Finanzgruppe
Deutscher Sparkassen-
und Giroverband

STANDPUNKTE
DER CHEFVOLKSWIRTE

Banking Market Germany: Regulation with a Sense of Proportion!

The German banking market has once again shown itself to be robust, having successfully passed the stress test of the banking system triggered, under real conditions, by the pandemic. With the corona-virus still rampant and above all on account of Russia's war of aggression against Ukraine, the German economy is facing a new test of endurance. In view of the massive economic and structural knock-on effects to be expected from the war, the Chief Economists of the Savings Banks Finance Group call, as a matter of urgency, for the supply of credit not to be restricted by excessive regulation.

- Systemic stability and lending to support the economic recovery are two sides of the same coin. As a result of this, a revision of banking regulation and a move away from mutualisation and centralisation measures within the framework of the Banking Union are required.

- Savings banks are crucial financing partners for German SMEs. In order for them to be able to make their important contribution towards supporting local businesses, it is imperative that the proportionality principle be properly observed in the regulatory sphere.

- Further capital burdens need to be avoided. In view of the cyclical setbacks which look to be in the offing, it is important to examine whether the planned increase in the countercyclical capital buffer should be postponed. The same applies to the sectoral systemic-risk buffer.

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Savings Banks and Landesbanken are crucial partners of SMEs

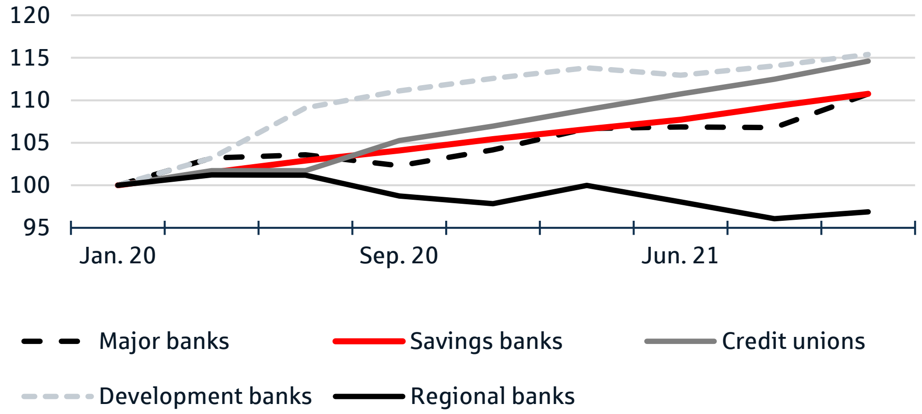
Savings banks and Landesbanken are responsible for generating a considerable proportion of credit growth

Small and medium-sized enterprises are a decisive economic factor in Germany, generating more than half of macroeconomic value added and providing around 60 percent of all jobs. For them to make this possible, SMEs are reliant not least on a strong financing partner. In most cases, their partners are savings banks and Landesbanken. These two segments, folded into the Sparkassen-Finanzgruppe (Savings Banks Finance Group), are the largest financiers of SMEs in the Federal Republic: approximately two-fifths of aggregate loans to companies and the self-employed are generated by this group.

Even (indeed especially) against the backdrop of the coronavirus pandemic, which has now been dragging on for more than two years, the public banking sector has once again proven to be a reliable contact for local businesses. It has not only ensured that state aid loans have been actually reaching the corporate sector since spring 2020, but has also been willing to grant corresponding moratoriums, wherever necessary. Where the savings-bank sector as a whole had extended loans of a volume of approx. EUR 444 billion to domestic companies and economically-independent private individuals back at the beginning of 2020, the size of this portfolio had climbed to virtually EUR 500 billion by the end of the fourth quarter of 2021. In absolute terms, this is the highest figure for any banking group in the Federal Republic. At the same time, saving banks, with their deep regional roots, have been ensuring that the loan spigot has been kept open locally across the entire spectrum of SMEs.

