Andreas Dombret: Banks' business models as survival strategies for difficult times

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bavarian Financial Summit, Munich, 24 October 2016.

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1. Introduction

Ladies and gentlemen

Professor Gerke

Mr Felix Breuer

A lot has been written about banks in the past few weeks. The state of the sector has been generally presented as worrisome, and various images have been used to illustrate this – most of which were not exactly flattering. Perhaps you remember some of those comparisons. But have you ever considered comparing banks with the giant panda?

Probably not.

Still, it is the panda that I would like to use today to illustrate the state of the German banking sector, and to show that the sector is not in as bad a shape as is currently perceived.

The panda and the banking sector do indeed have something in common. While many people, predominantly fintechs, see banking as being threatened with extinction, this was the sad prognosis for the panda until recently.

However, a few weeks ago, the United Nations announced the good news that giant pandas are no longer threatened with extinction, although they are still an endangered species. This is encouraging, at least, even if there is still a lot of work to be done to support the panda as a species. Now, eight years after the financial crisis, I would like to say the same about the banking sector.

Public perception in the last few weeks was dominated by short-term, negative exaggerations. We have recently experienced erratic price movements in bank shares, all combined with vague horror scenarios.

But setting aside these exaggerations, what is the actual state of the banking sector?

In my view, despite all the prophecies of doom, banks are not currently facing the question of survival. Moreover, contrary to all the negative coverage, I actually see many positive signals coming from institutions which are working towards being better prepared for the future.

My conclusion, therefore, is a more nuanced one: like the panda, banks are not threatened with extinction. They are, however, in difficulties. And future economic developments will put them under further pressure – pressure so great that banks could well be put onto the list of endangered species if they fail to adapt to the new environment.

This means that the vast majority of banks still have a lot to do. What is more, many institutions underestimate the major challenges that lie ahead. At the same time, they should not underestimate the fact that these challenges might indeed put the species “bank” onto the endangered list.

Today, therefore, at the request of the Bavarian Centre of Finance, I will talk about the business models of banks in a changing environment. Business models are, as it were, survival strategies. And in times of great change, they must be adapted in order to keep pace with evolution.

2. Earnings, business models and the future of banks

In the past few weeks, there has been much speculation about the future of European and German banks. Are banks still stable? Do they earn enough money? Must banks undergo a radical change? Are there too many banks? Will the sector have to shrink?

The central question is whether banks will continue to be able to earn enough money to be resilient, and therefore stable. Many people suspect that structural weaknesses in the banking sector call into question the future viability of these institutions.

Opinions are divided, however, on the issue of how to categorise the difficulties facing the European banking sector, and how to solve them.

Broadly speaking, there are two positions. One side argues that banks and savings banks must radically alter their business models in order to cope with future, choppier waters: digitalisation, a low-interest-rate environment, an unstable global economy and demographic change. New strategies and more efficient organisation would increase earnings, which in turn would stabilise banks.

The other side argues that this will not be enough to end the sector’s plight, and that further market consolidation is needed, which means a further reduction in volume in the banking and financial system. Only then can banks regain a level of competitiveness which enables sustainable profits.

As is so often the case, the truth lies somewhere between the two extremes.

3. Old accounts: the lingering legacy of the financial crisis

The difficult situation faced by the banking sector is caused by the convergence of old and new challenges. For some institutions, the malaise can be traced back to a heavy legacy that continues to burden them now: for many years, their success was fuelled by excessive credit growth and an overinflated financial market.

When the financial market bubble finally burst, it exposed just how many business models were built on sand. Monetary and fiscal expansion was brought in to buy time for renewal by initially stabilising the system. Yet did the banking sector really make the most of that time?

Unfortunately, not to a sufficient extent. Yes, considerable efforts have been and are being made, and results are already visible. Institutions have considerably improved their solvency and liquidity. Some institutions have made, and are continuing to make, considerable efforts to restructure.

But in many cases, unsustainable strategies have not yet been sufficiently adapted.

In this context, I regard the criticism of allegedly over-strict regulation, which has recently become acceptable again, as problematic. I often have the impression that eight years were enough to suppress the memory of the crisis of the century.

