Andreas Dombret: Germany's banks - the moment of truth for decision-makers

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bain Bankers Lounge, Frankfurt am Main, 21 September 2017.

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1. Introduction: structural change reaches a tipping point

Ladies and gentlemen

Banking is necessary, banks are not.

Don't worry: that's not my view, but that of Bill Gates. What this bon mot, uttered more than 20 years ago now, tells us is that structural change in the banking sector is not as new as it might seem.

In fact, it's something we are almost taking in our stride these days. For years now, there has been constant talk of upheaval and revolution, of banks dying off and structural change. But on the face of it, not much has actually happened. One could be forgiven, then, for thinking that we have more or less accepted structural change as an annoyance – even if it is a bearable one – rather like a visit from the banking supervisor.

My view where technological progress is concerned is a different one. Annoying though it may be to some, it's no good shrugging one's shoulders at it, nor is there any escaping it. The banking sector has reached a tipping point in its evolution. That is, we have reached a position where even the smallest change will unleash a wave of innovation in the banking world.

That is because technological progress always stands for upheaval, for a redirection of society's resources. Sooner or later, activities which once created significant value become automated, standard processes.

And this trend has now reached the financial sector as well. Ever more once-innovative banking operations are being standardised and performed by technology.

Ladies and gentlemen, I have a confession to make. There are some sides of structural change which I, too, struggle to come to terms with – to this day, I would much rather type on a Blackberry than swipe on an iPhone.

But in my capacity as a banking supervisor, I do wonder that if banking is possible without banks – who, then, will provide tomorrow's customers with the banking services they require?

That's not a question I can answer straight up. There are, however, five theories on the future of banking I would like to discuss with you today.

2. Reliance on net interest income needs to stop

Let's begin with the question of earnings. My first theory is this. Germany's banks and savings banks continue to be over-dependent on revenues from interest business. This is preventing them from being profitable in the long run.

Net interest income at German credit institutions has been shrinking for years now. To this day, they still haven't managed to refocus their strategies on the new normal, which is why their profitability has been ebbing away.

That was a very clear message from our low-interest-rate survey, which we released three weeks ago in conjunction with the Federal Financial Supervisory Authority, BaFin. Our findings show that small and medium-sized German credit institutions are expecting their profits to continue shrinking between 2016 and 2021, according to their planning. They are also projecting a remarkable 16% drop in their return on total capital.

Monetary policymakers are a popular scapegoat for this malaise – it is their low policy rates, some say, which have caused earnings to dry up in the banking sector. But that, I feel, would be oversimplifying things. If the ECB Governing Council considers an accommodative monetary policy stance to be appropriate, it also needs to set interest rate levels accordingly. Monetary policymakers are, after all, responsible for the entire euro-area economy. Seen through that prism, banking sector profitability is just one aspect, albeit an important one.

As understandable as the criticism directed at interest rate policy may seem from the perspective of German credit institutions, there's a risk they might overlook the bigger economic picture.

I say that partly for historical reasons. Interest rate levels in Germany have generally been on the wane for more than 30 years now, notably on account of demographic and macroeconomic factors. Unsurprisingly, then, the German banking sector's interest margin has been steadily narrowing for more than 30 years as well. Hence, accommodative monetary policy is just one – albeit important – aspect. That said, interest-driven business models have been under pressure for quite some time already.

And yet we are seeing very little in the way of adjustment. The business models of small and medium-sized German institutions, in particular, tend to be more reliant on interest business than those of their international peers, despite the fact that some of them can generate sufficient profits even in this challenging setting.

My conclusion, then, is this. Excessively interest-heavy business models are particularly exposed to structural change. It is becoming increasingly important to tap new sources of income.

3. Flight into risk isn't the answer

One simple escape route out of this malaise, it would appear, is a flight into risk – the search for yield is what I'm talking about here. My second theory, then, is this. Banks and savings banks would be unwise to escape from structural change by fleeing into risk.

And the longer the low-interest-rate environment persists, the greater the risk of institutions taking on excessive risk. After years of de-risking, we are now seeing the first signs in Germany of a growing willingness to assume risk.

Prices in financial markets are leaping from one all-time high to the next – the only thing is, volatility is conspicuously low, despite the absence of a consistently robust economic and political backdrop.

