Less significant institutions in Germany

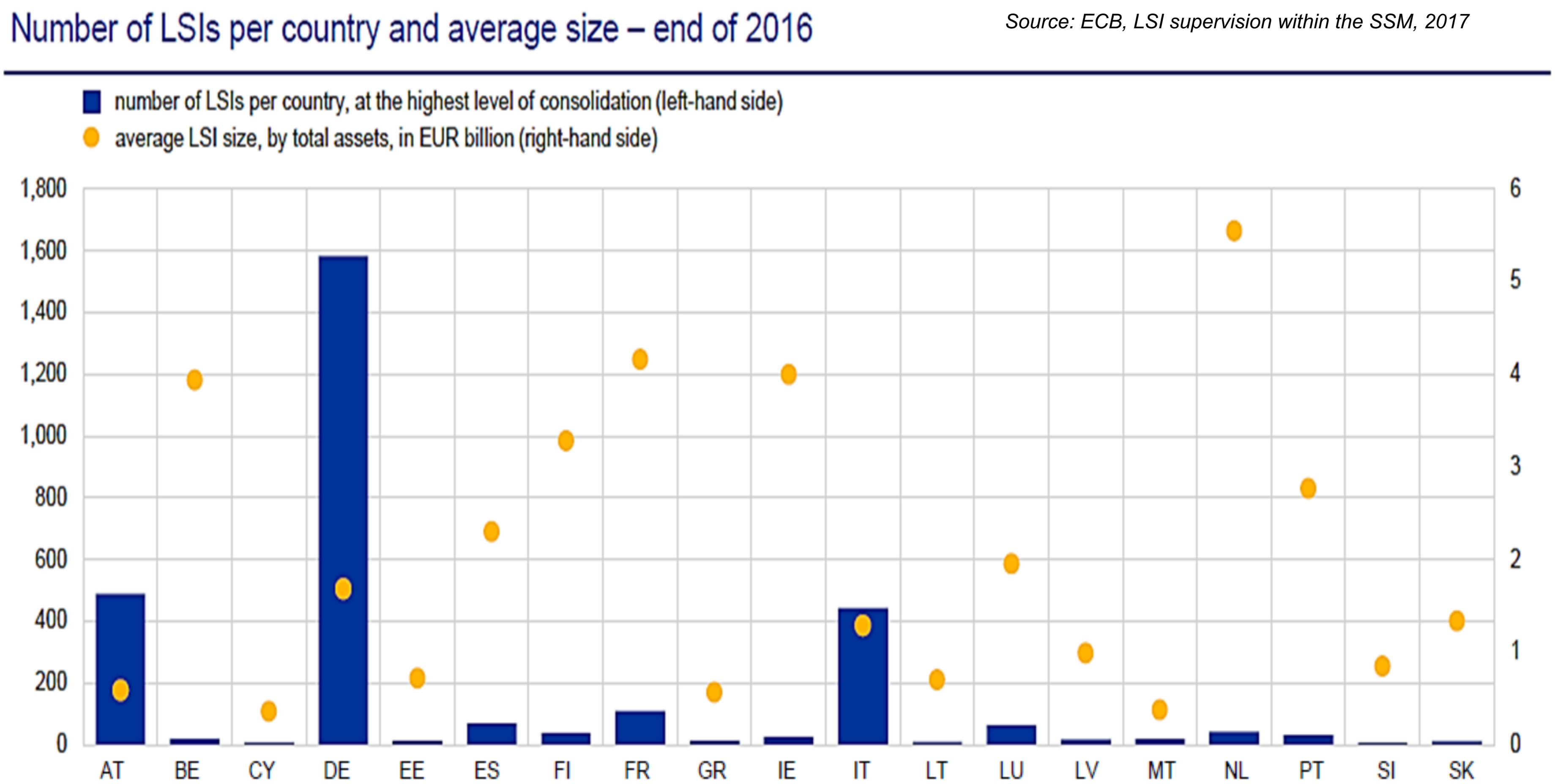
Current state and future challenges from a supervisory perspective

Christian Otto, Head of Division "Coordination of National and International Off-Site Supervision"

Agenda

1. **Overview**
2. **Current business environment**
3. **Performance of German LSIs**
4. **The supervisory perspective**
5. **Outlook**

1. Overview
Number and average size of LSIs



Source: ECB, LSI supervision within the SSM, 2017

➢ Total number of LSIs: Around 3.000 institutions in 19 SSM Member States (at solo level).

