Yves Mersch: Current developments in the German banking market

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at an event organised by the Bayerischer Sparkassenverband, Munich, 27 January 2016.

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Dear Mr Strohmaier (Chair of the Advisory Committee),

Ladies and Gentlemen,

You have invited me to speak about "Current developments in the German banking market". Allow me to say right at the beginning, not just in my official capacity as a representative of the European Central Bank (ECB), that a national banking market in a monetary union must be seen in the context of the monetary union as a whole. Therefore, I will first address the position of banks in the euro area in general, and then speak about the specific situation of German banks.

Resilience of European banks strengthened despite continued weakness of earnings

European banks are significantly more resilient than they were five years ago. They have strengthened their capital base and reduced their debts. The large, complex banking groups still have some catching up to do in this area, however.[1]

Credit risks vis-à-vis emerging economies in Asia are limited as a whole. In the past two years, fewer than 2% of European banks' loans have been accounted for by this region. That is why I expect that the weakened economic situation there will lead, at most, to limited losses for European banks.

What is more problematic is the increased interest rate risk. Since last spring we have seen greater volatility in interest rates. Rises in interest rates could lead to immediate valuation losses on debt portfolios. For example, systemically important banks currently have to value around one-quarter of their fixed-rate debt securities at market prices.

The earnings position of European banks has recently improved somewhat – primarily because of higher shares of non-interest related earnings. But in the current weak economic environment, and in view of low interest rates, earnings are still low. The interest rate margin is narrow and has been falling continuously for almost 20 years.

Portfolios of non-performing loans are also depressing earnings prospects. This applies above all in countries which were particularly badly hit by the financial crisis. Here, there is a need for policymakers and others to accelerate the reduction of these legacy assets. By, for example, ensuring that judicial systems work more efficiently and that insolvency laws comply with international standards.

It would be simplistic to attribute the weak earnings only to market factors outside the influence of bank managers. Many European banks continue to have very high administrative costs, for example. And something could certainly be done about that.

It is my expectation that interest income will play a less important role in the coming years. This is also a reason why there are prospects of rising earnings for Europe's banks, namely if they succeed in adjusting their business models.

Some may argue that the tighter regulation of the banking sector is weighing heavily on some banks. No one disputes that we do not need "regulation for the sake of regulation". Neither is it about shackling market participants unnecessarily; rather, an adequate

[1] ECB (2015), *Financial stability review*, November.

regulatory framework can create room for manoeuvre. That's because regulation which ensures more stability and reduces information asymmetries and other destabilising factors helps secure freedom of choice for market participants.

To meet this objective, regulators must continually review whether the existing rules are proportionate to current and future expected risks in the financial market. Banks should adjust to this. Just as the situation in the financial markets changes – think, for example, of financial innovation – so too does the need for regulation.

That was why, in the light of the recent financial crisis, it was necessary to adapt the rules. But I would not call it a "regulation tsunami" in this context.

Many banks have held too little capital to be able to survive a large economic shock unscathed. Accordingly, banks are now required to have larger and higher quality buffers. This also serves to protect the tax payer. And it has proven successful: European banks – thanks to higher Tier 1 capital ratios – have become more resilient.

The financial crisis also showed that panic situations can very quickly lead to liquidity shortages in the interbank market. That is why sufficient liquidity buffers are necessary. These buffers are the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), the latter being the structural liquidity ratio.

I am aware that the prospect of new rules can lead to uncertainty. And I know that it is not always easy for you to deal with this uncertainty. In the meantime, however, you have significantly more planning certainty. What were until recently loose guidelines are now becoming concrete.

It is clear, for example, that Deutsche Bank, as a global systemically important bank, has to hold an additional capital buffer (G-SIB buffer) of 2%. In addition, it will soon be clear which banks will be subject to stronger requirements in the future, as the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin, the German Federal Financial Supervisory Authority) will shortly decide which banks will be counted as other systemically important institutions (O-SIIs). Moreover, BaFin has for the first time set the countercyclical capital buffer. This has been 0% since the beginning of the month. The buffer will now be reviewed every quarter. The Governing Council of the ECB can demand a higher buffer. At the moment, however, we agree with BaFin's judgement.

These examples of implementation in Germany bring me to the second part of my speech – the situation in the German banking market.

Relatively solid situation of German banks is no reason for complacency

The German banking sector is, in absolute terms, the largest in the monetary union alongside the French one. In 2014 the total assets of German banks amounted to almost €6.8 trillion (€6,750 billion). That corresponds to roughly 250% of Germany's gross domestic product (GDP) and 28% of the total assets in the monetary union. In Germany there is also a comparatively large number of banks. If we leave out the branches of foreign banks in Germany, there are around 1,700 credit institutions. That constitutes one-third of the total number of banks in the monetary union.[2]

In view of the size of the German banking sector alone, it plays an important role for the ECB, which is responsible for the whole euro area.

