Andreas Dombret: Interest rates and the banking industry – a topsy-turvy world?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 63rd Kreditpolitische Tagung 2017, Frankfurt am Main, 10 November 2017.

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1. A topsy-turvy world (of interest rates)?

Mr Otto

Ladies and gentlemen

I recently heard a banker say that if things continued the way they are going, he would soon take out a loan for a few million euros and simply live off the interest. He will have known, of course, that even in the current environment those sums wouldn't add up. Nevertheless, it captures the feeling that many people in the surrounding office blocks here in Frankfurt and all across the country share – that a long-standing system of values is in danger of being toppled by interest rate developments.

This system of values concerns the distribution of roles in our society. According to this system, borrowers hold debt, and holding debt means making some sort of sacrifice elsewhere. Savers, on the other hand, have an asset – something of value – which they have built up by foregoing consumption – and they should therefore be rewarded for their efforts. However, as negative interest rates have now been unmistakably showing us, when it comes to the supply of and demand for money and loans, some seemingly absolute limits are ultimately only relative.

It should be noted that this change in the system of values did not begin with expansionary monetary policy. Indeed, the interest rate level has been steadily falling in Germany for decades. If you look at real deposit rates rather than nominal rates, losses are by no means a new phenomenon. There were already negative real interest rates on short-term bank deposits in the 1970s, the early 1990s, and in the 2000s.

Values, however, do not change nearly as fast as interest rates on the interbank market. Everyone affected is still used to other interest rate levels and, above all, to positive interest rates. A transvaluation of traditional values can therefore be seen in the interest rate level.

As much as I empathise with and share the general feeling that interest rates are topsy-turvy, this provides no help to you, me or anyone else in the industry who must coolheadedly crunch the numbers. I therefore support one of the statements found in the flyer of the 63rd Kreditpolitische Tagung: Merely hoping for circumstances to change for the better, for a return to the familiar, is too vague and simply inadequate. In my speech today I will even go so far as to say that hope is fundamentally the wrong approach in this case.

In the following I want to tell you my views on the "topsy-turvy" world of interest rates and consider, with you, what we can learn – and what we can't – from the viewpoint of banks, savings banks and supervisors.

2. What we can disagree on

Let me begin with the topic of interest rates. There are many things about which reasonable people can disagree, and interest rates are a splendid example. One reason is that there are almost no simple, clear-cut answers on account of the complex interrelationships involved. Indeed, monetary policy is only one of many factors influencing the supply of and demand for money and loans. Other longstanding factors have also been contributing to falling real interest rates. For example, productivity growth in Germany has been slowing since as far back as the 1970s. There are many explanations for this, not least the ageing population.

Furthermore, I am not here as a monetary policymaker and I'm not going to talk to you about the mandate of the ECB. I am here in my capacity as a representative of German banking supervisors, who must get to grips with the consequences of a low interest rate level for banks and savings banks in Germany. A lot of damage is becoming visible.

As a German banking supervisor, I have in mind, in particular, the earnings position of German institutions, as these are without a doubt being strongly affected by the interest rate environment, and unfortunately even more so than credit institutions in other (European) countries. Just as a reminder, net interest income in 2016 was far and away the largest source of income among German institutions, accounting for 73.2% – and this despite a year-on-year fall of nearly five percentage points. It is therefore hardly surprising that our recently published low-interest-rate survey reveals a massive worsening of the earnings situation – both in the planning scenarios of banks and savings banks and in the scenarios of stable interest rates predefined in our survey.

In addition to the interest rate level, the asset purchase programme of the ECB is also an issue. As you all know, at the Bundesbank we are critical of government bond purchases because they increasingly blur the boundaries between monetary and fiscal policy. I'll come to the other consequences in just a minute. The decision of the ECB Governing Council to reduce net bond purchases from 1 January 2018 from €60 billion to €30 billion and to continue the programme until at least September next year certainly doesn't amount to slamming on the monetary policy brakes – it's the equivalent of removing the accelerator from the floor – but only ever so slightly.

At the same time, we need to bear in mind that Europe is currently experiencing a broad-based economic upturn. According to forecasts, the output gap in the euro area will close in the coming year. In the short term, economic growth might even exceed previous forecasts. In light of the healthy economic situation and the gradual upturn in inflationary pressure in the euro area, from our perspective it would have very much been appropriate to make a clear end to the purchase programme. It is therefore my firm conviction that we should make an exit from ultra-accommodative monetary policy as soon as possible. At the Bundesbank, that is what we will be pushing for.

The negative interest rates in the euro area are making things very difficult for banks – that much is clear. At the same time, there is a reluctance within the banking industry to pass on negative interest rates to individuals. As a result, the majority of banks are not planning to impose negative interest rates in their retail business.