1. Overview
Structure of the German LSI sector – Three pillar system

Commercial Banks	Cooperative Banks	Savings Banks
▪ 133 LSIs ▪ Primary target: Maximisation of profits ▪ Committed to the interests of the owners / shareholders ▪ Regional focus: In general no specific regional focus **53 Specialized banks**	▪ 916 LSIs ▪ Primary target: To serve the interests of the members ▪ Mission: To support the propensity to save among the population and to satisfy the regional demand for loans ▪ Committed to their stakeholders, e.g. members, clients and the regional society ▪ Regional principle	▪ 388 LSIs ▪ Primary target: To serve the common public interest and to support the propensity to save among the population ▪ Mission: To support the propensity to save among regional society and to satisfy the regional demand for credit ▪ Committed to the regional society ▪ Regional principle

Cooperative and savings banks financial networks

Umbrella organisation of financial network (DSGV / BVR)

Institutional Protection Scheme, shared IT infrastructure (e. g. supervisory reporting systems)

Representation of interests of the financial network

Coordination and stipulation of joint strategy

Advice on legal, taxation, and business management issues

Information about developments in economy, politics, and banking

Central institutions (Landesbanken, DekaBank / DZ Bank)

Provision of specialized services for all group institutions

Savings banks / credit cooperatives

Concentration of presence and business activities on a traditional local region within the scope of the regional principle

Independent management on a decentralized basis

2. Current business environment
Sound economic conditions in Germany

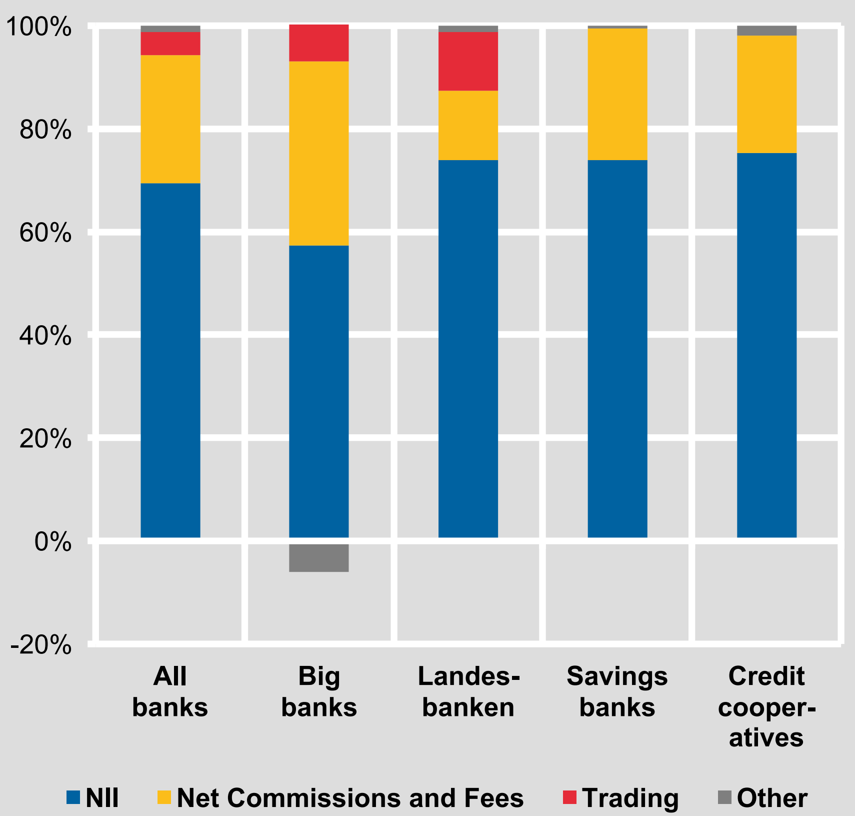
- In general, the economic boom in Germany is still ongoing.
  - The average GDP growth rate stood at 2.2% in 2017 and is expected to reach 2.0% in 2018.
  - Private consumption continued its ascent in spring 2018.
  - Negotiated wages rose sharply, reflecting recent wage settlements which were higher than in the last pay round.
- The domestic private sector‘s demand for loans accelerated.
  - The annual rate of growth of these loans to the non-financial corporate sector rose to 5.9% at end-June, its highest mark since 2008.
  - Loans to households picked up significantly (particularly high demand for housing loans).

