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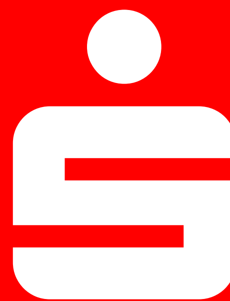

German Banking Market: Ready to finance the future

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In the view of the Chief Economists of the Savings Banks Finance Group, currently elevated inflation rates, along with a high interest-rate level which could definitely shift even higher still, are altering the economic landscape fundamentally. Earlier in the present year, financial markets in other currency areas (Switzerland, USA) suffered disruptions. By contrast, it has become clear that Europe has learned its lessons from the Great Financial Crisis. Financial markets in our part of the world have remained stable. The focus is now back on fighting inflation. The following considerations remain important from the point of view of the banking market:

- Regulatory tightening or fundamental innovations are not necessary in the European Union. In Switzerland and the USA, in contrast, there has been a supervisory failure of a kind that cannot be diagnosed here in the EU.
- The principle of proportionality must be preserved in the field of banking regulation. This requires a differentiation of requirements, on the one hand and, on the other hand, differing degrees of supervisory intensity depending on the size or systemic relevance of the banking institutions concerned.
- In order to create scope for financing transformation, ESG regulation should be geared less to the current sustainability status and more to the sustainability targets of companies.
- The confidence of savers must not be jeopardised by casting doubt on the viability of institutional protection schemes by substituting a centralised European deposit insurance scheme (EDIS) or by making changes to the EU Deposit Guarantee Scheme Directive (DGSD).

An “epochal shift” has taken place in the banking market too

Europe's financial institutions are facing challenges

"Epochal shift" ("Zeitenwende") was the Society for German Language's choice as word of the year in 2022, and such a seismic shift has also been becoming increasingly apparent on the banking market in recent months. The problematic cocktail of weak economic activity, pronounced interest-rate increases and the crisis of confidence which has temporarily spilled over from the USA is presenting Europe's financial institutions with fresh challenges. Such a business environment is highly unusual: as a rule, a decline in economic momentum is accompanied by falling interest rates.

Nevertheless, the ECB's interest-rate hikes are appropriate in the face of still rampant inflation rates, and Team Lagarde's key policy rates have not yet peaked. From a banking perspective, higher, "normal" interest rates definitely have a positive effect, on balance, although the pace of the rate-hiking cycle can pose problems, especially in the domain of maturity transformation, as the ESM has recently emphasized. In Europe, banks and savings banks have done their homework here in a comprehensive manner and prepared themselves, essentially by successfully undergoing the stress tests conducted by banking supervisory authorities.

No contagion effects in Europe from the recent crisis of confidence in the USA

In the United States, on the other hand, supervisory authorities have hardly been policing even the larger banking institutions. Where the net interest margin is rising, market-related valuation losses in asset portfolios are slowing down profit growth at banks. This negative effect was made unmistakably manifest by the crisis of confidence triggered in March of this year by the failure of three US regional banks. At the same time, though, it needs to be stressed that these regional bank failures were specific special cases, which have no counterparts in Europe's banking landscape. Individual shortcomings contributed decisively to the failure of the US banking institutions in question. The most prominent example is Silicon Valley Bank (SVB) from California: its business focus and unusual balance-sheet structure, but also the inadequate regulation regime in force, are typical neither of the German, nor of the wider European, banking system.

The banking system in the euro area is stable – solid fundamental underpinnings

To that extent, there is currently no acute reason to worry about the stability of the banking system in the euro area. The latter's fundamental underpinnings are solid on a broad scale. The results of the ECB Banking Supervision's interest-rate-shock test from last December likewise demonstrated that the local banking system is resilient. The long-standing problems besetting major Swiss bank Credit Suisse, which ultimately led to its emergency ("shotgun") sale to a competitor, are by no means par for the course for Europe's banking system.

On the other hand, the above cases do illustrate that there is room for improvement, especially with regard to interest-rate and liquidity-risk management. Deposits can be transferred within the space of minutes using a smartphone. And if the "digital euro" one day becomes reality, capital flight will be able to take place into central-bank funds (probably only up to a limited amount) instead of, for example, into money-market funds. This is an issue that needs to be addressed, as the ESM has recently pointed out.

