Andreas Dombret: The cake's getting smaller. Consolidation and reorientation in the German banking sector

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Frankfurt School of Finance & Management's Fifth Annual Conference on Integrated Performance and Risk Management, Frankfurt am Main, 30 March 2017.

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1 Introduction

Ladies and gentlemen

Thank you for inviting me to speak at this conference on integrated performance and risk management. The close ties between the Deutsche Bundesbank and the Frankfurt School of Finance & Management have already become something of a tradition, and I hold them in high regard.

The speech I am holding today is entitled “The cake’s getting smaller – consolidation and reorientation in the German banking sector", and you may be wondering what managing a credit institution has in common with this city’s famous cake, the *Frankfurter Kranz* …

Well, both are crowning achievements in their respective professions: the Frankfurter Kranz, invented here in Frankfurt am Main in 1735 by an unknown baker, is part and parcel of this city’s history in the 18th century. Shaped like a wreath – Kranz in German – it symbolises the emperor’s crown. Unsurprisingly, then, it takes a great deal of skill and craftsmanship to prepare.

Similarly, managing a credit institution has emerged as one of the elite disciplines in the business world. Steering an institution, with all the tasks that entails, has become far more gruelling in recent years – not just because market conditions have become harsher, but also because the cake that can be divided up in the first place has shrunk in size and is continuing to do so. And when the going gets tough, there’s no option but to tweak the recipes.

2 The cake’s getting smaller

The cake that can be divided up among Germany’s banks and savings banks has been shrinking for many years now. Just look at how earnings have been contracting for more than 15 years – the figure for 2015 is nearly 30% down on 1999.

This malaise can be traced back to a number of factors. One is that Europe, and Germany especially, are often lambasted for being “overbanked". Unless these overcapacities are reduced, they will continue to take their toll on earnings.

The low-interest-rate environment is having much the same effect. We are already seeing diminishing margins in deposit business, and that’s partly because institutions are loath to pass on negative rates to their retail customer base. It is also apparent that the contribution from lending business has remained largely steady.

Another factor we should not overlook here, of course, is the tougher competitive environment – though I might add that rivalry has always been very intense in Germany’s banking sector. Fintechs have been disrupting the market, and incumbent credit institutions have lost pace with developments on many fronts. Some segments of the value added chain have migrated to fintechs, eroding banks’ revenue streams in those areas. And as for tapping fresh sources of earnings such as alternative payment procedures, traditional credit institutions are already lagging behind the “new kids on the block".

The debate surrounding the low levels of profitability in Germany's banking industry inevitably returns to the role played by regulation. In the pre-crisis era, there were undoubtedly a number of regulatory blind spots which many institutions capitalised on to engage in excessively risky transactions. This behaviour has taken its toll on the entire economy. That is why it is good that improved rules are now in place and supervision has been tightened. Needless to say, I am not expecting a rapturous reception from credit institutions, but the reforms were right, they were important, and to a large extent, implementing them represents a one-off expense.

Regulation, digitalisation, low rates, overcapacities – all these factors suggest that profitability is going to remain under pressure for the foreseeable future. The economy may be on an upbeat path right now, but if the environment takes a turn for the worse, it will only add to the pressure on credit institutions.

What I am saying is that from today's perspective, it doesn't look like the cake is going to increase in size again over the short and medium term – in fact, it will probably even shrink a little further.

How can the sector respond to this state of affairs? Probably through a combination of consolidation on the one hand and reorientation on the other.

3 Consolidation and the ever-shrinking cake

Let's begin with consolidation. The gradual downsizing of branch networks and institutions is a clear signal that consolidation is already under way. But there is still some way to go yet. It would appear logical to press ahead with consolidation, particularly with a view to boosting the cost-income ratio. According to this metric, Germany's banking sector is still firmly entrenched among the worst in Europe. For that reason, measures aimed at cutting costs and increasing operational efficiency will probably have to remain a firm fixture on credit institutions' agendas.

Mergers and acquisitions are one way of unlocking substantial cost savings. This, too, is a strategy which has already been practised in recent years – with mixed results.

Don't get me wrong, I'm not saying that mergers are a panacea as such – after all, simply putting two ailing institutions together doesn't make one robust one. On the contrary, it is a potential source of contagion. Two minuses might make a plus in the world of mathematics, but that's rarely true in a merger.

Mergers and acquisitions, then, will only ever be crowned with success if they are underpinned by a realistic strategy. Thus, a deal between institutions with complementary regional operations might be a sound idea, as might a European merger. If a plan is well thought out, supervisors will be supportive, too. However, that is not a reason for us to lower the bar for ailing institutions; rather, we will take a very close look.

4 New and improved recipes needed

Ladies and gentlemen, consolidation doesn't go nearly far enough. That is why German credit institutions will, in some cases, need to recalibrate their business models. Some of them are already in the process of doing so. But can it really be said that realignment is already in full swing? I think more could still be done on this front.

If the cakes of the future are to be profitable ones, we are going to need new and improved recipes. You will probably be familiar with my long-held view that institutions should scrutinise their business models, and that many of them should adapt them, or even overhaul them altogether.

