DEUTSCHE BUNDESBANK
EUROSYSTEM

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Financial stability – challenges facing the public banking sector

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- Check against delivery -

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1 Introduction

I was glad to accept your invitation to speak to you today about “Financial stability – challenges facing the public banking sector”. This is certainly not a new subject. In fact, it is at least as old as the financial crisis itself. As early as in the summer of 2007, it was public sector institutions – not just public sector institutions, but they, too – or, more precisely, some Landesbanken that were at the centre of the financial crisis in Germany. In several cases, structural problems had accumulated in this area even before the outbreak of the crisis. These problems then began to put financial stability at risk.

There are two main reasons why this subject is still of current relevance.

- First, the financial crisis has by no means been overcome more than three years after its broke out. Although a number of positive trends can be identified overall, the financial system is still being set back by a whole host of factors, some of which are interrelated.

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- Second, there is still a need for financial intermediaries to adjust. In Germany, that goes not least for the Landesbanken.

If I now deal in my following remarks with the Landesbanken, that is certainly not because I want to become involved in a discussion about ownership. I am concerned with **financial stability**, not with ownership structures. I will be focusing in my speech on the Landesbanken and not, say, on the savings banks. This is because, from a financial stability perspective, the problems of the public banking sector lie, first and foremost, with some of the Landesbanken and their business models and not with the savings banks. And the Landesbanken belong to the category of large German banks. They clearly play a major role.

Please permit me to make one further preliminary remark. A business model is a very specific matter for each enterprise. It embodies the enterprise's self-image, its corporate identity, its corporate tradition – and, for that very reason, it is sometimes so difficult to change. In the best case, a business model can even represent something like the building block of a "community of values". Seen in that light, the Landesbanken sector consists of eight individual cases with eight very different traditions and sets of underlying data which allow only qualified cross-comparisons to be made.

2 Resilience in the German banking sector

The Bundesbank is well aware of the existing diversity among credit institutions. It is not without good reason that one main chapter of our recent Stability Review was entitled

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Increases and differences in resilience in the German financial system. That is one of the key messages of our Stability Review.

[Slide 1]

This means, first of all, that resilience improved overall last year. With regard to the one pillar of resilience – the capital side – capitalisation increased on an average of the large banks. On the other hand, there appears a notable gap among the large institutions. And this “two-class society” can also be found within the category of Landesbanken. As a category, the Landesbanken display lower tier 1 capital ratios than the other large banks. In the third quarter of 2010, the aggregate figure was 10.8%, compared with 11.5% in the case of the other large German banks.

[Slide 2]

Among Landesbanken, the longstanding trend decline in risk-weighted assets continued last year, which means they were de-risking. But not only that: they continued to reduce their total assets – unlike the other large banks, whose total assets increased.

These differences are primarily the result of EU state aid control procedures, which aim for the restructuring of government-supported banks.

Now, I am aware that, in weighing up the objectives of financial stability and a level playing field, the European Commission – as Guardian of the Treaties – will tend to emphasise the latter. In acute phases of stress, this can lead to decisions that are not always entirely fortunate. In a fragile environment, care has to be exercised not to take rash action that

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would, in fact, trigger stress. However correct and necessary they are in terms of ensuring a level playing field for competition, the decisions to be taken therefore have to be examined in terms of their systemic relevance in order to prevent an overreaction. At all events, a system change requires sufficient time for the necessary coordination.

On the other hand, I ask myself where we would be today in terms of the necessary consolidation without the Commission's requirements. Are these requirements not ultimately in the best long-term interests of financial stability? After all, their aim is that the Landesbanken refocus on the core business. Total assets are to be reduced overall, risk-weighted assets are to be scaled back and certain participating interests as well as non-core activities are to be sold. To that extent, current developments reflect progress in consolidation, which is most readily apparent where the European Commission has made government rescues subject to requirements as part of the EU state aid procedures. Other adjustments are still outstanding. As we see it, the parts that are sustainable finally have to be put together so as to create enduringly viable institutions. We must be able to perceive whatever holds the future Landesbanken world together in its inmost folds.