The portfolio of loans to companies and self-employed persons increased by 4.8 percent in the overall market in 2021. In this context, the highest growth rates were logged by savings banks (+5.4 percent), Landesbanken (+5.2 percent), cooperative banks (+7.8 percent) and “High Street” private-sector banks (+6.7 percent).

Figure 1: Loans to domestic enterprises and the self-employed, indexed (2020 = 100), quarterly data



Source: Deutsche Bundesbank, LBBW Research.

Overall, savings banks and Landesbanken (+34.4 billion euros), along with cooperative banks (+25.0 billion euros), have shouldered the lion's share of credit growth in the total market (+77.5 billion euros) in absolute terms. By comparison, Germany's "High Street" private-sector banks only grew their loan portfolios by 12.5 billion euros.

Germany's Landesbanken and savings banks have thus proved to be "part of the solution" when it comes to cushioning the severe economic setbacks suffered by German companies and to providing the credit to fuel the economic upswing that began last year.

But the ecological transformation of German society also constitutes a major challenge. In order to successfully manage the ecological transformation initiated by the new federal government in Berlin, and speeded up by the need to end energy dependency on Russia, the most substantial investment programme in many decades needs to be implemented. The Savings Banks Finance Group intends to support this venture to the best of its ability. For this ambitious plan to come to fruition, however, the whole range of lending options is required, without unnecessary regulatory obstacles putting spokes in the wheels. For example, the banking supervisory authority's current plans to withdraw the coronavirus-related aid measures, as well as the plans to introduce new capital buffers from 2023 onwards, could - unless recalibrated - have a counterproductive effect.

The Savings Banks Finance Group has enhanced its cohesion

The Group's further evolution will further increase its clout

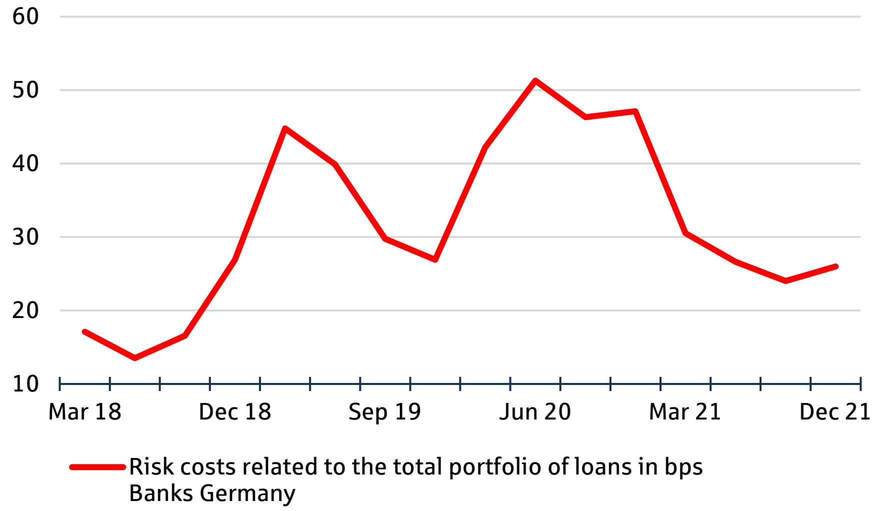
In order to be better equipped for these challenges too, the Savings Banks Finance Group positioned itself even better in 2021. That year marked the launch of numerous strategic cooperations, especially among the Landesbanken, aimed at bundling business activities. There were also major mergers, such as the takeover of Berlin Hyp by LBBW. In parallel with this, the savings banks strengthened their market presence and optimised cost structures. Ten savings banks sought to merge with other saving banks in 2021. This is proof of the Group's ability to consistently adapt to what is a highly competitive business environment.

Confidence in the security systems that have existed, and been tried and tested, in Germany for decades on end is of elementary importance for European financial-market stability. Particularly in view of the current fog of uncertainty and of the far-reaching changes wrought by the coronavirus pandemic and by the war ravaging Ukraine, the confidence of savers must not be put at risk by calling into question the tried and tested legal framework by centralising deposit insurance in Brussels (EDIS). The European Commission would do no service to the protection of savers if it were to undermine well-established and trustworthy systems.