Because the pressure is set to mount still further. The business environment has been transformed beyond recognition since 2008 – the setting today is often referred to as “the new normal". And business models cannot very well remain stuck in “old normal” mode.

Let me now turn my attention to one of the stiffest challenges facing banks and savings banks in this regard – the low-interest-rate environment. We are all aware that persistently low rates are rocking the very foundations upon which many German institutions have erected their business models – I’m talking specifically about the ones that run highly interest-driven franchises. That is why any institution that is over-reliant on revenues from interest business needs to rethink its approach.

And while banks are busy reviewing their strategies, there’s another scenario they must also bear in mind – that interest rates are going to pick up again. This will give rise to interest rate risk, which an institution’s risk management will need to be able to cope with. Institutions should each have a meticulously crafted response to this scenario at the ready – rather than hectically drawing up a plan when things come to a head and interest rates start climbing. Furthermore, the new recipes of the future will also need to include some digital ingredients, and that goes for business models and risk management operations in equal measure. State-of-the-art risk management needs to devote far more attention to cyber risks, which are a matter of general business management.

Efficient processes which harness economies of scale on the cost side can help stabilise earnings. Innovative information technology can play a role here, and it can also be supportive in reshaping business models.[1] In fact, to a limited extent, it can help tap new sources of income. Another way in which institutions can unlock new sources of revenues and optimise their existing profit centres is by cooperating with fintechs.

5 Stricter rules for the baking process: regulation and bank management

But it is not just the business models which need to be scrutinised – the management approaches should be reviewed as well. And this is where regulation comes into play.

Up until just a few years ago, integrated performance and risk management largely revolved around allocating capital according to an institution’s exposures. The chief objective was to allocate capital resources as efficiently as possible whilst adhering to the minimum regulatory capital requirements.

This principle is still the essence of bank management today. Yet the regulatory reforms introduced since the financial crisis have been forcing institutions to rethink their set-ups somewhat.

The problems facing the banking sector have shown that setting a minimum capital requirement that is based solely on risk-weighted criteria doesn’t go far enough to create sufficient resilience within the sector.

Because risk-weighted capital requirements alone did not provide the necessary level of protection, additional safety nets were introduced as part of the Basel III package. Thus, the existing risk-weighted standards have now been joined by the leverage ratio, and there are also two new liquidity ratios, capital buffers, loss-absorbing capital and individual capital add-ons under the supervisory review and evaluation process (SREP).

These are worthwhile additions from a supervisory vantage point because they give us a tailor-made toolkit to control the various risks which can cause a bank to fail.

But for credit institutions, the new system means that their management systems now have to take into account not just one metric, but several of them. So a decision whether or not to grant a loan no longer depends solely on the return and the efficient allocation of equity, but also, for instance, on the impact on the balance sheet structure, which is regulated by the net stable funding ratio (NSFR).

The toughest challenge probably lies in coping with the interplay between the various minimum standards and the need to simultaneously adhere to minimum capital requirements, the leverage ratio, requirements for an institution’s liquidity and balance sheet structure as well as varying point-in-time and institution-specific criteria – on this magnitude, this is uncharted territory.

What all this means is that the optimisation problem suddenly becomes much more complicated, raising the question as to whether compliance can be achieved by means of a simple equation. Or does a more multifaceted approach need to be adopted?

It is precisely this complexity which makes a smart approach to integrated risk management so crucial. There is the question, of course, of the levels which this integrated management approach ought to address. Can different metrics be broken down to individual business activities? Or does it make more sense to look at the bank as a whole or at portfolio level in order to identify risk drivers and render management measures more transparent? All this is forcing institutions to rethink both their operational and strategic set-ups.

One aspect, I believe, is particularly crucial. Institutions should not and cannot steer their business solely on the basis of compliance with the regulatory minimum requirements. Even if I do have to concede that the rules which supervisors including myself have created naturally curtail the scope of management action.

But there is nonetheless still a great deal of entrepreneurial scope which institutions can capitalise on – by running smart business models, by adopting innovative strategies, and by smoothly putting them into operation. Business models that operate solely on the basis of satisfying the regulatory minimum requirements cannot be successful over the long run. Adhering to the minimum requirements is a necessary constraint – the main key to success, however, is a smart business model that is built to last.

Ladies and gentlemen, the “new normal” is forcing institutions to rethink their business models and management approaches. It is a setting in which the cake is continuing to shrink. Logically, cake recipes and their preparation look set to become all the more challenging – but saying that, I firmly believe that the cakes of tomorrow not only have to be tastier; they should also be more palatable for customers, the real economy, supervisors and the banks themselves.

All of you here today are working on these new and improved recipes, and while there is still some way to go, I am in no doubt you are on the right track to come up with successful recipes.

Thank you for your attention.

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[1] Dombret, Andreas (2016): Digitalisation – repercussions for banks and their supervisors. Speech delivered at the 16th Norddeutscher Bankentag at Leuphana University Lüneburg, 8 June 2016. www.bundesbank.de/Redaktion/EN/Reden/2016/2016_06_08_dombret.html