2. Current business environment
Current challenges for LSIs in Germany

- Sustained low interest rate environment.
- High costs (e. g. due to local branch network, investments in IT infrastructure, digitalisation, rising wages).
- High competition in the German banking sector (including online banks with leaner cost structures).
- New competitors/digitalisation.

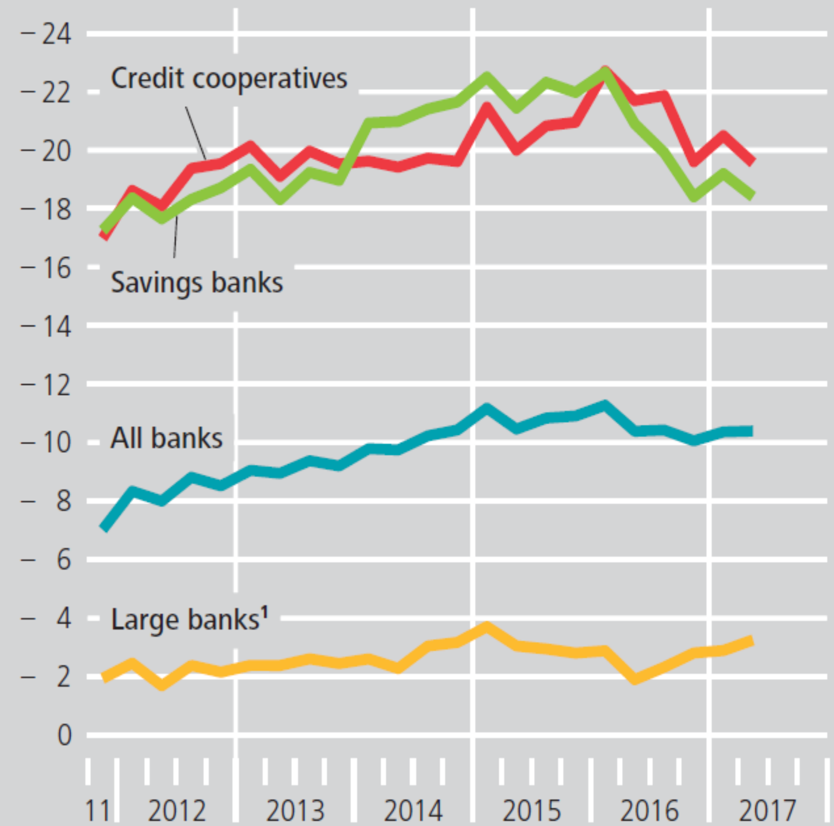
3. Performance of German LSIs
Sources of income (1)

Sources of income by banking group
Aggregate, in % of operating income (as of 31.12.2017)



Source: *Deutsche Bundesbank Monthly Report September 2018, "The performance of German credit institutions in 2017".*

Changes in present value given interest rate rise* As a percentage of regulatory own funds

