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

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the presentation of the 2017 Financial Stability Review of the Deutsche Bundesbank, Frankfurt am Main, 29 November 2017.

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1. Introduction

Ladies and gentlemen

I, too, would like to welcome you to our press conference. Now that Ms Buch has given you an overview of the risks in the German financial system, I will now, as usual, take a closer look at the German banking sector.

2. The German banking sector remains resilient

Let's begin with the good news. The capital adequacy of German banks and savings banks is today much better than before the financial crisis. Whereas, in 2008, the average tier 1 capital ratio of German credit institutions came to 9%, it reached 16.6% in the second quarter of this year. Many banks that were less well capitalised prior to the crisis have raised this ratio by a particularly large extent. This is something I welcome very much.

The strategies by which they achieved this varied from one bank to the next. Small and medium-sized banks and savings banks built up large amounts of tier 1 capital while at the same time expanding loans to the real economy. Big banks responded to the more stringent capital requirements rather by scaling back their risk-weighted assets by 36%. This they did partly by cutting back credit risk, partly by shifting to lower-risk investments, though for the most part by reducing their balance sheets. However, fears of a credit crunch, though often voiced, did not materialise.

With regard to credit risk, the problem of large holdings of non-performing loans (or NPLs) has become a subject for growing discussion at the European level. However, in Germany, this issue is limited to only a small number of institutions which invested more and more heavily in ships. On the whole, however, the German banking sector has a very low NPL ratio of around 2%, and the bulk of the portfolios concerned have largely been written down.

Allow me, nevertheless, to say a few words about Europe at this point. The current infighting over powers at the European level on how to deal with NPLs is not helpful. We have to tackle the reduction of NPLs in a determined and forceful manner – this is the only thing that should matter to us. For this reason, the Bundesbank expressly supports the initiative of the ECB, which in October published guidelines in an effort to push ahead with scaling back of NPLs.

3. Profitability in the German banking sector still low

After the good news, now for the not-so-good: The profitability of German institutions continues to be low. This effect is partly attributable to structural factors and partly to the low-interest-rate setting. Indeed, the impact of low interest rates is hitting the German banking sector especially hard, as in many cases, the business models are heavily geared to interest income. As a result, we are seeing a substantial drop in profits in traditional deposit and lending business. German credit institutions are predicting that this development will continue. Another factor is that German banks and savings banks are paying negative interest rates on their deposits with the central bank, but rarely pass these negative rates on to private customers.

So far, this development has been countered by the favourable macroeconomic conditions here in Germany. The buoyant economic development, which is reflected, for example, in the small number of corporate and personal insolvencies, is a major reason why both loan default rates and risk provisioning needs have stayed low. In other words, the write-downs banks are having to make on loans are very small. This effect has boosted earnings, which would otherwise have been even lower.

In the context of the dialogue with external auditors, who are advocating releasing risk provisions where possible given the current economic situation, I nevertheless advise banks and savings banks to stick with their conservative stance going forward. I consider necessary the additions to risk provisions which banks, according to information provided as part of the low-interest-rate survey, are planning in the medium to long term. It is good to see the managing boards at these banks are resisting the inclination to assume that conditions will always be good. To expect the favourable developments of the past to continue indefinitely might otherwise be tantamount to systematically underestimating credit risk.

4. A change in interest rates could hit parts of the banking system hard

This problem is compounded by the fact that German banks have expanded their maturity transformation in recent years. In order to stabilise profits in times of very low interest rates, they have increasingly extended the lives and the interest rate lock-in periods of their loans. For instance, the percentage share of longer-term loans and advances – that is to say claims with a maturity of more than five years – at German banks has risen from 60% in 2007 to just under 70%. The ratio among institutions in the savings bank and cooperative bank sector is especially high. At 83%, it is significantly higher than the 47% ratio for commercial banks.

Thus, we are in a situation in which banks and savings banks are holding many long-term, low-yielding investments in their books. Moreover, valuations for many investments are extremely high. By contrast, risk provisioning in the German banking system is very low, at 0.6% of total assets. This makes banks vulnerable to unexpected macroeconomic developments, such as an abrupt hike in interest rates or an unforeseen deterioration in economic activity.

At the same time, they have shortened the maturities of their liabilities. The ratio of overnight deposits to total liabilities towards non-banks has risen within ten years from 36% to around 60%. An important aspect in this context is that customers are parking their funds in deposits because interest rates on investments are so low. It is difficult to predict how these funds will be shifted as soon as more attractive investments become available. Historical experience gives us a rough idea, but in view of the extreme situation of the current low-interest-rate environment it is of only limited use as a guide for the future.

The bottom line here is that we see an increased vulnerability of banks to changing interest rates. This is why we have been keeping a very close eye on the topic of interest rate risk.

Our low-interest-rate survey 2017 focused on this very issue, simulating the implications of possible shocks for small and medium-sized banks and savings banks. One scenario entailing an abrupt rise in the yield curve by 200 basis points highlights banks' short-term vulnerability. In such a scenario, profits would initially plummet by around 55% before staging a recovery in the medium term. This means that the speed at which interest rates are raised is crucial.

The stress test carried out as part of our low-interest-rate survey combined several risks at once. Besides an abrupt rise in the yield curve of 200 basis points, it simulated a simultaneous increase in credit and market risk. On aggregate, in such a case the tier 1 capital ratio would drop from around 16% to around 13%, which is to say by some three percentage points. Yet a more detailed look reveals the positive impact of substantially improved capital levels. Small and medium-sized institutions prove largely resilient to a simultaneous rise in the three types of risk.