Banks emerge stronger from the crisis to face the next crisis

Fortunately, the disruption caused by the coronavirus pandemic has turned out to be relatively minor thanks to the government measures adopted and to the capital positions built up beforehand. The number of corporate insolvencies has fallen despite the economic slump. Housing loans have continued to be serviced reliably, and defaults and deferrals have remained rare. As a result, banks' loan-loss provisions normalised over the course of 2021, reverting roughly to pre-crisis levels.

Figure 2: Risk costs for the German banking system, in basis points (bps)



Source: EBA, LBBW Research

At the same time, the capitalisation of banks and savings banks in Germany has continued to improve. For example, the hard core capital ratio according to European Banking Authority (EBA) data could be boosted to 15.2 percent as of 31 December 2021, i.e. to above the pre-crisis level (14.5 percent as of 31 December 2019). Institutional profitability also increased significantly, with the return on equity reaching a satisfactory 4.3 percent (0.6 percent in 2019, 0.3 percent in 2020). In the German banking market, the savings banks boast a distinctly higher return on equity than the average across all banking groups, achieving a return on equity before taxes of 6.1 percent in fiscal 2021.

What is more, the quality of earnings has improved as well. The dependence on net interest income was further reduced by a noticeable increase in commission income. This should put the banks and savings banks in a comparatively auspicious position to meet the upcoming challenges posed by the consequences of the war in Ukraine.

In view of the persistently high amount of uncertainty about the further fallout of the pandemic, but also about the war in Ukraine, it remains very difficult to predict the outlook for the economic trend with any great degree of precision. This is the case even though German banks and savings banks already noticeably reduced their exposure to Russia in response to the annexation of Crimea and currently have a below-average exposure compared to other European banking systems. According to the Bank for International Settlements (BIS), German banks and savings banks had a total exposure to the Russian Federation of USD 8.1 billion as of 30 September 2021.

In view of the war in Ukraine, the outlook is currently fraught with a great deal of uncertainty

The EBA puts the Russian exposure of those German banks and savings banks which it supervises at EUR 4.5 billion as of 31 December 2021 (all European banks unter its supervision: EUR 76 billion). Only a small portion of this sum is attributable to the financial institutions belonging to the Savings Banks Finance Group. The bulk of the direct impact is weighing on Germany's three largest “High Street” private-sector banks.

Expectations regarding GDP growth going forward have recently been ratcheted down noticeably by research institutes as well as by research units of banks and savings banks: Though it is true that, according to EBA data, the ratio of non-performing loans (NPLs) in Germany is only 1.1 percent and thus 0.9 percentage points below the EU average, the fact remains that a noticeable increase is likely if the economic climate cools. The current cushion could then erode to some extent. In this respect, credit institutions need to remain vigilant with regard to the way things shape up among their borrowers.

Further capital charges are to be avoided

The knock-on effects of the coronavirus pandemic have saddled not only German but also many other European credit institutions with considerable challenges. Nevertheless, in cooperation with supervisory and regulatory authorities as well as with political policymakers, banking institutions have still been able to impressively demonstrate their resilience. Above all the beefed-up capital requirements implemented in recent years ensure that the banking sector is capable of fulfilling its classic task - financing the real economy - even when confronted with an unprecedented pandemic predicament. In most cases, this has proved possible without existing capital buffers having to be drawn on. It can therefore be concluded that the “informal” stress test of the banking system triggered, under real conditions, by the pandemic has been passed with flying colours.

However, BaFin has further tightened capital requirements for credit institutions. This contrasts with pronouncements during the height of the pandemic, when credit institutions were assured that they would have sufficient time to replenish capital buffers if they were used. Where, only a short time ago, politicians and supervisory authorities had explicitly called for unhesitant lending to the real economy, the activation of the counter-cyclical capital buffer on domestic risk positions by a record amount of 0.75 percent from February 2023 onwards is supposed to slam the brakes on lending - and that in the midst of a fog of economic uncertainties caused by the fog of war in Ukraine. Especially at a time when the economy is threatening to lose significant momentum, the planned increase should be postponed in accordance with the philosophy behind the concept of the counter-cyclical capital buffer. Such a postponement would make it easier to continue counteracting the downturn by extending lending.