However, the implications of extremely low interest rates extend far beyond the profitability of banks and savings banks.

From the perspective of savers and investors, this is about key issues such as their pensions. For some, extremely low interest rates are making financial planning into retirement simply impossible. When individual investors talk about a “topsy-turvy world", they are not just talking about their interest income; they are talking about fundamental questions of orientation and about the fear of a potential lack of funds in their old age. Let me put it clearly: if large swathes of our society can no longer manage with their long-term, planned savings, then our society has a serious problem.

Significant distortions are even being caused by the monetary policy setting. We can see this most obviously in the area of government debt. Current monetary policy has made government borrowing artificially easy. This cannot be the spirit of sustainable government finance. In addition, the low interest rate level in the periphery countries of the euro area means that urgently needed structural reforms can be postponed. This, however, is exactly the wrong approach and, over the long-term, it does not help but rather harms the country in question and the euro area as a whole. Similarly, due to distorted price signals, there is a growing danger of capital misallocation in the private sector.

Overall, this leads to false incentives as market pressure is undermined. However, if this pressure to adapt is reduced by a very loose monetary policy, then, in the financial sector, we run the risk of creating zombie banks that would otherwise be unable to survive without an ultra-loose monetary policy.

But the low-interest-rate environment also harbours other dangers. In the light of lower earnings from interest business, institutions tend to ramp up their searches for profitable investment opportunities – this is known as the “search for yield". This, in turn, raises the danger of an asset price bubble. In this interest-rate environment, it is therefore of critical importance to pay close attention to these risks and to manage them in a systematic way.

Incidentally, these problems would be even greater if banking supervision were more lenient. However, things can also turn out differently, as seen in the example of Scandinavia, where, after some initial hesitation, drastic measures were taken and banks’ balance sheets were cleaned up. The pain did not last long and the region recovered economically. By contrast, Japan continues to wrestle with the consequences of a less courageous intervention. Because zombie banks were propped up for years and were offered continued protection, they were actually able to support insolvent enterprises. As a result, the economy fared considerably worse than if authorities had intervened more courageously.

What we must learn from this is that staving off economic death with artificial life support only leads to harm in the long run – not least for the sectors of a national economy that are actually healthy. And this brings us to what I call the “topsy-turvy world".

In Europe, we need to take great care that we do not permanently find ourselves in such a topsy-turvy world. This threat continues to exist. New lending and growth are suffering under the huge volumes of non-performing loans – NPLs for short – on the balance sheets of institutions in certain member states. It appears that many NPLs were not tackled decisively enough by these institutions. The first successes were seen only after European supervisors had pressured them to act. The significant institutions in the euro area, which have been supervised by the ECB since the beginning of 2015, have reduced their NPL holdings from 7.5 per cent to a current level of 5.5 per cent. But this figure is still not entirely satisfactory. It therefore remains all the more important to apply appropriate pressure to act and to set the right incentives. In this regard, Europe must not react defensively, but needs to decisively push ahead in reducing volumes of NPLs. The current infighting over powers at the European level is not helpful here, either. I can only appeal to all those involved to approach this subject with urgency – in the interest of all those involved.

Ladies and gentlemen, the ECB’s crisis policy has received much praise – and rightly so, in my opinion. Through its intervention, it successfully stabilised the extremely unsettled European financial sector. However, the side effects of continuing this policy are becoming ever more apparent. We need to respond.

3. Challenges in a topsy-turvy world

So you see, So you see, I share the assessment of the majority of Germans – sooner or later, artificially maintaining low interest rates will lead to a topsy-turvy world. This is not only about interest margins, but also about pensions, savings plans, and fundamentally distorted incentives in the financial system.

This now brings us to the second and – for some credit institutions – more uncomfortable part. As I have mentioned, hope alone is not only not enough for banks and savings banks – hope may also be the wrong approach entirely.

Regardless of whether the world of interest rates is topsy-turvy or not, banks must ultimately be capable of turning a profit at any level of interest rates. In cases of doubt, this means that they must adapt their business models to make themselves less dependent on interest business. And, alongside the interest rate level, further structural challenges await banks and savings banks.

This means that established earning opportunities are diminishing: the earnings of German credit institutions have been falling for more than 15 years – between 1999 and 2015 this fall amounted to around 30%.

Likewise, there is a reason for the debate on excess capacity. Credit institutions in the euro area may have trimmed their balance sheets by slightly more than 15% between 2008 and the end of 2015, and German banks have shrunk their balance sheets by roughly 30%. However, you must remember that the European banking sector previously experienced immense balance sheet growth. The balance sheet reduction we have been witnessing since 2008 therefore has to be seen in the light of a significantly larger – probably excessively large – balance sheet expansion in the preceding years. Back in 2014, the European Systemic Risk Board was already sounding warnings of excess capacity. And the International Monetary Fund confirmed in 2016 that this problem was far from resolved. More work therefore still needs to be done to pare back the excess capacity that has accumulated over a number of years.

