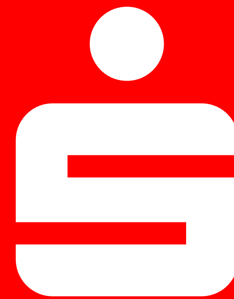
Finanzgruppe
Deutscher Sparkassen- und Giroverband

STANDPUNKTE
DER CHEFVOLKSWIRTE



Banking regulation should support the coming upswing

It is of decisive importance for the German economy that small and medium-sized enterprises are in a position to further evolve their products and services both sustainably and innovatively. To do this, they need local financing partners who can provide them with expert support. The Chief Economists of the Savings Banks Finance Group wish to emphasise that banking regulation should support the coming upswing. With its diverse, decentralised structure, the German banking market, as a partner of companies on the ground in the real economy, is an indispensable component of economic recovery and renewal. With the help of regulatory relief, the banking market can fulfill its task.

- The savings banks and Landesbanken has once again proved to be a reliable local financing partner for small and medium-sized enterprises during the coronavirus pandemic.
- Regulatory relief for the banking industry during the Covid-19 pandemic has been instrumental in ensuring that Germany's savings banks, and banks in general, have been able to cushion severe economic collapses in the corporate sector.
- It is now an urgent necessity that regulatory relief should be maintained at least until the recovery has propelled the economy back up to pre-crisis levels.

11 May 2021

Authors:
Uwe Burkert - LBBW
Uwe Dürkop - Berliner Sparkasse
Jochen Intelmann - Haspa
Dr. Ulrich Kater - DekaBank
Christian Lips - NORD/LB
Dr. Jürgen Michels - BayernLB
Dr. Reinhold Rickes - DSGV
Dr. Gertrud Traud - Helaba
Prof. Dr. Carsten Wesselmann - Kreissparkasse Köln

Coordinator:
Dr. Sonja Scheffler
sonja.scheffler@dsgv.de

Germany’s Savings Banks and Landesbanken as partners of SMEs

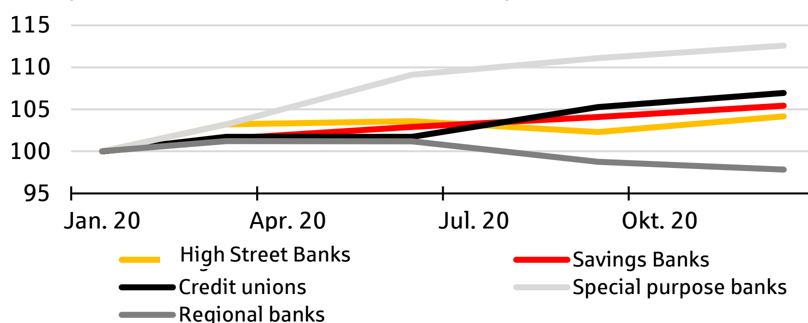
Small and medium-sized enterprises are an important economic factor in Germany, generating more than half of value added and providing around 60 percent of all jobs. Thereby, the country’s SMEs are reliant not least on financing partners, and most of these happen to be savings banks and Landesbanken. As members of the Savings Banks Finance Group, these two constellations of banks are the largest financiers of SMEs in this country - around two-fifths of all loans to companies and the self-employed are accounted for by the overall group.

In the midst of the coronavirus pandemic, the savings banks and Landesbanken has once again proved to be a reliable local partner, living up to its responsibility as the main financier especially of small and medium-sized enterprises. This banking entity has not only ensured that the state aid loans approved since the spring of 2020 have actually ended up at the companies concerned, but also corresponding moratoria have been agreed upon, wherever necessary. Where the aggregate volume of loans extended by al German savings banks to domestic companies and the economically self-employed came to approximately 444 billion euros at the beginning of 2020, the cumulative loan portfolio had climbed to around 470 billion euros by the end of the fourth quarter.