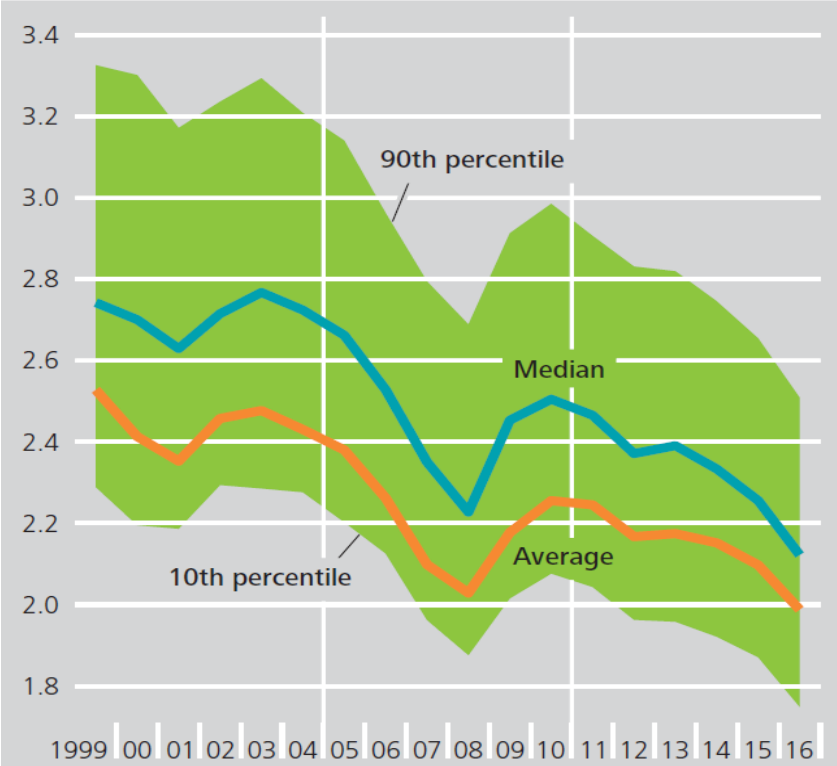


* Changes in present value of positions in the banking book subject to interest rate risk caused by an abrupt interest rate rise of 200 basis points across all maturities. The analyses are based on reports from institutions for the Basel interest rate coefficient. **1** 12 major German banks with an international focus which did not outsource positions to resolution agencies in the observation period.

Source: *Deutsche Bundesbank, Financial Stability Review 2017.*

3. Performance of German LSIs
Sources of income (2)

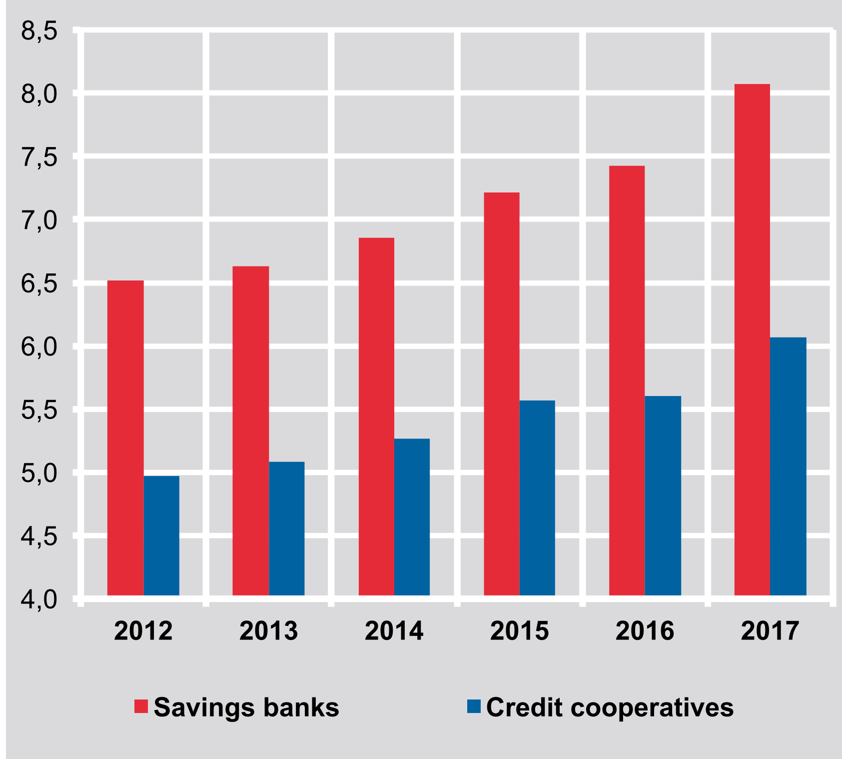
Net interest income of savings banks and credit cooperatives in % of average total assets[1]



1 Accounting-related rise in aggregate total assets in 2011 due to the Accounting Law Modernisation Act (Bilanzrechtsmodernisierungsgesetz).

Source: *Deutsche Bundesbank, Financial Stability Review 2017.*

Commission & fee income of savings banks and credit cooperatives aggregate, in € bn