The fact that some institutions did not seize the opportunity to apply for additional capital from Financial Market Stabilisation Fund (SoFFin) by the end of last year in order to equip themselves for restructuring is regrettable given the necessary adjustments to the new capital requirements and is, unfortunately, a continuation of the tradition of deferring or failing to implement adjustments that are needed. Since the beginning of this year, Federal funds have generally been available only from the Restructuring Fund under the conditions imposed by the restructuring administration. Such a regime would certainly not be a "walk in the park" for those concerned. The Restructuring Act (*Restrukturierungsgesetz*) nevertheless provides the opportunity to protect the systemic parts of an institution without

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escalating the “too big to fail” problem. It helps to prevent contagion and, at the same time, strengthens the responsibility of the owners and/or supporting organisations. Both aspects are of crucial importance for financial stability.

[Slide 3]

With regard to the second pillar of resilience – profitability – the banking sector as a whole can be divided into “winners” and “losers”. Overall, commission business at the big German banks has benefited from a growing demand for banking services, but even here there are differences. Those banks whose room for manoeuvre was limited by balance sheet shrinkage and restructuring saw a fall in their net commission income, one reason being that higher commission had to be paid for guarantees provided.

Interest business as a whole has been a major pillar of income since the outbreak of the financial crisis. Lower short-term interest rates have helped in this respect. In the case of Landesbanken, it supported net interest income in the third quarter of last year.

[Slide 4]

With regard to the trading results, particular attention should be paid to how many risks have been taken to achieve a given result. For the large German banks, the ratio of returns achieved and risks assumed has improved enormously since the dramatic trading losses in 2008. As a result, the average risk-adjusted trading results stabilised again at a normal level last year. In contrast to the years before the outbreak of the crisis, this positive development is not the outcome of additional risk-taking. Rather, the “model banks” that are active in the

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market – in other words, banks that use a model approved by the supervisors – benefited from a sharp rise in their trading volume, albeit with marked institution-specific differences.

Rather than looking at a current "snapshot", the longer-term averages and comparing them with other institutions can tell us more about business models, risk preferences and trading strategies. And here, too, I cannot fail to note that the risk-adjusted trading results of the Landesbanken sector are structurally – that is on a longer-term average – well below those of the other "model banks". The Landesbanken sector therefore has to take more risks than other "model banks" to generate the same income.

Consequently, the Landesbanken sector has, for years, been less profitable than other banks. Now, that would probably be acceptable if the returns, in exchange, were less volatile. But that is not the case. In a study, the International Monetary Fund noted, for example, that "*taken together the Landesbanken do not appear to have substantially lower volatility of ROEs than other banks …* ". The control group for this study consisted of the 100 largest European credit institutions. In other words, taxpayers have been investing their money in the Landesbanken sector neither very profitably nor very securely.

3 Crisis-prone business model

As I have already intimated, what this ultimately reveals is that the business operations and self-image – and therefore the business model – of some Landesbanken have changed a great deal over the past decades. They have moved far away from their original task of

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promoting state development as federal state-owned institutions and taking on important services for the savings banks as regional giro institutions. For some time now, network business with the savings banks has accounted for only a small part of their income.

By taking some Landesbanken as examples, it is possible – as in event studies – to follow the way in which business model and financial stability interact. The first "event" was the abolition of state guarantees and institutional liability. How did some Landesbanken respond to this with their business models?

In the second stage of the event study, the changed business models are then confronted with the external shock of the financial crisis. How have the new business models coped with the test? Where did the limitations become evident?

As is often the case in life, strategic errors are made less in times of crisis than in periods when things are still going comparatively well – in this instance, the period when the Landesbanken were still able to use the privileges of state guarantees. It was at that time that some decisions set the wrong track. A number of Landesbanken raised additional liquidity before state guarantees were discontinued – liquidity that was then urgently in search of higher yield and finally flowed into comparatively risky investments.