The German banking sector is not just relatively large, it also heterogeneous. Small and medium-sized banks – less significant institutions (LSIs) – which include the Sparkassen (savings banks), account for around 35% of the total balance sheet of the German banking

2 ECB (2015), *Report on financial structures*, October.

sector. Whereas in other euro area countries the systemically relevant banks, which are directly supervised by the ECB, contribute around 80%-85% of the total assets in the respective Member State, this contribution is only around 65% in Germany.

You yourselves are, of course, the experts on the position of small and medium-sized banks. A survey carried out by the Bundesbank and BaFin[3] shows that small and medium-sized institutions, if they do not take appropriate counter-measures, can expect further substantial profit losses. In the survey banks said that, even if interest rates rise, their profits would decline slightly in the coming years. If the market situation develops as the banks expect, then their profitability before taxes in the next three years would decline by around one-quarter compared with 2014. And this is despite the fact that conditions in Germany are relatively favourable at the moment and banks say that they want to reduce their costs. Assuming a negative interest rate shock of 100 basis points, income would decline by 60% to 70%.

The earnings position of small and medium-sized banks – and thus also that of the savings banks – is still sound. In the medium term, however, I see some risks if long-term loans are granted at very low fixed interest rates. As in the rest of the monetary union, the interest rate margin is also narrowing in Germany.

The large German banks are also experiencing this. Although the economic situation in Germany is significantly better than in some other Member States, these banks are hardly recording any growth in profits.[4] Under the current conditions, realising higher income is indeed a challenge. Profits, however, are the result of the difference between income and expenses, i.e. costs. Possibilities for making the *cost* structure more efficient certainly exist.

If interest margins are low over a longer period of time, business models need to be reviewed. That means, for example, developing other sources of income. Large banks already started to do this some time ago. But Landesbanken, which have a similar business model to large banks, continue to feature a large share of low-margin interbank business. This reduces the possibilities for strengthening the capital base.

And smaller and regional banks have hardly adjusted their business model at all over the past 50 years. They continue to focus on regional lending to households and firms, financed by deposits.

Small banks, especially savings banks, still play an important role in the financing of small and medium-sized enterprises. Not only here in Germany, but in Europe in general. However, it's by no means certain that this will remain so; not least because the large banks have adapted their strategies. They're scaling back their investment banking activities and focusing more on corporate clients and retail business. This means increased competition. The stability of the savings bank sector is not set in stone.

Structural change is an important challenge – not only for the smaller institutions. For instance, I see a need for catching up when it comes to new technology. Foreign institutions use such technology to offer loans throughout Europe, and thus also in Germany. That adds to the competitive pressure, even if it may only apply to standardised consumer loans at first.

In addition, I wonder how Germany's banks will respond to new market participants such as Fintech firms, and whether peer-to-peer loans will be of such importance in the future that banks will rethink their traditional business model.

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3 Deutsche Bundesbank and BaFin (2015), *Ertragslage und Widerstandsfähigkeit deutscher Kreditinstitute im Niedrigzinsumfeld*, September. Note that the related English press release is available at http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Meldung/2015/meldung_150918_pressegespraech_niedrigzinsumfeld.html?nn=2819248.

4 Deutsche Bundesbank (2015), "Structural developments in the German banking sector", *Monthly Report*, April.

If there is an increase in these and other alternatives to traditional financing via the banking sector, this may well provide incentives to push forward the consolidation urgently needed in this sector. In particular, the Landesbanken have already seen some changes. If Germany still had 12 Landesbanken before the financial crisis, today there are only nine. At the same time, the balance sheet total of this group of banks has shrunk by 30%. Overall, the number of German credit institutions has only decreased by 10% in recent years. In other Member States of the monetary union, the number of credit institutions nevertheless fell by nearly a quarter (i.e. 23%) during the same period. Not least because the overcapacity from the pre-crisis period is weighing on earnings prospects.[5] Financial institutions could well profit from “creative destruction”.

After having talked at length about the difficult earnings situation, I would like to say something positive: the capital base of German banks is in a very good position. Since the beginning of 2008 their Tier 1 capital ratio has risen steadily by 6.5 percentage points – to the current level of 15.6%. But the German taxpayer has also contributed to this. Between 2008 and 2013 the state provided some €144 billion in support to the German financial sector, in the form of capital injections (around €64 billion) and relief on assets (around €80 billion).[6] State guarantees were of a similar magnitude. Roughly 40% – or €26 billion – of the capital increase can be attributed to the Landesbanken.

Given the large capital buffer, even if earnings decline significantly (depending on future interest rate developments and German banks’ willingness to adjust), I presume that there are no noteworthy risks to financial stability in this country right now.

Even in a low interest rate environment, returns can be made on savings

Let me touch briefly on the situation of savers, as this is a theme that repeatedly receives special attention in Germany. Incidentally, German households hold only slightly more than 40% of their total financial assets as deposits with banks. That’s roughly in line with the average euro area saver – so the German saver isn’t really that special.[7]

I am well aware that nominal returns on savings deposits are very low right now. The public debate frequently refers to the nominal interest rate. Understandably, since financial institutions usually use nominal interest rates for marketing purposes. But what is actually more important is real returns. For example, a Deutsche Bundesbank study shows that, in the last three years, the real return on households’ financial assets stood at around 2%. Though below the long-term average of 3.5% for the 16 years prior to the financial crisis[8,] that is significantly higher than 0%.

