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The Savings Banks Finance Group Germany's Champion in the „Mittelstand“ financing field

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The debate about the German banking market has once again intensified. At the moment, discussion is centering on the role played by the existing architecture and on the need for further consolidation measures. It is important when conducting these strategic discussions to take proper note of the key advantages provided, in particular, by Germany's savings banks (Sparkassen) and Landesbanken, which perform a mainstay function. This is because the financial crisis has taught us the following lessons:

→ The decentralised network of savings banks (Sparkassen) and Landesbanken creates stability.

→ Savings banks and Landesbanken safeguard Mittelstand financing in Germany.

→ Germany's local authorities and savings banks form a community based on responsibility.

→ The guiding principle of "proportionality" in banking regulation points in the right direction.

Authors
Uwe Burkert - LBBW
Uwe Dürkop - Berliner Sparkasse
Jochen Intelmann - Haspa
Dr. Ulrich Kater - DekaBank
Christian Lips - NORD/LB
Dr. Jürgen Michels - BayernLB
Dr. Cyrus de la Rubia - HSH Nordbank
Dr. Gertrud Traud - Helaba
Prof. Dr. Carsten Wesselmann
- Kreissparkasse Köln

Coordinators
Dr. Reinhold Rickes
Reinhold.Rickes@dsgv.de
Dr. Sonja Scheffler
Sonja.Scheffler@DSGV.de

The Savings Banks Finance Group – Germany's Champion in the Mittelstand financing field

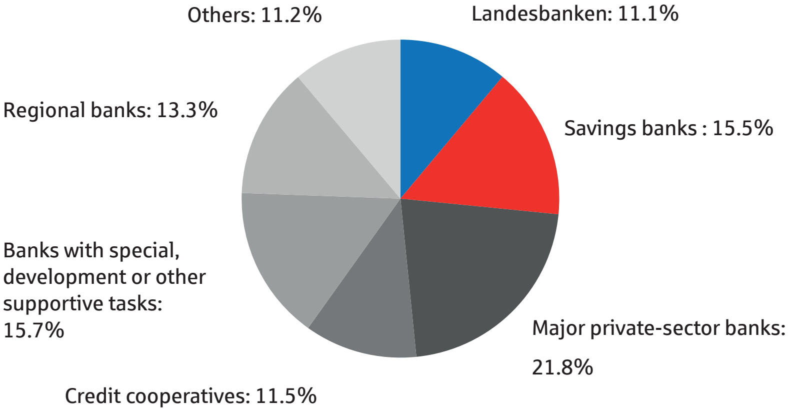
The world is in the throes of radical change. And this not only holds true for the current challenges facing global trade policy in terms of preserving the free and open markets which promote prosperity. The economic upswing in Germany, which has already lasted for a very long period by historical standards, appears to be gradually aging and losing momentum. Alongside this, the domestic banking sector continues to be subject to change, and is set to be confronted with numerous challenges in future as well.

The bedrock of the German economy, it should be recalled, is a broad "Mittelstand" of small and mediumsized enterprises wellknown outside the country, a high degree of international competitiveness, well-qualified employees and last but not least an efficient public banking sector which has been a reliable partner for both private companies and public authorities for decades now – and aims to continue to perform this task in future too.

Savings banks and Landesbanken – the mainstay of the German banking landscape

Savings banks and Landesbanken – a network which has grown up organically over time – are one of the main pillars supporting the German banking landscape. Whenever a savings bank's risk-bearing capacity is no longer adequate on account of its size, the Landesbanken come into play. This type of interaction amounts, in effect, to a division of labour to the benefit of corporate customers, functioning very well in foreign business, for example. This set-up helps small and medium-sized enterprises to open up new business activities beyond the borders of the Federal Republic. Very nearly 27% of the aggregate balance sheet of German banks is accounted for by the savings banks and Landesbanken sector.

Percentage share of various institutional groups in Germany's aggregate bank balance sheet as of 12/2017



Sources: Bundesbank, LBBW Research, DSGV statistics and forecasts

Know-how advantage for clients, incl. Mittelstand, due to regional underpinnings

What is more, Germany's savings banks and Landesbanken have strong relations with their respective core region simply because of their public-law status.[1] In turn, such regional rootedness is highly conducive to customer proximity, helping the banks in the network to stay true to the important "know your customer" principle. In addition, it should be noted that the rating agency Fitch argues that the broad regional distribution of German savings banks implies a high liability-solidarity capability in the event of a crisis. This obviates a "too-big-to-fail" risk. The protection system operated by the Savings Banks Finance Group safeguards deposits at savings banks, Landesbanken and Landesbausparkassen (the SBFG's affiliated savings and loan associations). The aim of this protection system is to prevent institutions participating from getting into economic difficulties. The system makes this possible through voluntary institutional guarantees in keeping with the legal provisions. In this way, business relations with customers can be continued as contractually agreed.