[Slide 5]

As time went by, some Landesbanken increasingly shifted their line of business to the capital markets, into international financing and into credit substitution business. This made it more difficult to control risks. And, like other banks as well, they relied too much on external ratings. In the end, the financial crisis revealed how dangerous this was. With

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business models that focus strongly on lines of business like international financing and credit substitution, the *asymmetric information problems*, as economists call them, cannot be ignored. They are certainly greater than if lending business had been concentrated on domestic non-banks, which is where the actual expertise of the Landesbanken lay. The outcome was preprogrammed: a portfolio with risky exposures, which – on top of everything – is also insufficiently diversified. Structures like this now have to be corrected, not least in the case of one or the other Landesbank.

What is striking is that the Landesbanken more strongly affected by the crisis are characterised by a smaller exposure in lending to non-banks. Loans were often granted to enterprises that were not operating in the Landesbank's own "catchment area", not least because they did not wish to compete against the region's savings banks. And in their own catchment area, loans were granted more to large enterprises than to SMEs.

[Slide 6]

Now, what does the picture look like on the liabilities side? Between the abolition of state guarantees and the outbreak of the financial crisis, intrabank business increased. The low weight of deposits by non-banks was a factor, too. As a consequence, refinancing stood on a basis that was prone to disruption.

Admittedly, it was indeed possible to observe similar developments at other large banks. However, the ownership structure of the Landesbanken would have suggested other, namely lower risk preferences and a different business orientation. This practice was, in any case, a long way removed from the idea of the Landesbanken, in terms of their lending policy, making a contribution to the development of their own federal state. The business

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policy of such Landesbanken had moved a long way from the principle of decentralisation. This explains why these institutions were hit particularly hard by the financial crisis.

These trends were evident right up to the brink of the crisis. With the crisis, there occurred the second big event of the past decade from the point of view of the Landesbanken. The crisis revealed the vulnerabilities of the business models: with the crisis of confidence in the interbank market, the Landesbanken were now faced with major wholesale funding problems and, in several cases, even by considerable needs for write-downs that had to be covered by taxpayers. Credit substitution business collapsed. And in the wake of the general deleveraging process, domestic business was rediscovered.

4 From crisis-prone business models to a restructuring of the Landesbank sector

One thing seems clear to me in this context: For the majority of Landesbanken, the issue of stable business lines and structures can be delayed no longer. What therefore has to be done to put less crisis-prone structures in place? The future viability of the Landesbanken sector hinges quite crucially on whether it is possible to develop sustainable business models and also on the willingness to reduce capacity surpluses. Up to now, there has been only isolated large-scale cost-cutting measures and, at most, selective adjustments to the business models.

Certainly, there is no master plan for the transition from crisis-prone business models and structures towards a robust reorganised system. Nor is it the central bank's or the supervisors' job to develop the specifics of business models. The supervisors' task in this area is merely to verify the consistency between business and risk strategies, and any

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structural change should, as far as possible, be subject to market processes and the business rationale of the savings banks and the other supporting organisations. Nevertheless, it may indeed be possible to sketch out a few key features of a potential new system.

Certainly, questions have to asked about the fact that some Landesbanken see themselves as global players. Fundamentally, the ownership structure calls for a low risk appetite. Likewise, they will have to distance themselves from broadly based “stand alone” solutions.

From a financial stability perspective, the reference model for sustainable business models should, as a matter of principle, comprise two points.

- The model should be geared, first, to **network cooperation** – in other words, to usefully augmenting and complementing the range of services provided by the savings banks.

- Second, the business model should be sufficiently **stable**. That means that the capital base should not be corroded in its substance even in difficult financial years and that an adequate return is generated in good years. That is the basis for all resilience and, hence, the basis for financial stability.

Besides traditional network business, this could include sensibly complementing the range of services provided by the Savings Bank Financial Group (*Sparkassenfinanzgruppe*), say, banking services for small and medium-sized enterprises and the settlement of payments as an ancillary to the savings banks’ corporate business.

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And this would undoubtedly also include looking after the foreign business interests of the enterprises that are the the Savings Bank Financial Group's customers. One thing has to be kept in mind, however: the foreign branches needed for that purpose entail a high level of fixed costs. For that reason, not every Landesbank that exists today can conduct such business in a cost-effective manner. Instead, it will be essential to refocus and concentrate business and use the resulting economies of scale. What would be consistent with this stance is, finally, purely customer-driven capital market business. In my view, what would no longer be part of such a business model would be proprietary trading and credit substitution business, nor would the extensive activities in foreign business, as in the past decade, that had no connection with the customers at home. Domestic commercial real estate financing might likewise be a function that complements the range of services provided by the savings banks.