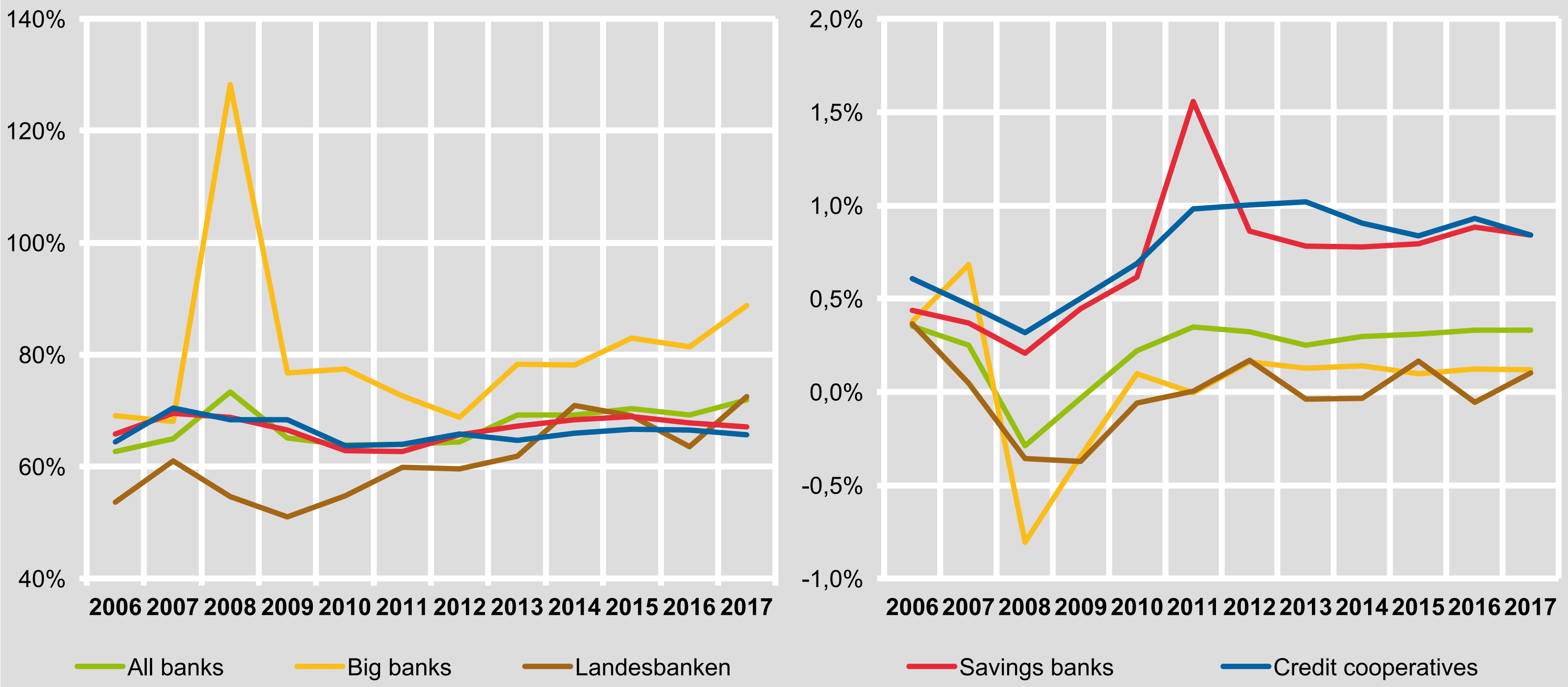


Source: *Deutsche Bundesbank Monthly Report September 2018, "The performance of German credit institutions in 2017".*

3. Performance of German LSIs
Profitability

Cost-income ratio and return on assets by banking group

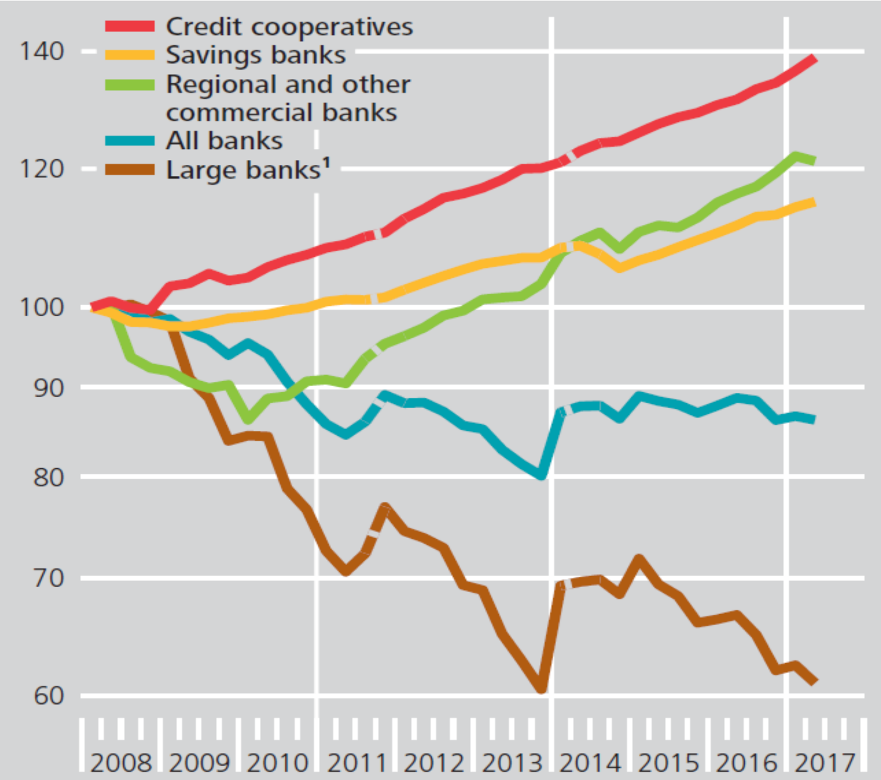
Aggregate, profit pre-taxes in % of total assets