What's the story for banks and savings banks? Interest rate risk remains at an elevated level. In real estate business, there are budding signs that institutions are softening their credit standards.

Our low-interest-rate survey likewise points to an increase in risk propensity. One-third of small and medium-sized German credit institutions are planning to increase their business volume and risk taking. However, they do not wish to increase their capital to the same extent – in the medium term, that will erode their resilience.

As we all know, one swallow does not make a summer. Not just that, taking on more risk, in and of itself, isn't a problem, not yet at least – after all, managing risk is the raison d'être of credit institutions. I am still at ease right now, because the stress tests we conducted as part of the low-interest-rate survey show that more than 95% of banks would satisfy the broadly based capital requirements even in crisis scenarios.

And yet caution is warranted on two counts. For one thing, banks and savings banks need to meticulously check whether they have tabs on the effects of the risks in their portfolios and can handle them when a crisis strikes. For another, taking on more risk – be it through portfolio shifts or extending the balance sheet – does nothing to resolve structural issues. At best, it will provide short-lived respite from earnings problems.

4. Credit institutions need to be open-minded to new forms of value creation

And that brings me to my third theory. If banks and savings banks are to fix their earnings problems once and for all, they will need to tap new sources of income and be open-minded to new forms of value creation. And I dare say that simply hiking the prices for existing services won't go far enough. Especially if competitors don't follow suit.

I have little time for overblown forecasts predicting that banks and savings banks will all be replaced by fintechs in the future. Hugely successful though Amazon has been, town centres are still abuzz with shoppers. As ubiquitous as smartphones are nowadays, people continue to send letters – but mail firms need to evolve to make up for the downturn in postal business, for example, by delivering parcels sent by online mail order companies.

I firmly believe that credit institutions will continue to exist in the future – but only the ones which are willing and in a position to embrace change.

No-one can say for sure what banking business will look like some years hence. Institutions can counter this uncertainty by exploring what it is that customers – both legacy and new ones – actually want; and also by harnessing the digital expertise of fintechs instead of regarding them as some kind of nemesis.

Take a look at customers and you'll see that, millennials notwithstanding, there is more than one type of customer out there. Plenty of people still prefer to bank via traditional channels. It's just that their share will continue to dwindle – making structural change an increasingly pressing topic for institutions.

I would also recommend harnessing the benefits of swarm intelligence. Open banking systems – arrangements where banks open up their data to trusted fintech partners which then provide apps for bank customers – are increasingly catching on, meaning that there is scope for new fee models and for boosting customer satisfaction.

Open banking systems do have their risks, though – in this case, cyber risks. I am pleased to note that our low-interest-rate survey shows that institutions are planning to step up investment in this field – but at present many of them are still vulnerable. This is a hugely important topic to me because I feel it is still being neglected. We intend to increasingly probe the extent to which credit institutions can handle cyber attacks.

Yet at the same time, supervisors are keen to take account of the competitive environment. The Single Supervisory Mechanism, of which we are a member, today released a consultation on guides concerning the assessment of licence applications – and this explicitly also addresses the question of fintech credit institution licence applications. I urge banks and fintechs to use the consultation phase constructively.

5. Banks and savings banks must become more efficient

I come now to the cost side and to the challenge of compensating for declining income through greater efficiency.

This brings me to my fourth theory: German credit institutions could provide their services more efficiently. Once again, I would draw your attention to the low-interest-rate survey, whose findings suggest that small and medium-sized German institutions are expecting their cost-income ratio to increase. Unfortunately, this puts German credit institutions at the bottom of the European league.

If the cost-income ratio remains poor because of a failure to significantly bring down administrative costs, then more has to be done. An optimist would therefore hope that the only reason why the numbers remain unsatisfactory is that the banks and savings banks are busy investing in things such as new IT infrastructure, better risk management systems and more efficient processes. I fully support those institutions which are doing just that, but I have to say that there are still many institutions which are not.

And I am talking here about all three pillars of the German banking system, although perhaps not to the same extent in each case. We point out these differences in our conversations with the sector associations, and I hope that what we tell them sinks in, because differences can definitely be a sign that more has to be done in some quarters than in others.