In absolute terms, this is the highest figure among all bank groups. Underlying this development is record new business in loan commitments of a shade over 106 billion euros, which was largely granted on the bank's own account. The share of special loans from Germany’s national development bank KfW and from the promotional institutions of the German federal states in this total works out at 7.5 percent. Even counting out these special coronavirus-related loans, the savings banks have set a new record. Changes in the portfolio of loans to companies and the self-employed increased by 3.8 percent in the overall market in 2020. High growth rates were generated at savings banks (+5.5 percent), cooperative banks (+6.9 percent), private “High Street” banks (+4.1 percent) and banks with special tasks (+12.4 percent).

Savings banks have set a record for loan commitments even without coronavirus-related special loans

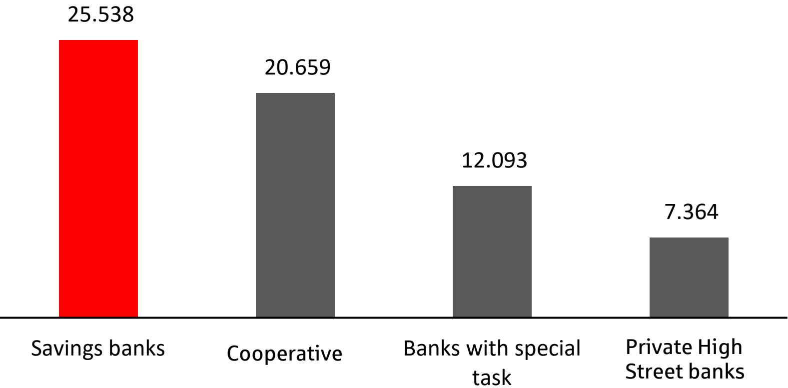
Fig. 1 Loans to domestic enterprises and the economically self-employed, indexed (2020 = 100), quarterly data



Sources: Deutsche Bundesbank, LBBW Research.

Overall, savings banks (+25.5 billion euros), cooperative banks (+20.7 billion euros) and special purpose banks (+12.1 billion euros) each shouldered a considerable share of the market's credit growth in absolute terms (+58.3 billion euros). By comparison, private “High Street” banks only managed to grow their loan portfolios by 7.4 billion euros. Savings banks in particular have been providing above-average support to their customers amidst the depredations of the coronavirus crisis and have simulaneously been able to further expand their market position in the customer-loan field.

Fig. 2 Loans to domestic enterprises and self-employed persons, portfolio changes in million euros over the course of 2020



Sources: Deutsche Bundesbank, DSGV.

During the present pandemic phase especially, the regional banking system in Germany has once again demonstrated its efficiency. The institutional specifics of a strong regional local-bank network have even turned out to be of crucial importance to the effective implementation of government credit programmes. A comparative study conducted by experts at the London School of Economics found that the implementation of German credit programmes (business loans and quick business loans) in the regional “house bank” system has been significantly smoother than through the corresponding state credit facilities in the British system where the consortium executing the programme consisted of private “High Street” banks[1]. The speed and quality of lending turns out to have been significantly higher in the German programmes, to the point that there has been much less abuse of state support loans in the Federal Republic because regional credit institutions in these parts have more detailed knowledge about prospective borrowers.

As a result, Germany's savings banks, like banks in general, have proved to be part of the solution in terms of cushioning the severe economic

[1] Hancké, Bob, Toon Van Overbeke and Dustin Voss (2021). 'Crisis and complementarities: A comparative political economy of economic policies after Covid-19', *Perspectives on Politics* (forthcoming)

slump suffered by businesses last year. It has to be remembered that the gross domestic product (GDP) in this country shrank by no less than 4.8 percent in 2020.

Regulation has supported the provision of funds

Regulatory relief is making an important contribution

During the pandemic, numerous credit institutions were able to extend loans. They have been instrumental in enabling many companies to cope with the pandemic so far. There have been some regulatory relief measures at European and national level that have supported the banking industry: By bringing forward the extended SME factor, reducing the countercyclical capital buffer and making targeted adjustments to the formation of balance sheet risk provisions, the capital ratios of financial institutions were strengthened in a targeted manner to enable them to provide the affected companies with the financing they need as quickly as possible. The rating agency Moody's estimates that the measures known as the "CRR II quick-fix" strengthened Common Equity Tier 1 capital ratios by an average of 0.4 percentage points. Moreover, these measures were balanced, as they did not jeopardize systemic stability at the same time. Some regulatory requirements could have been eased (risk measurement procedures, moratoria, non-relief in Pillar II as well as in the bank levy). Keeping them in place did not facilitate lending.