Source: *Deutsche Bundesbank Monthly Report September 2018, “The performance of German credit institutions in 2017”.*

3. Performance of German LSIs
RWAs and capital position

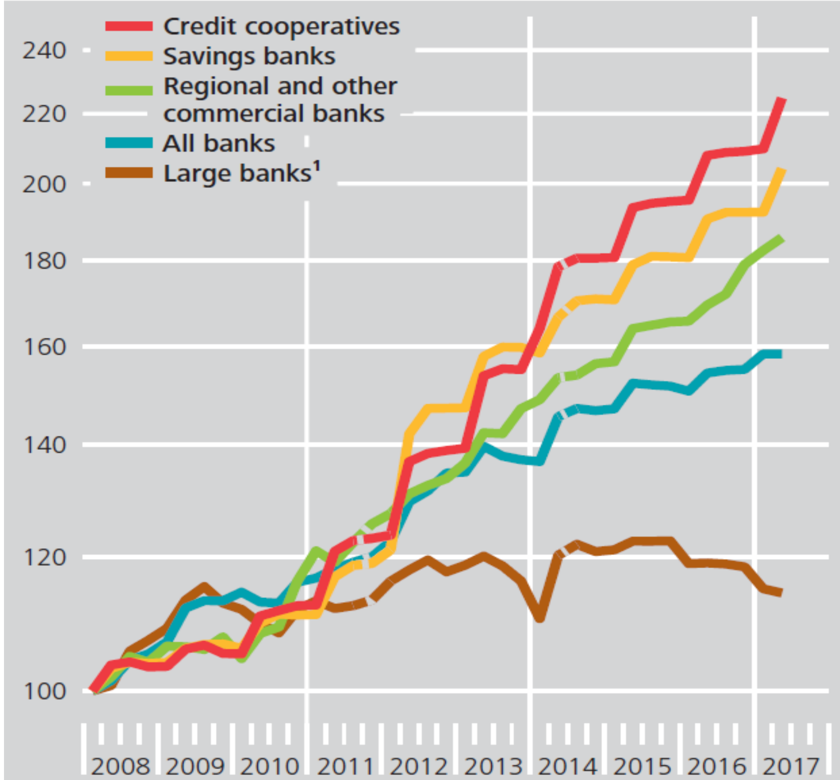
Risk-weighted assets by categories of banks*
2008 Q1 = 100, log scale



* Change in valuation in 2011 and 2014 as a result of Capital Requirements Directives CRD III and CRD IV. **1** 12 major German banks with an international focus which did not outsource positions to resolution agencies in the observation period.