The room for manoeuvre available in the sectoral systemic risk buffer needs to be utilised!

But that is not the end of the matter: assets in the residential real estate segment are scheduled to be additionally burdened with a sectoral systemic risk buffer of 2 percent from 1 February 2023 onwards. The aim here is to make the banking sector more resilient to loan defaults that could result from sharp price declines in the residential real estate market. The direct consequence of these decisions is a further increase in capital requirements for the German banking sector totalling 22 billion euros - in addition to what is already a sufficiently onerous level.

In order to combat the causes that made these regulatory steps appear necessary, i.e. to reduce overvaluations in the market for residential real estate, it is imperative above all that political policy parameters must be set correctly. Such parameters include the European Central Bank making a gentle exit from its zero-interest-rate policy, and sufficient construction activity in those parts where housing is particularly scarce. The goal should be to bring the market down for a "soft landing.” Even the higher inflation we are currently encountering could, paradoxically, be helpful on this score: in relative terms, this would make real estate less expensive again without the need for nominal price declines. In such an environment, the risks to the banking sector would decrease more or less automatically.

Unfortunately, BaFin is also leaving room for manoeuvre available in the sectoral systemic risk buffer unutilised. BaFin has failed to take into account reasonable exceptions involving acutely important political projects such as the financing of sustainable residential buildings or loans to municipal, ecclesiastical and cooperative housing construction companies, as well as low-risk lending by building societies/thrifts. As a result, the energy efficiency of buildings, which is currently more relevant than ever, as well as the accelerated construction of urgently needed new housing, will probably be even more difficult to realise in future, as several factors are combining to create an unfavourable predicament: the problems entailed by a widespread shortage of materials and personnel in the construction industry as well as by rising prices are now being compounded by more difficult financing conditions.

In principle, the financial sector should, as a matter of urgency, be given room to manoeuvre in order to be able to initiate positive step changes in the real economy. This role has been intended for banks and savings banks not least in the EU's "Fit for 55" package designed to spur sustainability and the transformation of the economy. On the other hand, it would be misplaced for supervisory authorities to employ macroprudential measures to compel banks and savings banks to correct undesirable developments in monetary policy, and their effects on the real economy, or else to compensate for a lack of (fiscal) policy measures.

Both these points are all the more weighty because the German banking market, with its large number of small and medium-sized credit institutions, is already being disproportionately affected in any case by EU banking regulation, which is conducted largely independent of size.

Yet the coronavirus pandemic, in particular, has demonstrated what a successful symbiosis between a decentrally organised banking sector and a decentrally distributed real economy should look like, while underlining the importance of regionality. To that extent, it would seem appropriate - precisely against the background of the present economic dislocations caused by the geopolitical situation - to further strengthen the proportionality principle in the regulatory domain. After all, a "one-size-fits-all" approach does less and less justice to today's challenges, and also flies problematically in the face of regionality as a stabilising element. Further corrections are necessary so that savings banks and cooperative institutions are in a position to continue supporting the small and medium-sized enterprises which are Germany's "economic engine” both metaphorically and on the ground of hard facts.

Admittedly, some progress has been made in this respect on the EU regulation front - for example, by introducing the category of "small and non-complex institutions", expanding the so-called "SME factor", and reducing the reporting frequency for certain capital and liquidity ratios. This means that the problem has definitely been recognised by politicians and supervisory bodies. But what is now imperative if we are to safeguard the future is to consistently build on these good approaches. This is especially important in view of the increasing reporting and disclosure requirements that are going to be imposed on financial institutions in the "sustainability" sphere. In its study on the costs of compliance with supervisory reporting requirements (EBA/Rep/2021/15), the EBA has shown that this can simultaneously provide significant relief on the expenditure side - money that can then be used to bolster the capital base or to fund investments in digitalisation.