The challenges associated with the new, improved regulations are not new burdens. On the contrary, the fact that risky business operations are now less lucrative for institutions, that they have to manage themselves more sustainably and develop durable internal risk management, is the result of legacy issues from times when regulation was too lax.

Complaining about this confuses cause and effect and distracts from the actual problems faced by the financial system.

4. New challenges in the midst of the economic climate change

Not all institutions have to struggle with old pre-crisis legacies to the same extent. Some of them were doing solid business even before the crisis. Nevertheless, these institutions are just as vulnerable to the new challenges.

And these challenges are massive. In many cases, the excessive debate about the details of digitalisation, the low-interest-rate environment or other future challenges overlooks the fact that we are in the middle of an economic climate change.

Since I don't intend to send you to sleep, I will just address the four most important aspects of this from the point of view of banks: namely, the risk of an economic downturn, demographic change, the low-interest-rate environment and digitalisation.

There is much talk at the moment about whether the era of ever-increasing economic prosperity in industrialised countries is over.[1] This is a complex debate which is likely to affect each society differently. The essence from the point of view of financial institutions is that we in Germany are currently still experiencing relatively comfortable economic activity by international standards, but that this could definitely slow down in the foreseeable future.

At the moment, it is difficult to predict whether this will happen. But from the point of view of the banking sector, it is important to bear in mind that the present, very comfortable economic situation and the low credit default rates associated with it are not self-evident. This means that institutions cannot expect their problems to decrease in the future. Rather, they must act now – if not yesterday – before an economic downturn sets in, even if there are, fortunately, no signs of that at the moment.

The second challenge I would like to talk about is demographic change, which is increasingly making itself felt. The ratio of employed persons to non-employed persons is declining steadily – Germany's figures are particularly poor. Nor is there currently much prospect of improvement, since birth rates are very low in our country.

For banks' business models, this entails enormously demanding medium to long-term changes: a dwindling population, smaller economic growth overall, a higher savings rate and less investment and consumption. The change in investment opportunities and customer expectations will confront German financial institutions with completely new questions and problems.

Even today, the sector is facing strong headwinds from the third major challenge – the low-interest-rate environment – which is eroding the profitability of interest-focused business models. This challenge is very serious for German institutions, given their rates-driven business models.

We can illustrate this challenge with just one simple figure: net interest income currently makes up around 75% of the operating profit of German banks. A persistent low-interest-rate environment means that a basic component of their business model no longer works: it means, quite simply, that it is no longer possible to earn enough money by focusing on maturity transformation.

For many years, institutions used the very favourable financial market conditions and their deposit holdings in order to cross-finance their customer services. They were able to offer current accounts free of charge because earnings could be made on the financial market using the money in the accounts.

This is likely to be significantly harder in future, since – in all probability – the interest rate level will remain low for a long time.[2] This means that institutions can no longer support their business models with earnings from financial market refinancing, since earnings from maturity transformation will not be sufficient. This requires enormous rethinking.

The fourth challenge is digitalisation. Although this is by no means new,[3] it has now developed into a broad mass phenomenon which is making ever-greater inroads into our everyday lives – which means it is also increasingly entering the financial sector.

Why is this such a massive challenge for the business models of banks and savings banks? Quite simply because it is eroding their customer base, and the expectations of younger customers are very different from those of today's bank customers – and even those are changing. Competition from "fintechs", with their innovative models, is now already taking away some of the banks' market share.

Furthermore, the old financial value-added chain is already lying in pieces and is being reassembled by the new fintech competitors. This means that services which used to be provided by one institution as a whole package are now being provided by several institutions, with various intermediate products being offered by firms outside the traditional sector.

Consider, for example, loan brokerage platforms: most of the intermediate products offered there, such as borrower rating, are not provided by those running the platform. This is also a good example of why banks are in danger of providing, in future, only the less attractive parts of the new value-added chain.

On the other hand, digitalisation offers banks and savings banks enormous opportunities to shape up for the future. I will return to this in a moment.

The combined force of these major challenges is bringing about an economic climate change. And institutions don't yet have any concepts for survival in this heated phase.

5. Solid business models with sustainable income targets

So, what now?

In my opinion, banking must return to being a normal economic sector, one in which earnings are generated through sound business models which are closely orientated to customer needs.