Source: *Deutsche Bundesbank, Financial Stability Review 2017.*

Tier 1 capital by categories of banks*
2008 Q1 = 100, log scale

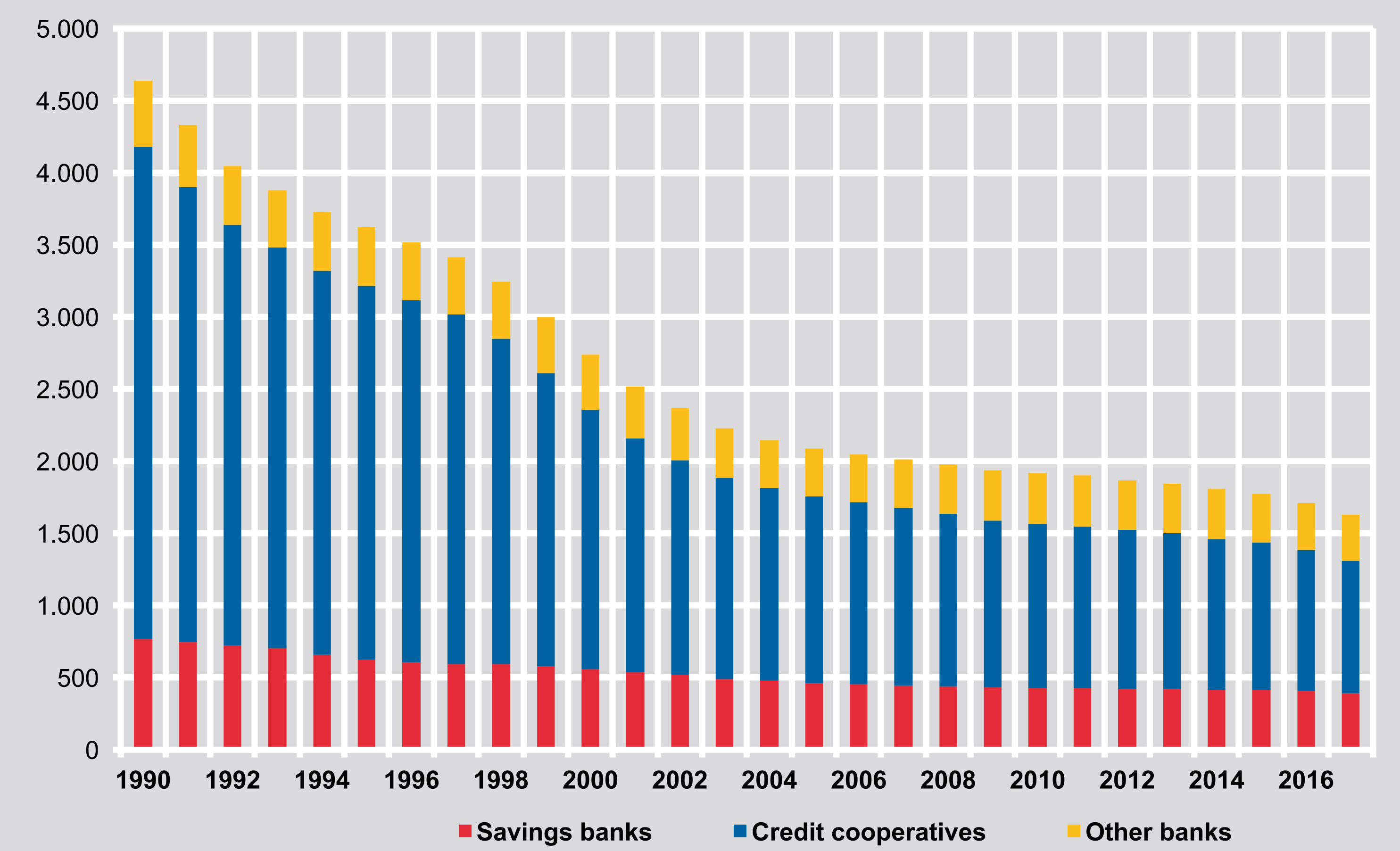


* Change in valuation in 2011 and 2014 as a result of Capital Requirements Directives CRD III and CRD IV. **1** 12 major German banks with an international focus which did not outsource positions to resolution agencies in the observation period.