Already thinking about future regulatory burdens today

This notwithstanding, the outlines of further regulatory burdens are already looming today. For example, the European Commission's October 2021 proposal for CRR III / CRD VI - also referred to as or "Banking Package 2021" - is currently being discussed at the EU level. According to the Commission, the objective here is to reinforce the resilience of the banking sector without "significantly" increasing capital requirements.

According to the Commission, however, such a regime will lead to an average increase in minimum capital requirements, after the end of the transition period in 2030, of between 6.4 and 8.4 percent. The risk here is that the financing of the real economy will have to be curtailed in the future, as the de facto capital requirements on the part of supervisory authorities and investors will be higher than the Pillar 1 minimum ratios due to further requirements such as the SREP capital add-ons. That such a heavier burden is being conceived is difficult to comprehend in the light of the need to transform the European economy in order to enable lower-carbon production in the coming decades.

Temporary interim solutions in EU regulation ought to be reconsidered!

In addition, the legislative proposal provides for temporary interim solutions in some quarters in order to cushion the increase in capital, for example in the case of claims on companies without an external credit rating ("unrated corporates"). This particularly affects lending to small and medium-sized enterprises, the "hidden champions" of German industry. The crucial pont is the following: in today's particularly uncertain times, scarred by the coronavirus pandemic and by the resurgence of geopolitical conflicts, planning security is more necessary than ever. For example, a risk weighting lower than under the current regulation for such an exposure, provided that the probability of default is correspondingly low, is only meant to apply until the end of 2032.

However, merely temporary regulation stands in contradiction to the regulatory methodology underlying the previous CRR II, which was only promulgated in mid-2019. Where the privileged treatment of SME lending was explicitly strengthened under CRR II, the wheel is now supposed to be turned back some way after the expiry of the above-mentioned transitional provision under CRR III. Our respectful suggestion, then, is that the regulation should be retained permanently and should apply to all institutions, i.e. to users of internal models and of standard procedures. The same applies to the treatment of low-risk residential real estate financing.

Particularly against the background of the immense need for investment to achieve a more sustainable economy, the regulation now being proposed is difficult to understand, especially since such exposures have not triggered value adjustments in bank balance sheets in the past. As that is the case, a revision to the proposed regulation on this count by the European legislator should not pose any threat to financial stability.

Conclusion

Particularly against the background of the more than two years of coronavirus pandemic, the public banking sector has once again proven to be a reliable local financing partner for Germany's companies. The equity base of the credit institutions in question has been strengthened and lending activity has been expanded. It should not be forgotten either that the guarantee system operating across the Savings Banks Finance Group likewise contributes to the stability of the institutions and to maintaining the trust of customers.

Achieving a better regulatory balance is the order of the day in view of the current lie of the land

The fact is, though, that the economic outlook is fraught with a great deal of uncertainty in view of the further repercussions of the pandemic and of the war in Ukraine, even if the direct exposures of German institutions to Russia and Ukraine are, in de facto terms, negligible. The golden rule for credit institutions, now as before, is therefore to remain vigilant - and it is, by the same token, incumbent on supervisory authorities to maintain a reasonable balance between financial stability and support for the economic recovery.

In this respect, the latest decisions by BaFin need to be critically questioned in the light of the altered situation. A postponement of the introduction of macroprudential capital buffers should be considered. On this score, it would be important not to overlook the burdens that lie further in the future due to the planned introduction of CRR III / CRD VI. Temporary interim solutions do not make much sense, since especially in uncertain times and in view of the complexity of the ecological restructuring of the economy which lies ahead, planning security is going to be more necessary than ever for banks and savings banks, as well as for their customers. The German banking market is in robust shape, and is indeed an integral part of this transformation process - but forward-looking and balanced regulation is also required if Germany’s banks are to rise successfully to the challenges presented by this new paradigm.

Disclaimer

This position paper of the Chief Economists does not necessarily reflect the position of all institutions of the Savings Banks Finance Group.

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