Institutional protection creates stability

At the same time, these events have shown that investors do not always act rationally. The psychological effects which can surface even in the event of a credit institution only appearing to get into difficulties should not be underestimated. In Europe, the existing scheme involving deposit protection and institutional guarantees within a single banking system has made it abundantly clear that the smooth functioning of markets is safeguarded in keeping with the dictates of stability. Regulation must therefore not be changed in this sphere. The tried-and-tested protection systems that have existed in Germany for decades have proven their worth during various crises.

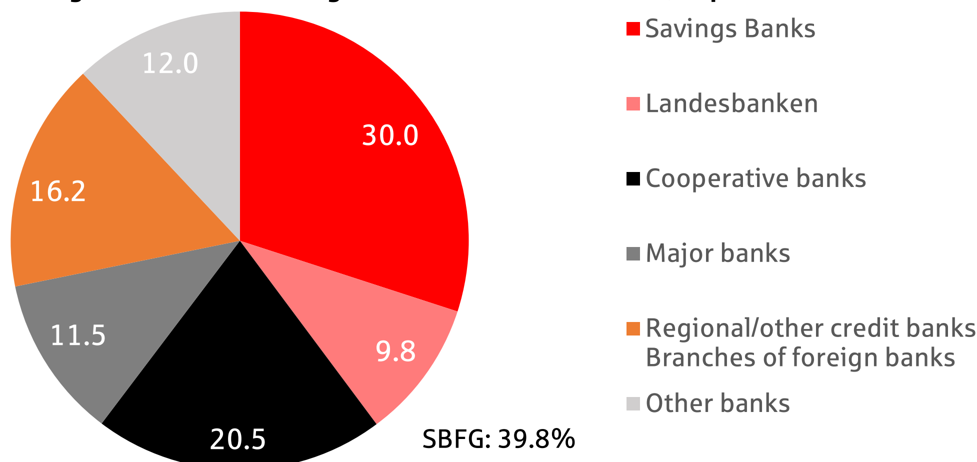
At the end of the day, however, the increased focus on the downside of the rapid rise in interest rates is unlikely to bode well for the already anemic economic development. It is true that lending to private households and companies is growing at a high level; however, a slowdown in lending momentum has been unambiguously detectable since the autumn of 2022. This applies as much to the euro area as a whole as to Germany in particular. What is more, this downward trend could accelerate further in the first instance. The ECB's latest quarterly Euro area bank lending survey points to both a weakening of loan-demand dynamics and to net tightening in credit standards.

Germany’s savings banks have kept a stable course in troubled waters

Savings Banks Finance Group a reliable financing partner for companies

Even in the depths of the coronavirus pandemic, Germany’s Savings Banks and Landesbanken remained a reliable partner to companies and private citizens thanks to high lending growth. After the outbreak of the war over Ukraine as well, the Savings Banks Group underscored its commitment to making a significant contribution to society by continuing to boost its lending volume. In fiscal 2022, for example, Germany’s savings banks pledged no less than EUR 107 billion in new loans to companies and the self-employed. Their loan portfolio expanded to EUR 530 billion, an increase of 6.5 percent. This means that the savings banks (plus 30 percent), and the Savings Banks Finance Group including the Landesbanken (plus 40 percent) remain the undisputed market leaders in Germany. At the Landesbanken, the loan portfolio grew to around EUR 180 billion, an increase of 5 percent year-on-year. Against the backdrop of sluggish economic growth, this momentum has slowed of late, although we expect demand for loans to stabilize again over the course of fiscal 2023.

Figure 1: Market shares of the banking groups in corporate lending (including commercial housing loans)[1] at the end of 2022, in percent



1) Loans to domestic enterprises and self-employed persons (including commercial housing loans)

Source: Deutsche Bundesbank banking statistics and own calculations, rounding differences possible.

It has to be said, however, that the outlook for the important construction-financing business, which accounts for more than 50 percent of lending within the Savings Banks Finance Group, continues to be particularly uncertain. Sharp declines in construction-financing loans have been observed for months now. In the first quarter of 2023, new business at savings banks and Landesbanken was running at around only 10 percent of the level during the same period of the previous year. This decline is certainly due to the rise in interest rates and to the marked increase in the cost of new construction; but the additional capital requirements imposed on banks (countercyclical capital buffer and systemic risk buffer for residential real estate) adopted a year ago and now implemented are exacerbating the development at a decidedly inopportune time.