One should not deceive oneself, however. Even if the Landesbanken set themselves up in this way, there will be no getting past a reduction of excess capacities. Whatever the specific details of a realignment, duplication and overlapping of work have to be eradicated.

Reorganisation requires the willingness to do this – as it does the willingness of the savings banks to share responsibility for network cooperation. This is a question of partnership. Another question that has to be answered is that of consolidation and integration. Theoretically, there are two possible options.

- The first option would be a **horizontal** integration of Landesbanken. The success of this would essentially hinge on the cost savings and synergies that can be achieved.

- The second option would be a **vertical** integration with savings banks of the region.

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From a financial stability perspective, what is important in the first option is that the portfolios usefully complement each other and that the overall risks become perceptibly smaller. Under no circumstances should a structure be created that is so large that the systemic risks ultimately become even bigger. In the case of vertical integration, there is the inherent risk of cementing existing structures. Business lines that are unsustainable in the long term would perhaps have to be supported by the affiliated savings banks.

Consolidation makes sense in order to reduce surplus capacities. I call, here and now, on all parties involved to do this.

5 Conclusion

Certainly, at this point a central banker should not go further. He can, however, point to the conditions which are essential for financial stability. The decisions themselves ultimately have to be taken by those responsible for them. But one thing is clear: it is time to act. The situation is a pressing one. Or as the Roman philosopher Seneca put it:

"Fate leads the willing and drags along the reluctant."

Thank you for your attention.

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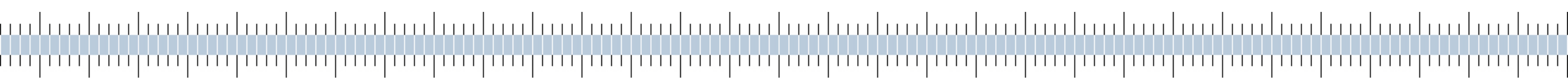

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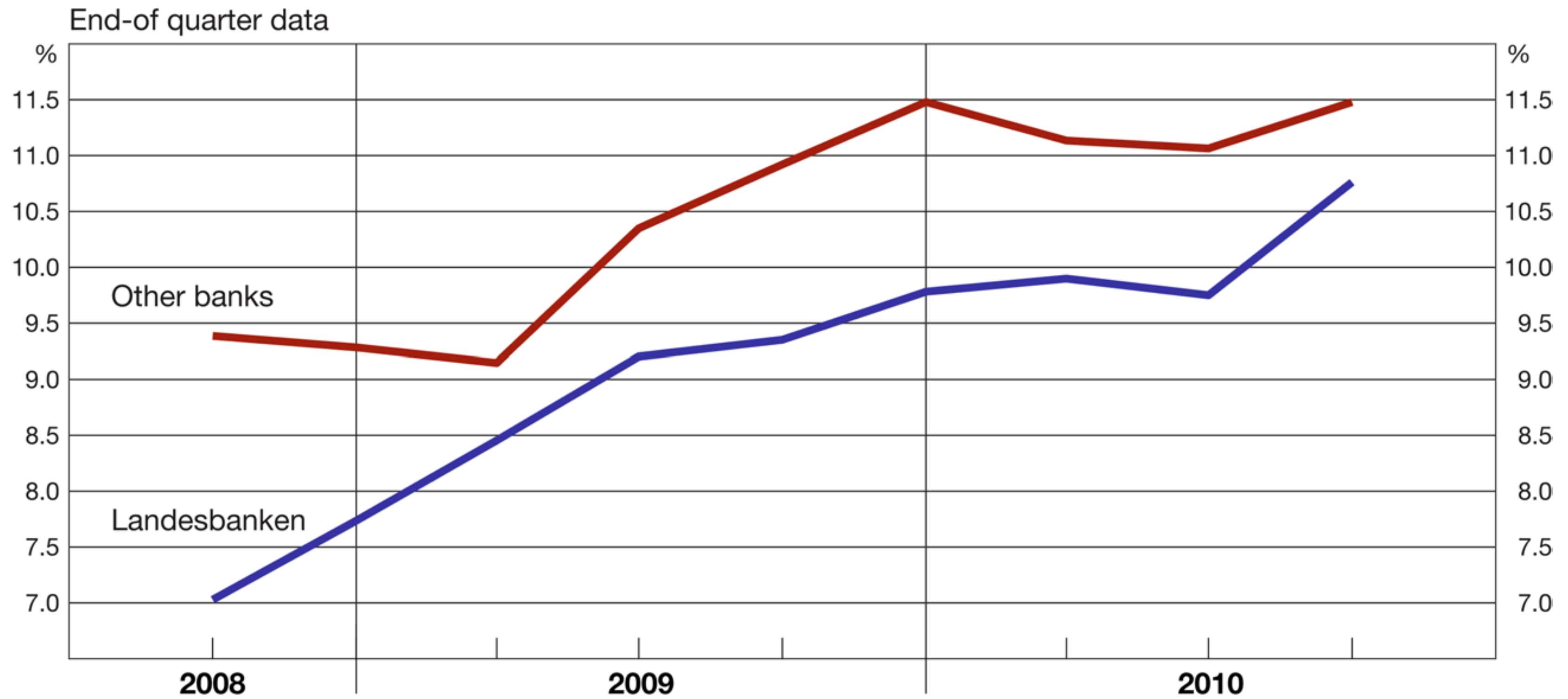