First and foremost, however, the fact that the equity-capital base has been strongly expanded in recent years has paid off, in the current difficult situation especially. Thanks to the additional stress resilience which the banking supervisory authority BaFin attested in the case of German banks in the spring of 2020, it has also proved possible, after weighing up all risks, to provide corresponding loans.

Loan-loss provisions are weighing on annual balance sheets...

Nevertheless, the coronavirus-related disruptions have, in the nature of things, left their mark on the current annual balance sheets of German institutions. In particular, the significant increase in expenditure on loan-loss provisioning has taken its toll. It is true that (frequently higher) commission income has been generated. However, despite volume-driven growth, for example in the domain of construction financing, net interest income continues to be under pressure due to the negative interest-rate environment. On balance, operating results have declined in many cases.

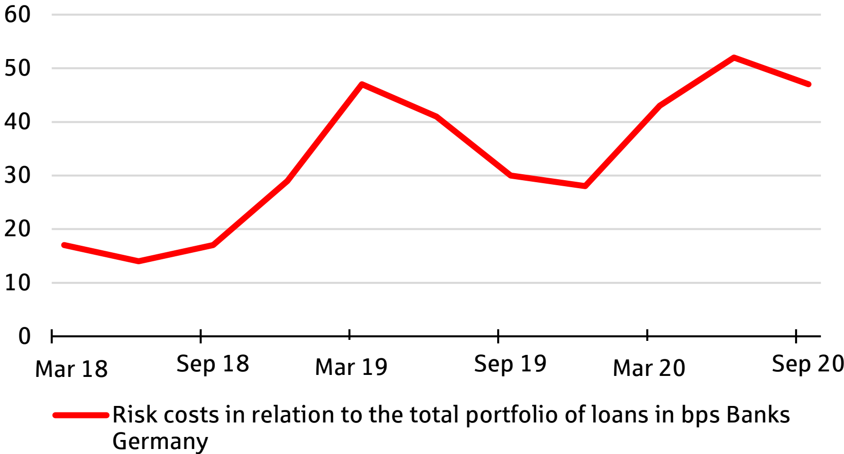
Falling operating results and a rise in risk provisioning inevitably lead to considerable pressure on annual net earnings. This notwithstanding, the two savings bank and cooperative bank groups have managed to report a net surplus after tax, albeit at a reduced level, and at the same time to replenish risk reserves. Thus, the German banking market, across the

board, should not turn out to be in quite as bad a pass as had been anticipated back in the middle of 2020. For 2020 as a whole, a positive annual result can (just about) be expected for the overall universe of German credit institutions. That said, the return on equity is likely to remain low, which constitutes a potential burden on financial stability and is a factor being closely monitored by both rating agencies and supervisory authorities. The low level of profitability is due not only to the recessionary macroeconomic development but also to exacting regulatory requirements, the long-term negative-interest-rate environment engineered by the ECB and the enduring payment obligations entailed by the European bank levy.

... nevertheless, a positive annual result is still on the cards for the German banking market in 2020

The ECB's longer-term tenders (TLTROs) have indeed provided some relief. Nevertheless, the sharp increase in the envelopes of the ECB's purchasing programmes and the negative interest rate on excess reserves have resulted in an onerous burden for credit institutions. Therefore, the ECB needs to be called upon more than ever to provide relief by increasing the tiering multiplier on excess reserves.

Fig. 3 Risk costs borne by the banking system Germany, basis pts (bps)



Sources: EBA, LBBW Research

If one takes a look at the already available forecasts of credit institutions regarding the profit situation over the coming years, they turn out to be characterised by great caution and restraint on account of the uncertainty surrounding the future trajectory of the coronavirus pandemic. Although most of the country's credit institutions are expecting loan-loss provisions to decline again in the medium term, they still see them remaining at a significantly elevated level. No normalisation is anticipated even during 2023. At the same time, many credit institutions are apprehensive that the positive earnings effects deriving in 2020 from securities transactions and investment-banking services will prove lower in future. Earnings growth could thus become almost impossible in the persistent low-interest-rate environment.