Thus the stress test scenario presents a mixed picture overall. On the whole, German banks and savings banks are robust and in good shape. But this should not blind us to the major challenges and the associated need for adjustments that banks face. Elevated interest rate risk and the low level of risk provisioning increase vulnerability to shocks. I would therefore call on banks to focus their risk management operations primarily on the issues of maturity transformation and interest rate risk.

5. Brexit will represent a challenge

Let me round out my remarks by discussing a challenge faced by all of us and which is having a particular impact on institutions. In all likelihood, the United Kingdom will be leaving the European Union on 29 March 2019. In that respect, no press conference on financial stability can avoid the topic of Brexit. I will therefore address this topic in the remainder of my remarks.

The negotiations' progress has tended to be on the sluggish side, creating considerable uncertainty for everyone: citizens, companies and not least the financial sector. In the 16 months that remain, the Brexit-related restructuring has to be completed in order to ensure the uninterrupted continuation of customer relationships between economic areas.

In this connection, I urgently advise all financial market participants to begin reorganising their operations as soon as possible, and to implement this process rigorously. This means, in particular, that all those banks seeking to continue to do business in Germany or in other EU countries once the UK leaves the EU should, if they have not yet done so, file applications for licences as fast as possible.

Solutions also need to be found with regard to how existing contractual relationships will be continued seamlessly after Brexit. For those institutions which change their contracts proactively hoping for their customers' tacit approval, legal risks could ensue, at least concerning retail customers. Time will ultimately be the decisive factor.

For the UK to achieve the smoothest possible exit from the EU, meticulous preparation by the banking industry is not the only thing that will be necessary. The preparations – or rather, the lack thereof – in the real sector give me cause for concern. Companies should put their own access to financial services on a solid footing, and vulnerabilities that the UK leaving the EU will create for their own business models need to be reduced. Reorientation is always complex and requires a lot of time – which, unfortunately, is in very short supply.

What will Brexit mean for Germany? Even if the EBA will not be coming to Frankfurt after all, the city will remain one of many EU financial centres where companies will relocate owing to Brexit. In particular, we are noticing that business areas with close proximity to the markets will be making their new home here in Frankfurt. And this relocation will have a perceptible impact on the structure of the German financial system. For instance, here in continental Europe we have never supervised brokers/dealers as large as those that are now likely to be moving to Frankfurt.

The German financial centre will therefore be closer to the capital markets. It will then be necessary to counter the negative stimulus of Brexit with a positive stimulus towards a deeper, high-performance capital market. This could promote the development of Europe's economies. That would require rigorous advancement of the European capital market union project. Yet the door needs to be left open for a close and deep partnership with the United Kingdom. I am therefore very much in support of a capital market union.

In those places where Brexit has driven a wedge between our economies, bridges need to be built post-Brexit. One opportunity for such a bridge could be, for instance, the topic of central counterparty (CCP) clearing. One way of building a bridge here could be through intensive cooperation between UK and EU supervisory authorities, which would also have to include far-reaching powers of information and intervention for EU supervisors vis-à-vis UK CCPs. To the

extent that this is assured, I am convinced that this could obviate the need for a large-scale relocation of clearing business, at least from an economic standpoint. The reverse naturally also applies.

At all events, London will remain one of the world's leading financial centres. That is why creativity and a truly global outlook will be necessary in order to place future cooperation between the EU27 and the United Kingdom on a solid legal footing. For one thing is also clear – the world's fast-growing regions are not going to stand idly by while Europe indulges in navel gazing.

German and European supervisors alike are making intensive preparations for the post-Brexit era. And this is our message: we will certainly not accept "empty suits", and the banks are perfectly aware of this. Sound local structures with working risk management frameworks are indispensable. This does not preclude a certain shifting of sub-risks to specialised risk hubs in London which ensure group-wide risk management. It is clear that decisions cannot be made exclusively from London. What makes this approach all the more important is that, in a crisis, EU-based units will have to be able to act, or be resolved, independently.

We will try to take as pragmatic an approach as possible in our preparations. Thus, for instance, we are willing to provisionally recognise models approved by UK supervisors in order to ensure a smooth transition. On-site inspections by our banking supervisors, however, will then gradually ensue.

The labour market for specialists is an aspect of Brexit that thus far has received little attention. This represents a dormant, and not very tangible, risk – as demand for experienced staff will encounter limited supply. These specialists' current employers will have to reckon with intensified competition for able brains. This must not be permitted to develop into a risk to the stability of our financial centre.

The Bundesbank – along with the SSM – will increase its staff in order to maintain the high quality with which it supervises the growing banking market. For us – precisely under the constraints of the public sector – this will represent a challenge. Our Executive Board has already taken the appropriate decisions, which we are now in the process of implementing.

All in all – as our talks with the affected institutions, amongst other things, have shown us – I see banks and supervisors alike as being on the right track in terms of shaping Brexit-induced change without any major frictions or risks to financial stability.

Another sign of this is that Brexit is not a sudden shock for which there was no time for preparation or response. Ever since the UK prime minister declared in the middle of last year that "Brexit means Brexit," it has been clear that the United Kingdom will leave the EU and that this will entail far-reaching implications for the economy in general and the financial markets in particular.

If nothing else, the principle of commercial prudence impels us to prepare for the least-favourable outcome – a hard Brexit. All things considered, I am convinced that, while Brexit will continue to impair the efficiency of the financial industry, it will, in the process, not entail any considerable direct adverse consequences for the stability of our financial system.

Thank you for your attention.