Additional equity requirements are exacerbating the decline in construction-financing business

On the one hand, it is foreseeable that the German government's target of 400,000 new homes per year will prove a pure utopia on shorter timescales: the acute housing shortage is therefore fated to persist. On the other hand, the urgently needed energy-efficient renovation of the housing stock is in danger of being slowed down and impeded - after all, lenders too will have to play a major role on this front if targets are to be complied with. It is therefore necessary to monitor whether relief measures (envisaged by the set of buffer instruments) are called for in view of the current toxic environment involving simultaneous economic stagnation and elevated inflation.

Looking at the refinancing situation in the Savings Banks Group, it is, in particular, the deposits of private citizens that contribute to a stable refinancing constellation. Germany’s savings banks have EUR 883 billion at their disposal, 2.3 percent more than one year ago. The anchor of trust here is the Group’s institutional-guarantee scheme, which is recognized as a statutory deposit-insurance scheme. Full protection of customer funds is guaranteed, even beyond the EUR 100,000 per depositor required by law. In the light of this, depositors have no reason to withdraw their deposits due to any fears of suffering losses. We would certify that this holds true not only for the Savings Bank Group with its special institutional guarantee but indeed for the German banking market as a whole. It would not be appropriate to compare the deposit structure here, or the possible knock-on effects of deposit withdrawals of the kind seen recently at SVB in the USA, with the situation under other statutory regimes.

Savings banks enjoy stable refinancing

We expect the upward ratchet in the interest-rate level to have a positive impact on banks and savings banks. Interest margins in lending business have widened, even though valuation losses may occur in the short term, for example on securities portfolios. Here too, though, a comparison with SVB would be highly misleading, because that regional US bank was forced by a flood of deposit withdrawals to sell off securities that were actually safe (mainly long-term US government bonds) and to sustain valuation losses in the process. We firmly believe that the vast majority of the valuation losses on the asset portfolios of German banks and savings banks are of an accounting nature only, and will have been recouped by the time the securities in question mature.

We see the rise in interest rates having a positive impact on banks

Figure 2: Comparison of banking markets

	Banks USA	Banks EU	Banks Germany
Data status	Q4 2022	Q4 2022	Q4 2022
Capital resources			
CET1 ratio	13.6 %	15.5 %	15.6 %
Leverage Ratio	9.0	5.6	5.3
Profitability/profitability			
Net interest margin	3.0 %	1.4 %	1.1 %
Cost/income ratio	57.7 %	60.6 %	69.5 %
Return on equity after tax	11.8 %	8.0 %	6.0 %
Asset quality			
Risk costs	0.3 %	0.5 %	0.3 %
NPL ratio	0.7 %	1.6 %	1.0 %
Liquidity			
LCR	N/A	165 %	153 %
Loan-to-deposit ratio	63 %	108 %	119 %

Source: FDIC, EBA Risk Dashboard

European banks boast robust key parameters by comparison with their US counterparts

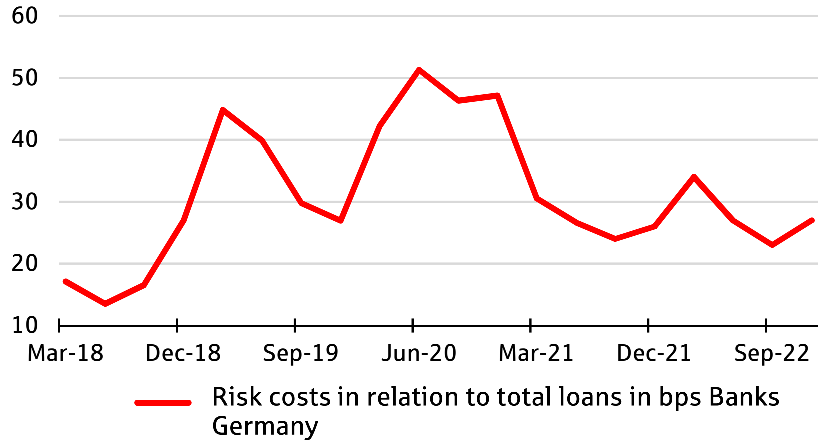
A comparison between the banking system in the United States and its European and German counterparts reveals that the profitability of US banks is significantly higher than that of their European competitors. This is mainly a function of higher net interest margins stateside. By contrast, risk-weighted capital resources look more adequate and comfortable in Europe's case. Data on the most important liquidity ratio, the liquidity coverage ratio (LCR), is not available on a nationwide basis in the USA. Due to the greater importance of the capital market on the far side of the Atlantic, the proportion of bank deposits that are extended as loans is lower than in Europe, where corporate financing is more strongly skewed towards bank-financing. For this reason, balance-sheet items on US bank balance-sheets react faster and more sensitively to changes in interest rates than in Europe. On the other hand, a look at the quality of loan books reveals few differences, above all between German and US banks. Although asset quality in Europe has improved significantly over the past few years, it is still lagging behind even years after the crisis in Europe's periphery.

