Andreas Dombret: Major challenges facing Germany's savings banks

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the retirement of Dr Rolf Gerlach from his position as President of the Westfalen-Lippe Savings Bank Association, Bochum, 31 March 2017.

* * *

1 Introduction

Finance Minister Dr Schäuble

Mr Fahrenschon

President Müller

Dr Gerlach

Ladies and gentlemen

It is more than apt that so many of us should have gathered here today in Bochum to pay tribute to Dr Gerlach as he leaves office. For my part, I intrinsically associate the city of Bochum with Herbert Grönemeyer. He even dedicated a song to the city which, among other things, he describes as "no great beauty, for work’s lined your face". Even if the song does not seem so at first glance, it is first and foremost a declaration of love for his hometown. Grönemeyer goes on to sing "You don’t like wearing make-up – you’re an honest place, […] Your heartbeat’s of metal It hammers out through the night."

Speaking for myself, I can’t help seeing some of Dr Gerlach’s traits in the lines of this song.

But I’ll come back to that later. During his time in office Dr Gerlach has always focused his attention on the substance of the matter in question. Bearing this in mind, I would like to follow his example and shall therefore begin my speech by outlining the challenges Germany’s savings banks currently face.

2 Savings banks face an array of major challenges ...

No matter where you might focus your attention as a board member of one of Germany’s savings banks, be it old or new competitors, the regulators or your institution’s cost calculations, there is pressure to act. But perhaps the greatest challenge you’re going to face lies somewhere down the road. For many of the problems that are currently the subject of intensive debate at savings bank conferences around the country will not impact in full until a later date.

I refer, in particular, to the prevailing low-interest-rate environment. Lower interest margins started to impact on savings banks back in 2016, doing so in the form of reduced interest income. At that time, these institutions were still able to counter this effect, chiefly by raising net commissions received and cutting administration costs. But the longer the current interest rate prevails, the greater the problems will become.[1]

But we need to be clear about one thing: putting an end to low interest rates will not bring relief right away. On the contrary, the quicker and higher interest rates rise, the greater the burden this will represent for those institutions that provide short-term refinancing for long-term loans. This risk, referred to in your circles as interest rate risk in the banking book, naturally also impacts on savings banks that follow their own heavily deposit-based business model. Based on the Basel interest rate shock scenario, supervisors have now taken to classifying every other savings bank as subject to heightened risk. Savings banks are thus awarded more or less the same average rating as that of German credit institutions.

This status does not, in itself, tarnish the reputation of an institution as the latter can safeguard itself by pursuing an appropriate risk management strategy and ensuring that its risk buffers are sufficiently strong. Nevertheless, it exemplifies how relevant risk is in the event of an interest rate reversal. And it justifies closer monitoring by supervisors.

For credit institutions, interest rate risk already represents a demanding balancing act. For any expansion of lending in the current interest rate environment, say to offset the lower interest margins, intensifies the negative consequences of a sudden, strong hike in interest rates.

As you can see, there are no simple answers to the challenges we face at present. Savings banks find themselves in a position that begs for balanced decisions that also think of the distant future. But there is also a positive side to all this. Entrepreneurial skills are the key factor here – indeed, they will make all the difference, going ahead. And this is where savings banks have an advantage.

Boards of directors and supervisory boards have good reason not to leave any stone turned when it comes to taking action in this challenging environment. First, of course, this means that savings banks need to actively manage and hedge their interest rate risk. Second, they need to have a stable capital base. And third, they need to strengthen their profitability in the long run. Cost-cutting measures such as streamlining their branch networks and strategically prudent consolidation are key to achieving these goals.

To avoid any misunderstanding, I should point out that nobody can reliably predict what kind of market structure will be economically appropriate for savings banks in five or ten years' time. Banking supervisors are likewise unable to foresee what the future holds for this sector and they have no clear targets or target ratios in mind. That said, at this juncture, I see no indication of current trends coming to an abrupt halt or even undergoing a reversal. German savings banks and credit institutions have been scaling back their operations since the early 1990s. No fewer than 9,000 savings bank branches have been shut down and the number of institutions has almost halved. Given today's challenging environment, it is fair to assume that, in some cases, consolidation might still be the soundest response in economic terms.