The watchword is to remain vigilant

In view of the continuing high level of uncertainty about the further repercussions of the pandemic, and despite the accelerating vaccination rollout and the prospect of an economic recovery kicking in over the coming quarters, the environment for Germany's financial institutions remains a challenging one. According to data from the banking supervisory authority EBA, the ratio of non-performing loans (NPLs) in Germany comes to only 1.3 percent, and is thus 1.3 percentage points below the EU average. In addition, the average hard core Tier 1 capital ratio works out at 15.6 per cent, which is 0.1 percentage points higher than in the EU as a whole.

It is going to be difficult to assess borrower quality going forward

The fact is, though, that the NPL ratio is late-cyclical in nature, and temporary state aid commitments as well as the suspended insolvency-filing requirement make an assessment of future borrower quality very difficult at the present point in time. Loss buffers were indeed strengthened in 2020, but in view of the expected increase in corporate insolvencies it is a moot point whether they will need to be further reinforced. The currently solid capital base at banks is also threatened by a deterioration in the internal ratings of borrowers in the aftermath of pandemic effects. The current cushion could then erode to some extent. On this front too, then, banks need to remain vigilant.

The same applies on the supervisory side to ensure that the equity previously released for lending is not "frozen" again too soon when the economy picks up. For such a “freezing” scenario would not ultimately support the economic recovery, which is likely to be accompanied by an increase in the financing needs of companies. The regulatory measures adopted at the onset of the crisis had a supportive effect on the real economy as well as on the financial system, attentuating the sharp surge in uncertainty, and the same kind of approach is advisable during the coming quarters. At the same time, the fact that the ECB supervisory authority has placed the monitoring of credit risks at the very top of this year's priority list is reassuring from the point of view of systemic stability.

It would be wrong to tighten the regulation screw again too early

Currently, corporate credit demand is not all that strong. In January 2021, the growth rate in Germany was 4.2 percent compared to the same month of the previous year; the monthly average for 2020 had still been as high as 5.6 percent. However, this should change quickly once the pandemic is over - and this upswing should not be stifled by a premature tightening of the regulatory screw. The deviation of the ratio of domestic credit to GDP from the long-term trend is crucial for calibrating the

countercyclical capital buffer. A strong economic stimulus throughout 2021 as a result of Covid-19-induced catch-up effects is unlikely to be sufficient on this score.

At the same time, further destabilising regulatory effects on the economy should be avoided in this phase through the NPL backstop, which provides for deductions from banks' own funds for the first time as of 26 April 2021. It would be counterproductive to now curtail the scope for credit institutions to support companies in their restructuring endeavours and thus to hinder the recovery of the economy, especially in those sectors particularly battered by the coronavirus pandemic. More specifically, it would be helpful to suspend the deduction calendar for 24 months and to take greater account of "in value" mortgages.

Furthermore, it should not be forgotten that the definitive Basel III regulations (often referred to as "Basel IV"), which the Basel Committee on Banking Supervision (BCBS) published in December 2017, have so far only been partially transposed into European law. According to the updated BCBS recommendation, the output floor, which is to be introduced in various stages over five years from January 2023 onwards, is going to lead to a significant tightening of capital requirements. This floor is designed to limit the deviation of the capital requirements determined by banks' own measurement methods from those that would result from application of the standardised approaches.

The additional capital requirements dictated by the Basel IV output floor will create a big burden in future

In the impact study which it published in December 2020, Deutsche Bundesbank calculated that the output floor alone would increase the minimum capital requirements for the overall banking segment by 17 percent on average by the beginning of 2028. Even for the savings banks, which generally do not use internal measurement methods, the changes to the risk weights in the standard credit-risk approach will increase capital requirements by almost 10 percent, which adds up to a significant burden. The capital tied up in this way could well be lacking to finance the upswing, because credit institutions are already going to anticipate the future burdens today, at least in part. Furthermore, if we look into the more distant future, SMEs especially are going to be confronted with the challenge of transforming their business activities in a digital and sustainable fashion. For this reason too, it is important not to restrict bank lending through excessive regulation.