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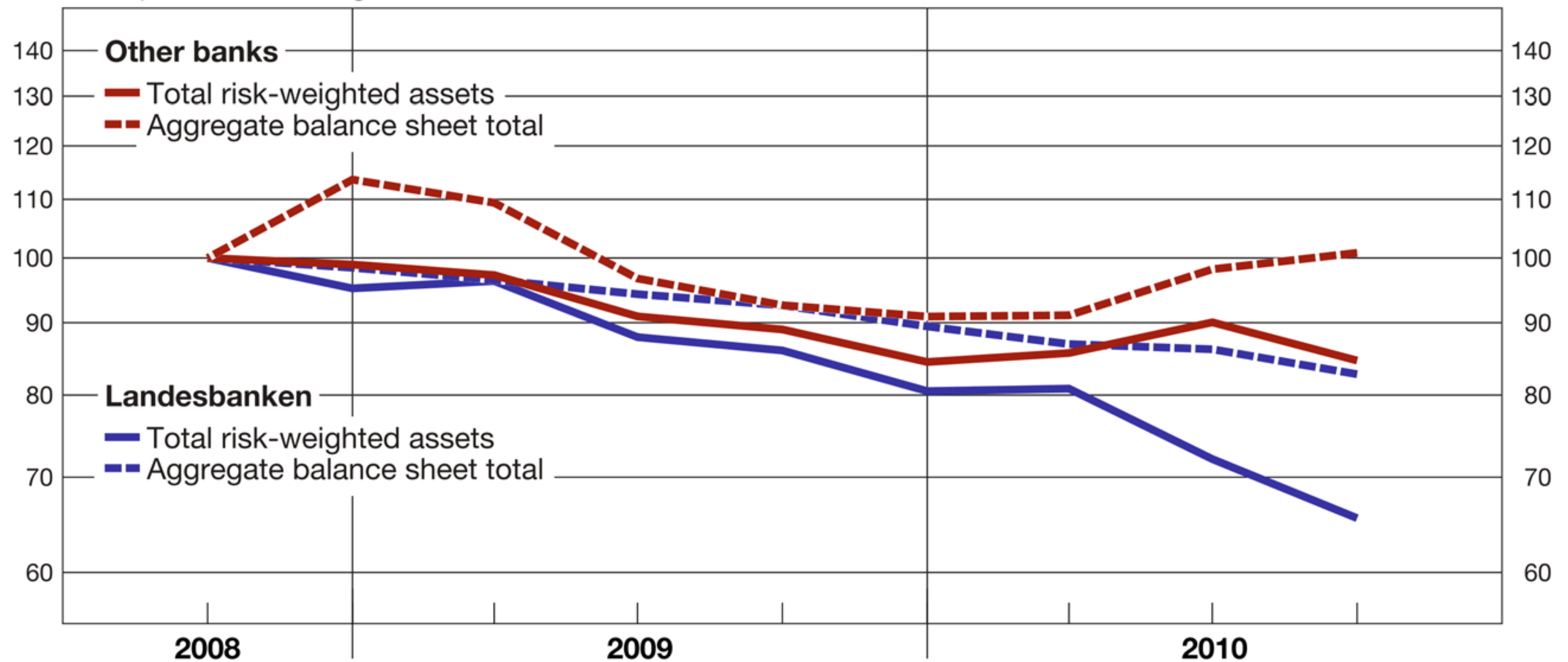

