Andreas Dombret: What's the state of play in Germany's banking sector?

Statement 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, 15 November 2016.

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1. Between more Europe, and less

Ladies and gentlemen

Before I delve into the risk situation in Germany's banking sector, let's look back at the past 12 months – a period which, in a nutshell, saw the sector oscillate between more Europe, and less.

It was the second year in which the Single Supervisory Mechanism (SSM) was in operation. Over the past 24 months, the ECB has been directly responsible for overseeing the euro area's largest banking groups, which now number 129, of which 21 are German institutions. By adding "more Europe" to the realm of banking supervision, the SSM is clearly paying ever greater dividends, and I am confident that we can iron out any issues that remain.

We took a step of a different sort towards "more Europe" at the beginning of the year, which saw the establishment of the second pillar of the European banking union – the Single Resolution Mechanism (SRM).

And judging by the European Commission's agenda, there are to be further steps in this direction. I'm talking about the plans to establish the third pillar of the banking union: the European Deposit Protection Scheme (EDIS). But this is an initiative that should be viewed with a degree of caution, because the conditions for creating a single deposit guarantee scheme still haven't been fulfilled. Just take the areas of fiscal and economic policy in Europe, which are still firmly in the national realm and have a major bearing on the health of each country's banking system. As long as we haven't created a common set of European rules for these policy areas, establishing the EDIS would result in the fallout of misguided national policymaking being passed on to savers across the entire euro area.

And there is also the fact that banks continue to carry huge amounts of sovereign bonds issued by their home countries on their balance sheets. And yet again, these are exposures that are not backed by capital. If a single deposit protection scheme were put in place, the community might end up shouldering the risks associated with general government debt. Furthermore, the problems surrounding non-performing loans are still unresolved in a number of countries, which means the risk situation differs strongly from one national banking system to the next. I will return to this particular point later in my statement today.

While a recently published draft report by Esther de Lange at the European Parliament does already address some of the criticism levelled at the Commission proposal, that paper indicates that the proposed initial re-insurance phase starting in 2019 will still take place without any risk-reduction measures whatsoever. That would be inacceptable in my view.

My conclusion from this is that we should stick to the current system – harmonising the national deposit insurance schemes – as long as many outstanding issues remain unresolved.

For all the progress that has been made towards deeper integration, European unity suffered something of a setback on 23 June this year. That was the day on which the UK electorate voted against the country's continued membership of the European Union. That brings us to the topic of “less Europe". I won’t wade into the political debate today, but focus instead on what Brexit means for financial markets.

Five months on from the UK referendum, we can say that the European financial system has done a pretty good job overall of absorbing the outcome of the vote. Apart from a bout of heightened financial market volatility, notable share price losses, particularly among bank stocks, and the sharp depreciation of sterling, the Brexit vote did not unleash any turmoil in financial markets, nor, might I add, was there ever any risk of a financial crisis. There are two reasons for this. First, the good level of resilience that has now been achieved in the European financial system. Second, and no less important, the response shown particularly by the Bank of England.

Nonetheless, the long-run repercussions of the Brexit vote will only really come into view when we get a better idea of the outcome of the forthcoming exit negotiations.

The signals which the UK government is currently sending out would appear to suggest that a “hard Brexit” might be in store – that is, the UK would leave not just the EU but also the European Economic Area. That would spell the end of the current EU passporting regime – an arrangement which presently enables financial institutions domiciled in the UK to offer their products and services across the entire European Economic Area. It also permits continental European institutions to do business in the UK.

If the UK were to leave the European Economic Area, the question facing some business areas in the financial sector will be whether the UK’s future supervisory regime will be equivalent to the one on the continent. Assuming we do see a hard Brexit, I expect the UK wouldn’t want to unravel the accomplishments of EU regulation and that its future regulatory measures would be geared to global and European standards.