Uncertainty about the economic trend persists

Uncertainty about the economic trend going forward persists nevertheless. The impact of the war in Ukraine on German companies remains unclear. What is already conspicuous is that energy-intensive manufacturing companies are having to face onerous burdens. Loan-loss provisions of German

banks and savings banks are still at a moderate level and are characterized more by additional overlays, or "top-level adjustments" (TLAs), due to geopolitical and economic considerations than by actual loan defaults. Overall, most banking institutions are expecting defaults to tend to increase in fiscal year 2023.

Figure 3: Risk costs



Source: Deutsche Bundesbank

At the same time, the capital resources of Germany's banks and savings banks have continued to improve. According to data from the European Banking Authority (EBA), for example, the common equity tier 1 (CET1) ratio had increased to 15.6 percent as of December 31, 2022 (up from 15.4 percent on December 31, 2021). Bank profitability has also increased significantly. The return on equity returned to a satisfactory level of 5.2 percent in 2022 (climbing back from 0.6 percent in 2019, 0.3 percent in 2020, and 4.3 percent in 2021). While the savings banks reported a significant 19 percent increase in operating profit before valuation of assets in 2022, predominantly temporary valuation losses on securities portfolios stood in the way of a further increase in the return on equity. On the basis of the key fundamental parameters, German banks and savings banks are well prepared to rise to the potential challenges 2023 may bring.

The German banking market is well prepared to face any potential challenges

Various strategic initiatives and enhancements within the Savings Banks Finance Group have also been boosting this resilience. For example, numerous strategic cooperative ventures have been initiated, especially involving the bundling of business activities at Landesbanken. At the same time, the savings banks have strengthened their market presence and optimized cost structures.

Bolstering trust, rather than putting it at risk through the proposed EDIS scheme

Confidence in the tried-and-tested security systems that have existed in Germany for decades is of elementary importance for European financial-market stability. Particularly in view of the current uncertainty, and of the far-reaching changes brought about by the coronavirus pandemic and by the war over Ukraine, the confidence of savers must not be jeopardized through an undermining of the functionality of existing institutional protection schemes by substituting a common European deposit insurance scheme (EDIS) or by postulating objectively unjustified preconditions for preventive measures - as put forward by the European Commission as part of the reform

The CMDI review must not lead to an undermining of the functionality of institutional protection schemes

proposal for crisis management and deposit insurance at banks (CMDI review).

Despite such warranted misgivings, the proposed EDIS regulation has not yet been amended as it is being ground through the mills of the European legislative process. In its current form, the EDIS proposal would trigger the compulsory and complete communitarization of all deposit-guarantee schemes, without considering the special features of institutional protection which distinguish savings banks and cooperative banks. In the event of the EDIS eventually being passed into Community law, a structural exception is re-quired for such institutional protection schemes in order to ensure that they keep functioning smoothly. Legislative proposals must not be allowed to encroach counterproductively on tried-and-tested existing structures. This also applies to the ongoing review of the EU rules on deposit insurance and bank resolution (CMDI review).

The European Commission's proposals to amend the EU Deposit Guarantee Schemes Directive (DGSD) as part of the CMDI review would, if implemented, severely restrict institution-protection measures in future by imposing heavy administrative requirements, various stipulations subjected to approval by the authorities, a no-risk-of-default prerequisite (“failing or likely to fail”) and a mandatory least-cost test. The European Commission’s proposed amendments with regard to preventive measures should therefore be rejected in their present form. This is especially imperative if the legacy risks encumbering some banking systems in the euro area are not remedied prior to implementation (a case in point being the cluster risk stemming from a given country’s asset portfolio containing substantial holdings of government bonds of lower credit quality). Every effort must now be made to safeguard Europe's stability advantage, especially vis-à-vis the USA.