To do this, there is no need for banks to set over-ambitious earnings targets, which ultimately only lead to short-term profitability. Short-term earnings which come at the expense of long-term profitability weaken institutions rather than strengthening them.

Instead, banks must set earnings targets which are realistic and geared to continuity.

Banks will have to work out for themselves exactly what this means for them. Banking supervisors are not the "better bankers".

But it is likely that the sector's problems can only be solved by a triad of increasing efficiency, renewal and scaling back.

Let’s begin with increasing efficiency. The cost efficiency of German banks has been below the international average for many years now. Unfortunately, this has not improved in the past few years – in fact, the figures have even worsened.[4] This means that, despite a significant reduction in the number of branches and institutions in the last few years, the efficiency of these institutions still leaves a lot to be desired.

It is important to make operations more efficient so that economies of scale on the cost side can finally take effect. Here, digitalisation can contribute one of its two keys to success: by helping to reduce costs through systematic process optimisation. For example, processes can be rebuilt systematically with the aid of new information technology, enabling them to be organised far more efficiently.[5]

Let’s look now at the second element of the triad: renewal. Business models must be rethought and in many cases reorganised, because the economic environment for which they were developed has changed.

When undergoing this reorganisation, banks have to master a tough balancing act: returning to a sound business model, on the one hand, and countering new and innovative fintech rivals with innovations of their own, on the other.

I have already mentioned that earnings from maturity transformation will not be sufficient. This means that the low-interest-rate environment is weighing additionally on interest-focused business models. But it is not just these institutions which should consider whether they can charge fees for the services they perform for their customers – as, after all, other sectors of the economy do.

The second digitalisation key can also assist the reorganisation process: to a limited extent, this can help to tap new sources of income. Institutions can tap such new sources of income and use existing sources more efficiently by cooperating with fintechs. This might make the balancing act easier to accomplish.

Completing the triad is a moderate, structural scale-back of capacities in the banking sector and its adjustment to customer demand. Ultimately, revamping the institutions and increasing their efficiency will expedite this structural change. The result: capacities and structures which meet the needs of the real economy.

6. Conclusion

Ladies and gentlemen

The banking sector may not arouse the same sympathy in us as the giant panda – bankers simply do not have such fluffy fur.

Even so, fortunately, like pandas since the recent announcement, banks are not under threat of extinction. The efforts at reform since the financial crisis have already had some success.

But banks and savings banks are in danger of being supplanted unless they carry out further reforms. This is the only way for them to survive in the long term in the changed economic climate.

In order to keep pace with economic evolution, market participants will develop a multitude of strategies – some successful, some less so.

Ultimately, all institutions will develop different versions of the triad – but in general, operational processes have to be made much more efficient, while business models have to be rethought, and in many cases revamped.

Finally, I would like to thank you for inviting me here. The Bavarian Financial Summit is a special occasion, and I hope that this relatively young tradition will continue. And now, I look forward to discussing this year's issue!

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[1] RJ Gordon (2016) The rise and fall of American growth: The U.S. standard of living since the Civil War. Princeton.

[2] Even if central banks were to raise interest rates again, since we see upon closer inspection that it is not monetary policy alone which is responsible for low interest rates. Rather, fundamental social shifts such as demographic change have also caused the interest rate to fall continuously since the 1980s. See L Rachel & TD Smith (2015) Secular drivers of the global real interest rate. Bank of England Working Paper No 571.

[3] What is known as the "digital revolution" was already complete in 2002. This is regarded as the first year in which humanity was able to store more information in digital than in analogue form. Meanwhile, over 90% of the global storage capacity is now digital, although this only describes digital possibilities and not their actual use. See M Hilbert & P López (2011), The world's technological capacity to store, communicate, and compute information. In: Science, 2011, 332(6025), pp 60–65.

[4] A Dombret (2016), Gibt es zu viele Banken? Der Sektor nach der Finanzkrise. Speech delivered to the general meeting of the Austrian Society for Bank Research in Vienna, 27 September 2016.

[5] A Dombret (2016), Konsequenzen der Digitalisierung für Banken und die Bankenaufsicht. Speech delivered at the 16th Norddeutscher Bankentag at Leuphana Universität Lüneburg, 8 June 2016.