3 ... and need a functioning administrative board

Ladies and gentlemen, there is no doubt that Germany's savings banks are facing some major challenges. And if these challenges are to be met, qualified staff will be needed at all levels. Clearly, this includes the supervisory bodies, in other words the administrative boards, in the case of savings banks.

As you will probably have noticed, in recent weeks, this issue has been the subject of increased debate in the press. This debate was prompted by the current draft proposal for a European Banking Authority (EBA)[2] guideline as well as a corresponding ECB guideline[3]. Both papers contain requirements applying to the members of supervisory bodies in financial institutions and thus also to persons sitting on the administrative boards of savings banks. Among other things, the requirements address these individuals' specialist knowledge and possible conflicts of interest.

Let me begin by making one thing clear. In my mind, it makes good sense for the EBA and ECB to address these matters. Supervisory and administrative boards are extremely important bodies. It is therefore essential that their members ask the right questions. To do this, they need to be uninfluenced by other interests. And their professional skills need to be tip-top. Academic studies of the German banking and savings bank sector have confirmed how important the skillsets of an institution's supervisory board members are in achieving success.[4]

For some commentators, however, the current proposals are a step too far. The relevant associations and politicians have voiced their criticism. But are the basic principles that underpin the German savings bank landscape really being questioned? To be more specific: What do the European proposals mean for administrative bodies within the savings banks and their members?

I would first like to remind you that requirements relating to the specialist skills of administrative board members have long been part of the picture in Germany. They are already enshrined in the German Banking Act and are partly written into the laws governing savings banks. Compliance with them is monitored by the supervisors. In practise, this means that members of these boards will have acquired the necessary specialist skills either during their training period or in the course of their professional career or, alternatively, in follow-up courses.

The EBA and the ECB are therefore putting down on paper targets that are already being met in Germany. The principle of proportionality also stipulated in their proposals is designed to ensure that the specialist skill requirements are not overly stringent for any given individual or institution. To this end, they are tiered according to the size of the institution, as well as its business model and complexity. This guarantees that the administrative board can effectively oversee the respective senior management team – no more, no less.

But the European proposals are not confined to the professional qualification element. A second key part of the procedure to test suitability focuses on identifying potential conflicts of interest. This has raised fears that the new rules could broadly exclude local politicians – or at least those wielding strong political influence – from joining the board of a savings bank. But this concern is unfounded. Individual politicians would solely be subject to mandatory careful examination of any potential conflicts of interest and the commitment to take action, where necessary, to counter any such conflicts.

For sure, some details of the European proposals need further discussion. National particularities have to be considered, including the principle of municipal support that applies to savings banks. Overall, I believe the proposals are moving in the right direction. Existing structures in Germany's savings bank landscape will not be destroyed by them. And the notion of municipal support will not be thrown overboard.

In any case, there is nothing to justify such a move. Because, as far as I can see, there are no major objections to be made to the presence of municipal representatives on administrative boards. On the contrary, it is only logical that savings banks should be monitored in the performance of their public duties by persons representing the public authorities that fund them. From the broader perspective, I am also convinced that the vast majority of administrative boards do a good job. And their regional identity assists them in this regard.

Even so, there are two areas where we cannot afford to make any compromises.

First, conflicts of interest must not be allowed to get in the way of the responsible execution of daily activities. In the past, it has not always been possible to ensure that this was achieved. I remember a case some years ago where a large savings bank found itself in need of financial support. In the documents concerning the relevant EU state aid procedure, the difficulties being experienced by the institution were explicitly attributed to, and I quote, "politically motivated investment". As a consequence, the institution was forced to restructure its administrative board.