The CMDI review also sets the wrong tone for resolution planning and the single resolution mechanism

Furthermore, resolution planning and the single resolution mechanism should only be applied in the case of banking institutions which are of systemic relevance (“too big to fail”). The European Commission's CMDI review sets the wrong tone in this respect too: extending the preconditions for resolution to include small and medium-sized banking institutions such as savings banks and cooperative banks in an undifferentiated “broad brush” fashion would not be expedient. More specifically, such small and medium-sized institutions should not be roped into such a resolution regime if they are members of an institution-based protection scheme. That would be objectively unjustified and would lead to the latter having to bear disproportionate financial and bureaucratic burdens.

More vigorous implementation of proportionality in banking regulation

Banking regulation is influencing the business practices of banking institutions: between 2006 and 2022, the number of savings banks decreased significantly, and the average balance-sheet total of the institutions concerned increased accordingly. This process of concentration is also due to the sharp rise in the fixed costs entailed by banking supervisory law ("too small to comply"). Nevertheless, savings banks are doing everything in their power to fulfill their public mandate both locally and digitally.

The principle of proportionality needs to be emphasized more strongly in banking regulation. This requires, on the one hand, a differentiation of requirements and, on the other hand, differing degrees of supervisory intensity

depending on the size or systemic relevance of the banking institutions concerned.

Greater emphasis needs to be placed on the principle of proportionality

In particular, the EU resolutions on the finalization of Basel III scheduled for 2023 could lead to a deterioration in financing conditions, in the SME domain as well. Legislators must not lose sight of this, even (indeed especially!) when negotiations are on the home straight. Key issues to be addressed here are the treatment of unrated companies/financial institutions and of untapped credit lines. There is also a need for change in the treatment of strategic /long-term equity investments. The introduction of the output floor will further increase capital-adequacy requirements. The SME support factor should be used to enable future-oriented investment in the small and medium-sized enterprise sphere.

In addition to differentiation based on proportionality considerations and to the unbundling of national and European responsibilities in the banking-supervision and bank-resolution domains, regular inflation adjustment for all thresholds under banking supervision law is necessary. This applies in particular to the "less significant institutions" threshold.

Facilitating sustainable transformation

The decarbonization strategies of customers are already being taken into account when granting loans. In this context, banking institutions are not primarily guided by the current sustainability status of their customers, but rather by their corresponding target paths. Loans are also granted to companies that are currently less sustainable if such financing is going to improve their sustainability profile. ESG regulation should take this approach into account and focus less on companies' current sustainability status in order to leave scope for the financing of transformation.

ESG regulation must leave leeway for financing transformation

ESG risks are already factored into the risk-management systems of banks and savings banks. The management of ESG risks is increasingly becoming the focus of supervision, for example in the context of the current 7th MaRisk amendment. As the evolution of the required new methods is, in the nature of things, costly and complicated, banking institutions need sufficient time to comply with the ESG requirements. Under no circumstances should small and medium-sized institutions be given deadlines that are shorter than those granted by the ECB to large, systemically important banking institutions.

Another key desideratum is that sustainability reporting should be made easier, especially for medium-sized companies and small and non-complex financial institutions. The number of key figures and audit criteria to be reported should be reduced to essential parameters and standardized within the value chain so that the effort which has to be made is affordable.

Sustainability reporting needs to be facilitated

Many small and medium-sized enterprises (SMEs) pursue sustainable economic activities, but their financing partners are not allowed to take account of these in the Green Asset Ratio (GAR) due to legal requirements. Financings to SMEs that are not subject to reporting obligations and that voluntarily provide their sustainability data should be included in the GAR in future in the event of their being taxonomy-capable and -compliant.

Conclusion

The problematic cocktail of weak economic activity, the steep rate-hiking cycle, and the crisis of confidence which has temporarily spilled over from the USA is presenting Europe's financial institutions with fresh challenges - challenges that have so far been mastered on a sound basis (capital adequacy, and risk management including effective supervision). The continent's fundamental underpinnings are sound. There is accordingly no reason to worry about the stability of the European banking system. The ECB's recent interest rate-shock test confirms the resilience of our banking architecture.

Disclaimer

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

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