Come what may, what matters for us in the EU is that we continue to press ahead with our flagship financial market projects – first and foremost the capital markets union – even after the UK leaves the EU, and that we reinforce the EU’s financial system. In doing so, we must make sure that the door is open for close cooperation with the UK authorities. This is the context in which I see the scheduled merger between Deutsche Börse and the London Stock Exchange, for, once merged, the enterprise could serve as a bridge between the UK and EU financial markets and ensure continuity, such as in the clearing of euro-denominated financial instruments.

Let me now turn to the current risk situation in the German banking sector.

2. German banking sector still stable ...

I’ll start with the good news: German institutions have substantially increased their capital levels – and thus their resilience as well – since 2010.

The tier 1 capital ratio of the German banking system as a whole rose by just a slim 0.16 percentage point between June 2015 and June 2016, leaving it broadly unchanged at its year-end 2015 level of 15.7%. But this underlines the long-term trend improvement in capital adequacy, which is the key determinant of any banking sector’s resilience. In early 2008 – the year of the global financial crisis – the tier 1 capital ratio averaged no more than roughly 9.1%.

A major effect that impacted positively on the tier 1 capital ratio in Germany came from the decline in risk-weighted assets since 2008. That is to say, banks have stepped up their investment in assets with lower capital requirements.

The results of this year’s EBA stress test confirm that the German institutions which took part in that exercise are more robust to macroeconomic shocks today than they were just a few years ago. To sum up – there can be no doubts as to the solvency and liquidity of the German banking sector.

3. … but profitability is too feeble by international standards

Yet having a stable capital base alone isn't enough to ensure sustained resilience. Banks need to generate sufficient profits as well.

Let's start by looking at Germany's major banking multinationals. Compared with their total assets, these institutions have slightly improved their operating income, which is up from 1.31% in 2009 to 1.51% in 2015.

However, the major banks saw their return on total assets dip again for the first time last year. While it is true that the provisions made by one major institution had a negative impact on the return on total assets in Germany, if we exclude that particular institution, the remaining group of banks saw an increase in return on total assets, at 0.35%. All in all, that figure is still low by international standards, however. German banks as a whole are likewise lagging behind the international field – their aggregate return on equity, for example, languishes at just under 6%.

What's causing these problems? The diagnosis is relatively simple. Profitability is exceedingly weak among German credit institutions, and the persistent low-interest-rate environment is only making matters worse. Credit institutions whose business models are heavily geared to net interest income, in particular, might encounter serious medium to long-term problems if the phase of rock-bottom interest rates persists. The longer rates remain low, the more the pressure on net interest income in Germany will intensify.

But for now, we can cautiously sound the all-clear, particularly for small and medium-sized German institutions, because although the low rates are leaving a dent in their profits, most banks and savings banks are still bearing up. Net income from traditional interest business for German banks as a whole was down by €0.9 billion at €78.1 billion, but that decline was offset by an increase in net fee and commission income, which was up by €1.2 billion at €30.5 billion. Credit cooperatives and savings banks – institutions that are heavily reliant on interest business, relatively speaking – also managed more or less to maintain the previous year's net figure.

But the low-interest-rate environment is also posing a threat to the financial system. As higher-yielding legacy loans mature, they are being replaced by ones generating lower returns, some of which have longer tenors.

Moreover, the narrow spreads between short-term and long-term interest rates are squeezing the margins that banks can generate from maturity transformation. Together, these effects are crimping net interest income. Furthermore, banks are recording stronger flows of short-term deposits, which increases their exposure to interest rate risk. Ever since 2011, we have been seeing an almost steady rise in the Basel interest rate coefficient, which is a measure of interest rate risk. What this means for German credit institutions is that they should actively manage and hedge their higher interest rate risk – having an adequate capital base helps as well.