A further postponement of the introduction of the output floor is recommended

A renewed postponement of the introduction of the output floor, or an explicit reference to the Pillar 1 capital requirements and thus an "offsetting" of the risks covered by this with those already addressed by individual Pillar 2 add-ons, would therefore appear advisable. For that would mitigate the aforementioned hike in equity-capital requirements. In recent years, the ECB supervisory authority, in cooperation with the national supervisory bodies, has carried out a targeted review of such

internal bank models within the framework of the large-scale project "TRIM" (Targeted Review of Internal Models) in order to reduce inconsistencies and unjustified deviations. The rationale behind the TRIM project is thus identical to the purpose of introducing an output floor. Building on its experience, the ECB's supervisory authority finally drew up a more than 200-page set of guidelines on the use of internal models in October 2019.

Moreover, further administrative and financial burdens resulting from the European Banking Union need to be avoided in their entirety. Neither in terms of proportionality nor from the perspective of financial stability would it be necessary to expand the competences of the Single Resolution Board (SRB), nor to envisage the resolution mechanism for all credit institutions as a general rule. What is more, further increasing levy payments to the multitude of administrative budgets of European authorities, including the European Supervisory Authorities (ESAs), the SRB and the ECB banking supervisory body, are to be rejected as counterproductive.

The implementation of the European Commission's proposals for the compulsory centralisation of deposit insurance would cost the savings banks and their associated institutions 5.9 billion euros, which would dramatically cripple their lending capacity and plunge Germany’s SMEs into a credit crunch. In addition, financial stability would be undermined if tried-and-tested institutional protection systems such as those operated the public-sector and cooperative financial groups with their preventive measures were to be weakened or even abolished.

Conclusion

So far, Germany's financial institutions have come through the coronavirus crisis relatively unscathed, although the pandemic has nevertheless left its mark, especially on profit and loss accounts for 2020. Savings banks, like banks in general, have been part of the solution to the crisis, supporting companies on the financing front. Fiscal policymakers and regulators acted swiftly and energetically last spring. Yet with the expiry of state aid measures and the resumption of the obligation to file for insolvency, burdens in terms of asset quality are likely to show up in bank balance sheets after a time lag, despite the economic recovery that is projected to materialise over the coming quarters.

A premature withdrawal of regulatory relief would jeopardise what we have all achieved together, and should therefore support the economic recovery. This applies first and foremost to a possible reinstigation of the countercyclical capital buffer and the NPL backstop, but also, in the

medium term, to the implementation of the so-called Basel III finalisation or the proposed introduction of the output floor. The latter, if introduced, would lead to significantly higher capital requirements and jeopardise the ability of savings banks, and banks in general, to support companies' investments in digitalisation and sustainable business by granting loans to them. Burdens from the European Banking Union must also be limited under all circumstances. Increasing levy payments, an expansion of the SRB's competences as well as a mutualisation of deposit-insurance schemes would place an immense burden on credit institutions and should therefore be rejected as counterproductive.

More than ever, banking regulation with macro- and micro-prudential requirements as well as the link-up with the effects of monetary policy for the smooth functioning of banking markets in the euro area and beyond must be looked at in the overall context of world financial markets. A new balance likewise needs be found regarding the nature of regulation and the lessons to be learned from the pandemic. The health crisis, more than any other, has made it unmistakably clear just how essential a functioning banking system is.

Disclaimer

This position paper by the Chief Economists does not necessarily reflect the stance of Deka Bank or the stance of the respective Landesbanken and savings banks.

Imprint

Publisher
German Savings Banks and Giro Association
Economics, Financial
and Economic Policy Division
Charlottenstraße 47, D-10117 Berlin
Tel: +49/30/20225-5303
DSGV-Volkswirtschaft@DSGV.de

Editorial deadline for this issue
3. May 2021

Design
Franz Metz, Berlin

Picture credits
Unsplash/Lance Asper

Responsible

Pia Jankowski - DSGV
Director
Head of Economics, Financial Markets
and Economic Policy
Pia.Jankowski@DSGV.DE

Dr. Reinhold Rickes - DSGV
Department Director, Head of
Economics
Reinhold Rickes@DSGV.DE

Note
All publications in this series can be found at
https://www.dsgv.de/positionen.html#standpunkte

ISSN
2509-3851