Regional underpinnings

Such a business model, which is not geared to profit-maximisation as an end in itself but which is, at the same time, explicitly committed, inter alia, to fostering the best interests of the (regional) economy, therefore strengthens the stability of the banking system as a whole. For it is a fact that the sheer diversity of the business models used by different banking groups (the German banking landscape differs structurally from that in other European states) helps to cushion shocks in the real economy and the financing bottlenecks which might possibly result from these. Metaphorically speaking, we are basically talking about a system of checks and balances. Just as federalism is an essential characteristic of the German political system, the regional roots possessed by the country's savings banks and Landesbanken make a decisive contribution towards bolstering the strength of the "local" economy. Local prosperity is boosted by the degree to which this banking group identifies with the best interests of the regional economy, without losing sight of risk parameters in the process.

In Germany, corporate financing via bank loans has traditionally had a high profile. For small and mediumsized enterprises ("Mittelstand") in particular, raising debt capital via the capital market tends to play a comparatively negligible role, although such capital-market-funding activities could, wherever possible, be expanded for the sake of diversification.

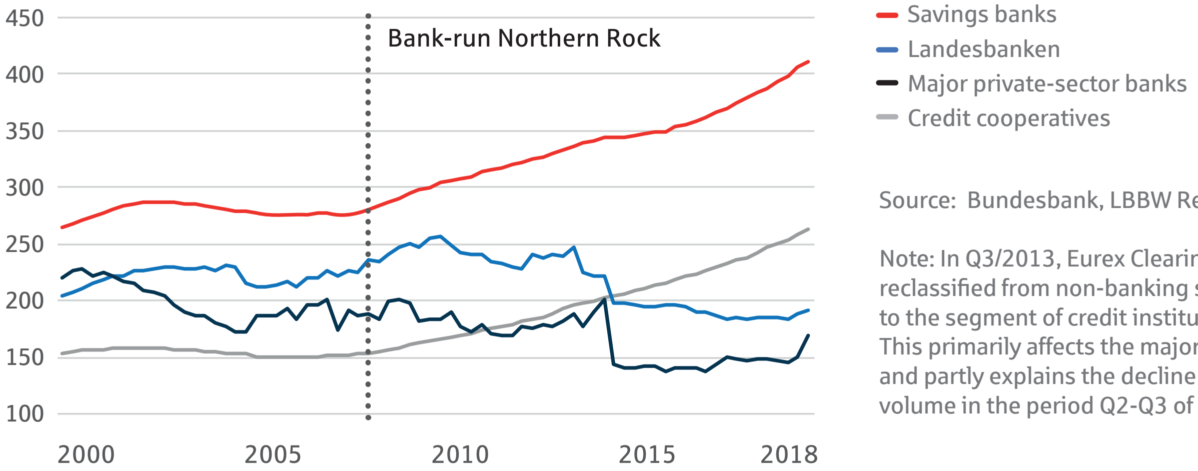
[1] In Germany, there are five non-public savings banks (Sparkassen). These so-called "free savings banks" were founded by public-spirited private individuals at the end of the 18th century. Even though governance structures differ here to some degree, the "free savings banks" are also committed to serving the best interests of the region in which they are rooted.

Savings banks and Landesbanken as anchors of stability

Accordingly, Germany's savings banks have made an especially large contribution towards stabilising the domestic supply of loans since the onset of the financial crisis, whose inception we date back in the following chart to media reports in September 2007 that the British financial group Northern Rock was encountering funding difficulties. Over the period from Q3 2007 to year-end 2010, which is when the German gross domestic product returned to positive territory on a year-on-year basis, savings banks and Landesbanken lifted their share of aggregate lending to companies and self-employed persons by 2.7 percentage points to 37.6%. At 41.6%, the equivalent ratio is actually even higher today. By contrast, Germany's major private-sector banks have lost ground: where their share in lending was still as high as 15.2% in 2007, the current figure is below 12%.

