, the challenges facing German banks and savings banks are not minor in nature. The persistent low-interest-rate environment is squeezing earnings, while the incomplete regulatory reforms are causing uncertainty and entail considerable costs for many institutions. Moreover, the advance of digitalisation, while promising fresh opportunities, also harbours risks. Making strategic decisions under these conditions can feel like having to lay the tracks for a train journey without knowing where the destination is.

And this is precisely where the difficulty lies, because one thing is certain: it will not be enough for German banks and savings banks to rely solely on precautionary measures. Take the low interest rates, for example. Building up additional capital buffers is necessary for cushioning short and medium-term losses, and institutions would be wise to significantly shore up these defences. But those who think that they can simply wait out the storm are mistaken. Banks and savings banks must additionally initiate fundamental reforms and pursue these decisively. This is the only way that the banking industry can overcome today's problems and also prepare for tomorrow's challenges.

The German banking industry has already taken decisive action in some areas. Many institutions carried out a thorough review of their business models after the crisis and have thus learned from their own mistakes. Banks and savings banks are also facing up to the structural challenges of a changed market environment. For example, there has been a steady reduction in branches over a period of many years now. In the case of savings banks and cooperative banks, there have also been numerous mergers. At the beginning of 2016 there were roughly 30 fewer credit institutions in Bremen, Lower Saxony and Saxony-Anhalt than ten years earlier.[7] This is a decline of 12 %. So you see, the banking industry has risen to the challenge, whether in terms of realigning business models, embracing consolidation or through other effective instruments.

6. Conclusion

Ladies and gentleman, the economic situation of the German banking industry is a topic that certainly occupies me.

Let me therefore summarise my main points, before I draw to a close. Low interest rates and a change in regulatory requirements are presenting banks and savings banks with a major challenge. The same is true of advancing digitalisation. They all harbour risks, and credit institutions need to respond appropriately. Those who place their hope in superficial reforms or mere cosmetic changes run the risk of falling by the wayside in future. Even when times get tough – and especially then – institutions must therefore stick to the reform path they have embarked upon. Their willingness to do so is not just in the interests of the individual institutions. For it is only when banks and savings banks in Germany fare well as a whole that they can fulfil their central economic function – and when they do that they ultimately serve us all.

Thank you for your attention.

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[1] Deutsche Bundesbank, Monthly Report, February 2017.

[2] Dombret, Gündüz, Rocholl (2017): "Will German banks earn their cost of capital?", Deutsche Bundesbank Discussion Paper No 01/2017.

[3] Deutsche Bundesbank, Monthly Report, September 2015.

[4] The results of the last survey, carried out in September 2015, are available online at: www.bundesbank.de/348250.

[5] "The revolution is over. Long live the revolution!", speech by Sam Woods at the City Banquet, Mansion House, London, 26 October 2016.

[6] Federal Reserve Bank of Minneapolis, Economic Policy Paper 13-3: "Quantifying the Costs of Additional Regulation on Community Banks." Quoted in The Economist (11 February 2017): "The Litter of the Law."

[7] Deutsche Bundesbank, bank office statistics 2007, 2015.