Banks and savings banks will have to become even more efficient, and they will have to do so in a new, tougher regulatory environment. What I am getting at here is that the regulatory framework cannot be loosened so as to allow inefficient institutions to kick structural change into the long grass.

I readily admit that credit institutions incur costs because of regulation and oversight. But a bank or savings bank which cannot survive in an effective regulatory and supervisory environment needs to urgently rethink its business model.

It goes without saying that adapting to the new regulatory requirements is a mammoth task, and the uncertainty surrounding the regulatory reforms which have yet to be put in place is clearly a problem. What will Basel III bring with it, and what will it mean for banks in the EU?

This is why we are making every effort to complete Basel III without creating excessive burdens. Once that has been done, Basel III should, as far as possible, be implemented in a way that is committed to the Basel rules.

But there is one thing we must ensure: namely, that we remain true to the original intention of the Basel Accords: to provide global rules for global credit institutions. For all the others, I would like to see appropriately gradated rules. This is something which we can achieve by means of the CRR and CRD: by applying smart threshold values, below which simplified rules apply, and by putting in place a separate oversight regime for the smaller institutions, what is referred to as the “Small Banking Box”, which we are currently lobbying for in Brussels.

6. Not even mergers shield institutions from structural change

Ladies and gentlemen, regulation must not and never will be an instrument of structural policy. That is something which the market players need to decide among themselves. And this brings me to my final theory, which is that mergers and takeovers will not make banks and savings banks immune to structural change.

Many commentators believe that fierce competition in the German banking sector[1] makes further consolidation inevitable, and I for one share that view.

The forms which consolidation takes will be determined by customer behaviour and the banks' response to that behaviour. Capacity reduction by existing institutions is likely to play a major part in this.

The specific question which we have to ask is therefore, will there be more mergers and, if so, can they alleviate the problems associated with structural change?

Again, our low-interest-rate survey provides some interesting insights: about one in every nine of the nearly 1,600 institutions which took part in the survey are already in the process of merging with another institution or have specific plans to do so. And a similar number of institutions think it a plausible proposition that they could be taken over as part of a merger in the next five years.

But I wish to warn against unrealistic expectations: there are numerous examples of mergers which have failed. This is because, for a merger to succeed, a number of important conditions have to be fulfilled. For example, there have to be sustainable synergies in the business models or in regional coverage.

There is no exhaustive list of factors which determine success, nor is there a blueprint for success. German institutions must therefore perform a comprehensive health check in order to detect avoidable problems at an early stage.

Even where mergers are successful, however, new opportunities for value creation do not come about automatically, and customer needs are not automatically better served.

7. Conclusions

Ladies and gentlemen, an animal that tries to resist evolutionary change because it is not congenial risks becoming another animal's dinner. Similarly, technological progress changes value creation in the banking sector. There is no escaping this simple truth. Adapt or die.

It is undeniable that monetary policy and regulation are currently having major side effects on the banking sector, but we cannot allow these side effects to blind us to the uncomfortable fact that it is precisely the new, creative and innovative forces that are destroying existing structures in the banking sector.

Every bank and every savings bank must ask itself if it wants to be part of the creative force, part of the new structures, or part of a ruined structure. I dare to suggest that most of you wish to belong to the first group. Do you believe that it is possible without taking courageous decisions? Without risky decisions? Or without unpopular decisions? I do not.

Creative decisions presuppose creative questions: questions which show the world in a new light. In Germany's banking landscape, the questions which are being asked are all too often framed in a decades-old mould of thinking. So, to misquote title of a song by German singer Ina Deter, perhaps the country needs new bankers?

Essentially, it does, because you will not be able to lead your institutions to a new era with the old thinking. Banks are becoming service providers with banking licences; account holders and bank customers are becoming "users" who require a broad spectrum of flexible financial services. So, yes, a new world needs new bankers, or at least experienced bankers who have the courage to take innovative decisions.

My challenge to the sector is therefore to perform a mental demolition of established institutions wherever necessary and to rebuild them on green-field sites. Today's banks will only be successful tomorrow if they have enough new bankers, or take new decisions.

I will be pleased to take your questions and hear your comments.

[1] The findings of the low-interest-rate survey suggest that two-thirds of institutions are expecting competition from other banks to increase, and no fewer than 85% of them expect greater competition from fintech companies.