Solidity bracing

Lending to enterprises and self-employed persons, in bn euro, by institutional group

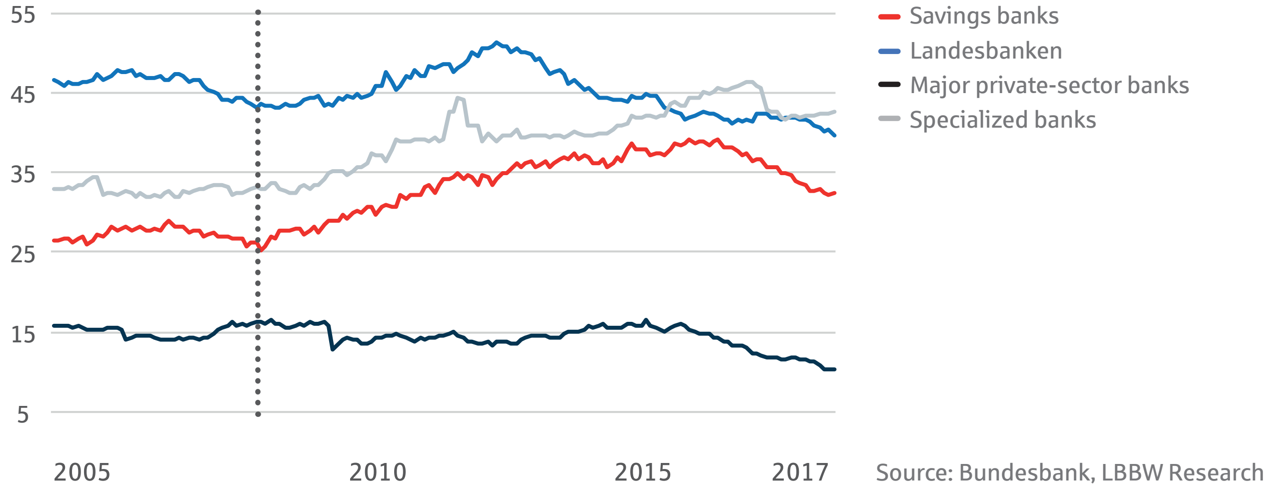


Source: Bundesbank, LBBW Research

Note: In Q3/2013, Eurex Clearing was reclassified from non-banking segment to the segment of credit institutions. This primarily affects the major banks and partly explains the decline in credit volume in the period Q2-Q3 of 2013.

The same picture emerges if we turn to lending to the public sector. Where the German state in particular, and increasingly German federal states ("Länder") as well, are refinancing themselves to a pronounced extent by issuing bonds, capital-market financing has only held very limited appeal so far in the case of Germany's local authorities. In this segment too, it is the Landesbanken (26%) and the savings banks (21%) which are ensuring sustainable capital provision, along with the development banks, which have traditionally had a strong commitment on this count (27%). The local authorities are responsible for providing numerous social benefits as well as for a large proportion of capital expenditure on tangible assets. Solid financing of local authorities is therefore of crucial importance for public-sector investment activity. The Savings Banks Finance Group makes an important contribution in this sphere – especially in economically more difficult times.

Loans to local authorities and associations of local authorities , EUR billion, by institutional group



Source: Bundesbank, LBBW Research

Needs-oriented infrastructure provision is a significant locational factor fuelling economic activities. In recent years, various studies, for example the annual country analyses published by the European Commission (e.g. for 2018 or 2017), have concluded that there is an investment gap, especially in the local-authority field – this applies above all in the case of transportation infrastructure and the education domain. Yet it is precisely infrastructure which constitutes the basis for local corporate activity and which makes a decisive contribution towards reinforcing the competitiveness of the companies concerned. Great importance therefore continues to attach to solid bank lending. It would hence appear to be urgently necessary to ensure that sufficient external capital to maintain public-sector investment can be made available in the event of a cyclical slowdown. In view of the fact that the fiscal multiplier for public investment – i.e. the ratio between one euro of public spending and the amount of additional growth generated – is well in excess of 1 in Germany's case, (regulatory) restrictions on the lending capacities of banks and savings banks ought, wherever possible, to be avoided. Of course, the overriding objective – to safeguard systemic stability – has to be guaranteed at all times. In our opinion, though, a "national champion" is not necessarily needed for the Federal Republic to achieve this goal. This is because Germany already has two mainstays – the strong networks of the Savings Banks Finance Group and the cooperative sector – which are ensuring adequate capital provision.