Source: *Deutsche Bundesbank, Financial Stability Review 2017*

3. Performance of German LSIs
Consolidation trend

Number of banks in Germany



4. The supervisory perspective
Supervisory SREP stress tests

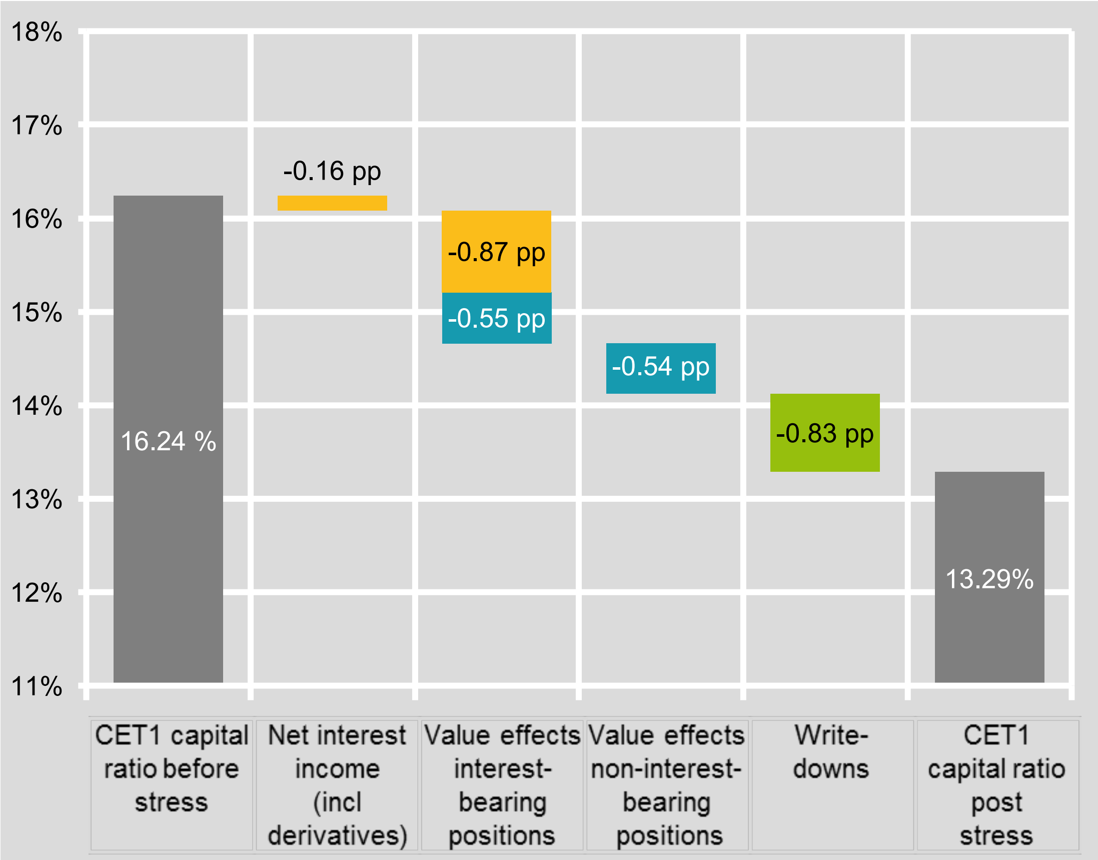
3 different stress tests in 2017:

SREP stress tests		
	Interest rate risk	Baseline: constant yield curve
		Stress: +200 bp interest rate shock
	Credit risk	Probability of default: +155%
		Loss given default: +20%
	Market risk	Interest-bearing items: +30 bp to +1500 bp risk premium
		Other positions: 20% haircut

For the Pillar 2 Guidance all three stress effects are aggregated and mapped to capital add-ons (0 % - 10 %; bucket approach)

4. The supervisory perspective
Impact of supervisory stress tests

Impact of the stress effect on CET1 capital ratio
Aggregate in percent and effects in percentage points



Source: *2017 low-interest-rate survey.*

- The stress test has shown that German institutions are mostly well capitalised in each of the stress scenarios.
- CET1 capital ratio drops by 2.95 percentage points in aggregate in one-year stress horizon (16.24% to 13.29%).
- Main drivers are value effects on interest-bearing positions as a result of interest rate increases.
- Additionally: hidden reserves may serve as another capital buffer for some institutions.
- Taking hidden reserves into account, roughly 4.5% of institutions would fail to meet supervisory requirements (Pillars I & II plus capital conservation buffer) in a stress event.

4. The supervisory perspective
Supervisory activities

- Supervisory focus for LSIs
  - Profitability risks (including business model risks)
  - Interest rate risk
  - Digitalisation and IT risks

- The low-interest-rate environment continues to weigh heavily on small and medium-sized credit institutions in Germany. BaFin and Bundesbank continuously monitor the related risks by conducting a low-interest rate survey and a stress test on a bi-annual basis (2019).

- Supervisory focus on the viability and sustainability of banks‘ business models in ongoing supervision and SREP assessments.

5. Outlook

- The ongoing favorable economic situation will benefit German banks' earnings situation, while low interest rates and the flat yield curve will continue to present challenge.
- The resilience of German LSIs is expected to remain relatively high with most institutions intending to increase their CET ratio in the upcoming years.
- Competition will remain high.
- Mergers can be one option for small regional banks within their sector, but not the sole solution for the challenges ahead.
- Increase of commission income.
- Adaption of business models – Sustainability is essential.
- German banking sector will maintain its three-pillar-structure.
- Finding the best-fitting strategy is the responsibility of each institution's management.

Thank you for your attention.
Any questions?

Christian Otto

Christian.Otto@bundesbank.de
+49 69 9566 6957