A major risk associated with a low-interest-rate environment materialises when that spell comes to an end. In this scenario, pre-tax net income would probably suffer a short-term slump, especially if interest rates were to climb abruptly following a long period of low rates. This would not only generate present-value losses in the short run, but might also cause interest expenses to outpace interest income in the medium term. Moreover, German institutions are now carrying more risky assets in their books than they were just five years ago. Not just that: they are also extending the average residual maturity in their proprietary business, which is exposing them to more credit default and market risk.

But from a long-term vantage point, an interest rate hike would help the banking sector recover and regain stability. And that’s precisely why it’s so important for the banking system to be adequately capitalised, since that would help it cushion shocks over a short to medium-term horizon.

Supervisors are closely monitoring German institutions in this setting. Following on from our exercises in 2013 and 2015, we at the Bundesbank are planning to conduct another survey on the low-interest-rate environment next year among the institutions we supervise directly – this time with added interest rate, credit and market risk stress tests. We hope this survey will give us an insight, early on, into any critical and risky developments in the banking sector and assist supervisors in their dialogue with institutions.

Past survey results tell us that credit institutions are responding to the new setting and pushing up their earnings from commission business – which includes, amongst others, account management and payment fees – and also increasingly passing on negative interest rates to major customers. We have also been seeing a steady flow of consolidation and mergers in the savings bank and cooperative sectors.

For all the progress we have made, there’s still one topic that continues to worry me. Roughly eight years on from the onset of the financial crisis, a number of European banks are still saddled by disturbing amounts of non-performing loans (NPLs). Therefore, scaling back these legacy exposures is one of the foremost aims of banking supervisors in the euro area, and rightly so.

There are two main reasons why we’re interested in NPLs. One, they make banking systems more vulnerable because they drive up both capital requirements and funding costs. Two, they make it harder for the banks in question to supply credit; this, in turn, puts the brakes on growth in the euro area. As a consequence, NPLs don’t just weigh on credit institutions’ earnings; they also intensify solvency risk and obstruct economic activity in Europe.

In this context, I would like to highlight the public consultation on the draft guidance to banks on NPLs which was initiated by the ECB and ran until yesterday. Equipped with this guidance, banking supervisors will be in a position to uniformly assess banks’ internal handling of NPLs as part of their regular supervisory dialogue.

But as far as financial stability in Germany is concerned, I see no immediate cause for alarm. NPLs are far less of a problem in the German banking system than they are in some of the other euro-area countries. At roughly 2%, the NPL rate in Germany last year was well down on the euro-area average. That figure also includes non-performing shipping exposures, and they certainly do worry me because there are still no signs that the economic situation in the shipping industry is about to recover. It goes without saying, then, that we shall continue to keep a close eye on banks with substantial exposures to shipping loans.

As for the institutions saddled by NPLs, we expect them to take measures that are conducive to promptly reducing legacy exposures and bolstering their resilience. These measures include not just thoroughly cleansing their balance sheets of both existing and anticipated losses but above all conducting appropriate credit risk management and holding an adequate level of capital.

4. Conclusion

In summary, there are three points I would like to highlight.

- First, the supervisory environment for banks has become even more European since our last Financial Stability Review, and for good reason. The establishment of the Single Resolution Mechanism at the beginning of this year marks another major milestone. However, before we take any further steps towards deeper integration, we should now gauge whether all the groundwork has been laid, and as far as the European Deposit Insurance Scheme is concerned, we shouldn't take the second step before the first.

- Second, German banks have boosted their stability still further – equity capital ratios are up again, leverage is down again. That's good news.
- Third, persistently weak earnings are taking their toll on German banks. The low-interest-rate environment will particularly make itself felt at small and medium-sized institutions over a medium to long-term horizon. Institutions will need to tackle these challenges head on if they are to safeguard their stability and profitability. My advice to them is this: there's no blueprint for guaranteed success. But what I can say is that besides regularly reviewing their business models, credit institutions should also consider further mergers, a more streamlined branch network and other cost-cutting measures.

Thank you very much.