Indeed, time and again, there were phases of negative real interest rates in the past, for example at the beginning of the 2000s and during the recent financial crisis, and also in the 1970s and at the start of the 1990s – but with significantly higher inflation rates then. If one takes residential property assets into account, during the last five years German households

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5 ESRB (2014), “Is Europe Overbanked?”, *Reports of the Advisory Scientific Committee*, No 4, June.

6 Bundesanstalt für Finanzmarktstabilisierung, *Historischer Überblick über die Maßnahmen des SoFFin, Maßnahmestand 31.12.2015*; see also the European Commission’s *State Aid Scoreboard 2014 – Aid in the context of the financial and economic crisis*.

7 ECB (2013), “The Eurosystem household finance and consumption survey: results from the first wave”, *Statistics Paper Series No 2*, April.

8 Deutsche Bundesbank (2015), “German households’ saving and investment behaviour in light of the low-interest-rate environment”, *Monthly Report*, October.

have even realised a higher return than in the five years before the crisis, because of increased real estate prices.[9]

For savers, ultimately, it is longer-term real interest returns that are of importance. And they are mainly dependent on factors which we, the central bank, cannot influence on a lasting basis.[10] For example, economic growth and the real return on physical capital play a decisive role in terms of how real interest rates develop in the long term. Furthermore, the overall relationship between savings and investment influences real interest rates. Since the end of the 1990s, emerging countries in Asia have increased their currency reserves significantly. Accordingly, they are contributing to a global savings glut. People in developed economies started to save more because of aging societies. And, over this period, real interest rates have also dropped. Thus, the average real interest rates for the ten-year government bonds of important industrialised countries, including Germany, fell from the (around) 4% recorded at the middle/end of the 1990s to approximately 2% in the year 2007[11] – note that this was before the outbreak of the financial crisis.

According to survey results, Germans are presently satisfied with their financial investments.[12] Recent developments indicate that they are slowly showing renewed interest in riskier types of investment. Thus, in the third quarter of last year they invested considerably more money in the capital markets than in the previous six years.[13] However, they also suffered noticeable valuation losses. The savings book or fixed-term deposits still remain popular.

This underlines what studies and statistics[14] have long been suggesting: German savers are exceptionally risk averse. Weighing risks carefully is in itself a healthy attitude – one that is also positive for financial stability. But excessive caution also lowers the return. Here, I see a great opportunity for savings and cooperative banks. Their strategic advantage is the proximity to customers. They can advise their customers competently and contribute to a full understanding of financial products and the risks thereof.

Concluding remarks

Lastly, a brief summary: after the financial and economic crisis Europe's banks strengthened their capital base. That also applies to the German banking sector, the largest one in the euro area.

Even if German banks are in a better position than the financial institutions of some other Member States, there is no reason for complacency. On the one hand, excessive costs have until now prevented the building up of additional equity. And, on the other hand, competition in the German banking sector is likely to intensify noticeably. As a result of the financial crisis, some of the larger German banks are changing tack. They are increasingly focusing

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[9] Leibniz-Institut für Wirtschaftsforschung Halle (IWH) (2015), ""The German saver" and the low policy rate environment", *IWH Online*, No 9/2015.

[10] Bindseil et al. (2015), "Critique of accommodating central bank policies and the 'expropriation of the saver' – A review", *Occasional Paper Series*, No 161, ECB; Executive Office of the President of the United States (2015), "Long-Term Interest Rates: A Survey".

[11] Bean et al. (2015), "Low for Long? Causes and Consequences of Persistently Low Interest Rates", *Geneva Reports on the World Economy*, No 17, International Center for Monetary and Banking Studies.

[12] See the December 2015 survey conducted by the Gesellschaft für Konsumforschung (GfK) on behalf of the Bundesverband deutscher Banken (Association of German Banks).

[13] Deutsche Bundesbank (2016), " *Acquisition of financial assets and external financing in Germany in the third quarter of 2015 – Results of the financial accounts by sector*", press release, 15 January.

[14] Grabka, M.M. and Westermeier, C. (2015), "Reale Nettovermögen der Privathaushalte in Deutschland sind von 2003 bis 2013 geschrumpft", *DIW Wochenbericht*, No 34/2015, pp. 727–738.

on traditional corporate clients and retail business and are scaling back investment banking activities. Furthermore, technological progress is making it easier for foreign banks to gain access to the German market. Both the smaller and larger German banks are feeling the effects of this development.

The pressure to adjust should also rise for German savings banks. Even if there was hardly any need for the savings bank sector to adjust its business model in the past, its stability is not set in stone. Intensified competition within an environment of low interest rates over a longer time period could markedly reduce earnings in the future. In the light of lower interest margins, the traditional business models should be put under scrutiny.