Robust competitiveness on-site

As already argued, the savings banks functioned as an anchor of stability from the loan-provision point of view during the most recent financial crisis. However, banking regulation needs to set the right priorities if the partnership between the Savings Banks Finance Group and both private-sector companies and public authorities is to remain as strong in the future as it has proved to be in the past. The rationale here is that regulatory requirements have increasingly evolved into a huge challenge for "smaller" banking institutions in particular, especially because the Basel III regulatory framework has been geared to large universal banks. Although we definitely acknowledge, and indeed welcome, the principal thrust of the Basel III strategy, we nevertheless think that there is room for improvement on a number of points.

Banking regulation needs to take greater account of decentralised structures

The centralistic approach underlying Basel III shows little consideration for national requirements. Yet the structure of the German banking market, marked by a three-pillar system ensuring stable lending during the financial crisis, demonstrates that it is not appropriate to disregard such specific factors. By way of illustration, the extensive reporting and disclosure requirements imposed on smaller financial institutions are hardly suited to ensuring greater stability. It is therefore important to take greater account of the principle of proportionality in the regulatory jungle, without at the same time taking an axe to minimum-capital and minimum-liquidity requirements. What is called for is smart, systematic pruning of such regulations which aid and abet the "too small to comply" phenomenon and therefore entail a risk of lending capacities being unnecessarily cut back in future. Regulatory hurdles which are, in some cases, unnecessarily high tie up staff resources which are therefore unavailable to be mobilised in the interests of customers.

Attention on proportionality

It is pleasing that the principle of proportionality is already being heeded by political decision-makers. For example, it is a reason for cautious optimism that plans are afoot to incorporate elements allowing for greater differentiation in regulatory requirements in the amendment to the CRR. A balance-sheet total threshold of EUR 5 billion is being envisaged. However, absolute thresholds are problematic in view of the role played by inflation and on account of the fact that countries are of different sizes. More meaningful would be a relative threshold of up to 1% of the balance-sheet total as a proportion of GDP and a delimitation dependent on regulatory classification as systemically relevant institution.

In order to rule out regulation-induced shifts in market structure, it is of central importance to introduce a regulatory regime graduated according to size and systemic relevance – a "small banking box" – in a single-minded and efficient manner. A regulatory framework configured in such a fashion would resemble the multi-layered regime operating in the United States, under which the rules applied depend on the size of the institution.

Municipal lending not disadvantaged

We also see room for improvement with regard to the non-risk-weighted debt parameter known as the leverage ratio. This parameter, introduced as a backstop for risk-based capital-adequacy requirements, risk-weights exposures at 100% regardless of their risk profile. This especially disadvantages the low-risk business of lending to local authorities because a high volume of equity capital is then required by comparison to risk-weighted capital ratios. As a result, the leverage ratio can have the effect of curtailing the financing of local-authority budgets, in a downswing phase especially. As a study conducted by the European Banking Authority (EBA) shows (EBA-Op-2016-13), it is indeed the leverage ratio which frequently curtails lending activity. A readjustment to this parameter would therefore appear worth considering, especially with regard to local-authority financing, without too strongly affecting the functioning of this parameter as a "corrective" to risk-weighted capital-adequacy requirements. One way in which this could happen would be if less than 100% of the corresponding exposure to the public sector (possibly limited to certain maximum thresholds) were factored in when ascertaining the ratio.

To summarise, it can be concluded that the Savings Banks Finance Group is a mainstay of loan provision in Germany for both public sector and numerous "local" companies. The Group provided abundant proof of its key role as a financing partner during the financial crisis. However, an appropriate regulatory framework is indispensable if the SBFG is to be able to continue performing this task in future. In the nature of things, such a framework should be principally committed to preserving systemic stability – but it should equally respect the specific features of the various banking systems which have grown up organically over time. In this context, a "one-size-fits-all" type of regulation would not seem very likely to achieve the desired results.

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks.

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Deutscher Sparkassen- und Giroverband
Abteilung Volkswirtschaft, Finanzmärkte
und Wirtschaftspolitik
Charlottenstraße 47
10117 Berlin
Telefon: 030 20225-5303
DSGV-Volkswirtschaft@DSGV.de
www.DSGV.de

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

Dr. Reinhold Rickes – DSGV
Head of Economics
Economics, Financial Markets and Economic Policy
Reinhold.Rickes@DSGV.DE

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