To neglect structural change would be to jeopardise our ability to evolve and adapt. If economic realities change, banks and savings banks must likewise adapt. That is my message to German banks, without wishing to appear in any way cynical. There is an awful lot banks can do to ensure their long-term survival. Many institutions have recognised this and are increasingly taking the appropriate action.

I could say a lot just on the subject of digitalisation and the changes happening in the banking sector. It would simply be naive to neglect these changes. Other areas also leave plenty of scope for entrepreneurial activity. Specifically, I am referring to specialisation and mergers, and of course the subject of cost-cutting. German banks' cost-income ratio averaged 69.2% in 2016, only slightly better than in 2015 and towards the bottom of the European league table. That means there is scope for improvement.

How banks go about effecting such improvements is up to each individual institution. Supervisors should not get involved in the competition to see where the future of banking lies and should certainly not be responsible for corporate earnings. When we examine business models, we do so primarily under the aspect of capital adequacy. We are not the better bankers and should keep out of any business decisions as much as possible.

4.The role of supervisors in a topsy-turvy world

As supervisors, we are interested, first and foremost, in a healthy and stable banking system. For this, we have a clear mandate. That certainly does not involve pleasing all credit institutions, but it does mean that we have to supervise the sector diligently and conscientiously.

Nonetheless, we too have some leeway in deciding when and where we impose what measures. That is particularly true when interest rates are topsy-turvy. We are therefore justified in looking to see where we can mitigate the burden for banks and savings banks without neglecting our duties. Specifically, I am thinking of three issues.

First: proportionality in regulation and supervision. We have already incorporated this into many areas of our supervisory activities. We have already relaxed requirements for smaller institutions in many areas of regulation. But in my opinion, a lot more could be done. We therefore put forward very concrete proposals in the first half of this year as to how we can further strengthen the principle of proportionality. I am very confident that our proposals will be heard and meet with support in the ongoing negotiations in Brussels.

Second: the subject of ad hoc inspections. Without doubt, ad hoc inspections present an extraordinary burden for banks. When considering a possible ad hoc inspection, it is therefore important and right in the current environment that we ask ourselves some probing questions about whether it is really justified in the current difficult situation or whether it could perhaps be postponed to a later date.

And third: the large area of regulation. Once we have concluded the Basel III reforms, which will hopefully be soon, I will appeal for a period of calm and reflection to examine the overall effects of regulation. It is now time to turn our gaze away from individual measures to the big picture in terms of regulatory reforms and their impact. I believe it would be a good idea to take a “regulatory break".

5. Conclusion

Ladies and gentlemen, before concluding, I would like to clarify three things.

First, I can very well understand that many of you feel as though you are in a topsy-turvy world of low interest rates. To the extent that artificially low interest rates not only frustrate the long-term strategies of savers, investors and credit institutions, but also prevent economically necessary adjustments, we are indeed in a “topsy-turvy world". The danger that comes to my mind, in my role as a banking supervisor, is of zombie banks which pump themselves full of loans yet are economically not viable – and this is not necessarily (only) the case in Germany, but not least also in other European countries. With this, and other factors, in mind, the exit from loose monetary policy must happen as soon as possible. The time may not yet be ripe given the various economic developments in the euro area. But we at the Bundesbank will continue to campaign to ensure that the right moment is not missed.

In the meantime, credit institutions must apply risk management. In the current environment, and in the face of adversity, caution is key, and risks must be very carefully managed.

Second, regardless of whether the world is topsy-turvy or not, a bank must be capable of turning a profit at any level of interest rates. That may include restructuring its own business model in order to be less dependent on interest rate business. Given the challenges facing the sector, supervisors are interested in examining exactly what burdens for the institutions are truly justified in order to avoid placing any further, unnecessary obstacles in their way.

And third, I would like to stress that we must not concentrate solely on the interest rate level. We face a number of quite different challenges, too. To name just one example, I expect that the London banks that are likely to move to Germany and to Frankfurt as a result of Brexit will try to poach qualified staff from local banks. To paraphrase Helmut Qualtinger, an Austrian actor, author and cabaret artist: a lot of things get worse by looking at them, but nothing gets better by looking away.[1] To this end, the room for manoeuvre must be recognised and utilised.

I now look forward to the other speakers at today’s event and am interested to see what issues they will focus on.

Thank you very much for your attention.

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[1] Helmut Qualtinger, Austrian actor, writer and cabaret artist (1928-1986).