And there are always fresh cases where members of the administrative boards take the bolstering of local authority coffers at least as seriously as, or indeed even more seriously than the long-term resilience of their savings bank. Please don't get me wrong: There is nothing to be said against profitable and soundly situated savings banks distributing some of their profits to their shareholders. But dividend payments that limit the options available for adequate risk provisioning or that eat away at their resources are unacceptable. And this is especially true in the challenging times we now live in. It is precisely amidst an environment of low, or even negative, interest rates and the associated interest rate risk that generous reserves need to be accumulated. The long-term stability of any given savings bank must not be sacrificed in favour of budgetary policy considerations.

Second: Expertise is the indispensable prerequisite that enables administrative board members to exercise their mandate. For they can only effectively control their institution’s board of directors if they have a sound understanding of its business activities and the associated risks. Training courses are of great significance in this context. The fact that the savings bank associations are taking this in hand is evident here in this region. Take the example of the training programme “Savings bank forum – administrative boards” that is offered by the Savings Bank Academy in North-Rhine Westphalia. Elsewhere, in other federal states of Germany, similar formats are also on offer. That said, it should also be clear that a day or weekend spent attending a seminar is not enough to make up for a deficit of economic knowledge and banking expertise. We all have a vested interest in ensuring the highest possible standards.

The new European rules will help make sure that the aforementioned points of focus, ie conflicting interests and specialist skills, are properly considered in the future. This is where the owners of savings banks need to step in. As early on in the process as selecting and assigning their representatives to a certain administrative board, they should take care only to appoint persons who are well versed in the business at hand, never losing sight of the long-term interests of the institution.

4 Tribute to President Gerlach

Ladies and gentlemen, I have discussed the matter of qualifications in great depth. But what qualities does one need to count as qualified? Aside from having the professional knowledge, skills and experience required, one needs to take one’s job seriously and be fully committed.

Dr Gerlach is a prime example of just such a person. Some would go so far as to say that, in his capacity as President of the Westfalen-Lippe Savings Bank Association, Dr Gerlach has sometimes taken his job a wee bit too seriously. He has certainly never given way to compromise when the interests of his institution were at stake. But the crux of the matter is that he has always acted in a fair, straightforward and open-minded manner. In view of these traits, an associate of his – who wishes to remain anonymous – recently referred to him as "a man who exhibits Westphalian clearness of purpose". Grönemeyer would call you “an honest place".

What I appreciate about your work ethic is that you have consistently remained true to your convictions, resisting the temptation to succumb to the mood of the day, always stating your case loud and clear. For instance, you have never shied away from addressing awkward issues like the need for reform within the ranks of German savings banks. In that sense, you definitely possess what Grönemeyer describes as "a heartbeat ... of metal (that) hammers out through the night".

Your sense of commitment has not stopped outside your duties as President. For alongside your professional duties you have also performed numerous tasks in an honorary capacity. Before I overdo the Grönemeyer quotes, I would like to recite a verse by Wilhelm Busch who once expressed his views on voluntary work in a somewhat sceptical manner. Here goes:

"If you wish to lead a happy and joyful life

take care to avoid all voluntary strife

If you wish to avoid an early grave

do not to this be a slave"

The verse continues

"Deeds of charity impart no honour

for, cutting away like a scissor,

the desire for applause

will diminish your cause."

Unlike Wilhelm Busch, however, I am absolutely convinced that Dr Gerlach has chosen his honorary positions wisely. He will, for instance, continue to serve as Chairman of the Board of Directors at the Foundation for Photography and Media Arts. At this juncture, I should also mention his invaluable efforts supporting the Picasso Museum.

Ladies and gentlemen, Dr Gerlach, I would like to conclude my remarks with one last quote from Grönemeyer's song dedicated to Bochum. In its last line he sings "Glück auf", which roughly translates as "Good fortune!". And on behalf of the Executive Board of the Deutsche Bundesbank, it is good fortune that I wish you, Dr Gerlach, now and in all your future endeavours.

---

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

2 Consultation paper: Joint ESMA and EBA guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU of 28 October 2016 (EBA/CP/2016/17).

3 ECB draft of a guideline on assessing professional qualifications and personal reliability, dated 14 November 2016.

4 Harald Hau and Marcel Thum: "Sub-prime crisis and board (in-)competence: private versus public banks in Germany" in Economic Policy, October 2009, pp. 701-752.