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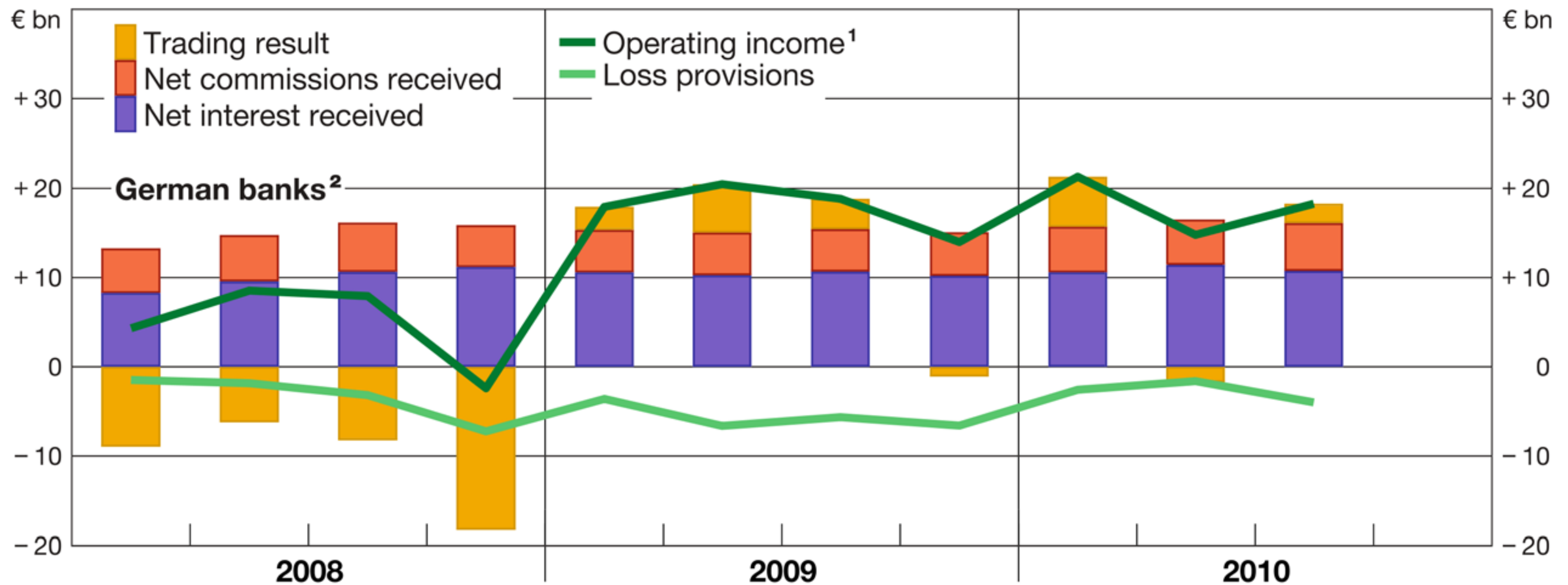
Income components



1 Sum of net interest received, net commissions received and trading result. — 2 Comprises 13 major German banks with an international focus.

Financial stability – challenges facing the public banking sector

Risk-adjusted trading results

As a percentage

Trading result / Value at Risk

of which

Landesbanken

+60
+40
+20
0
−20
−40

2004
2005
2006
2007
2008
2009
2010

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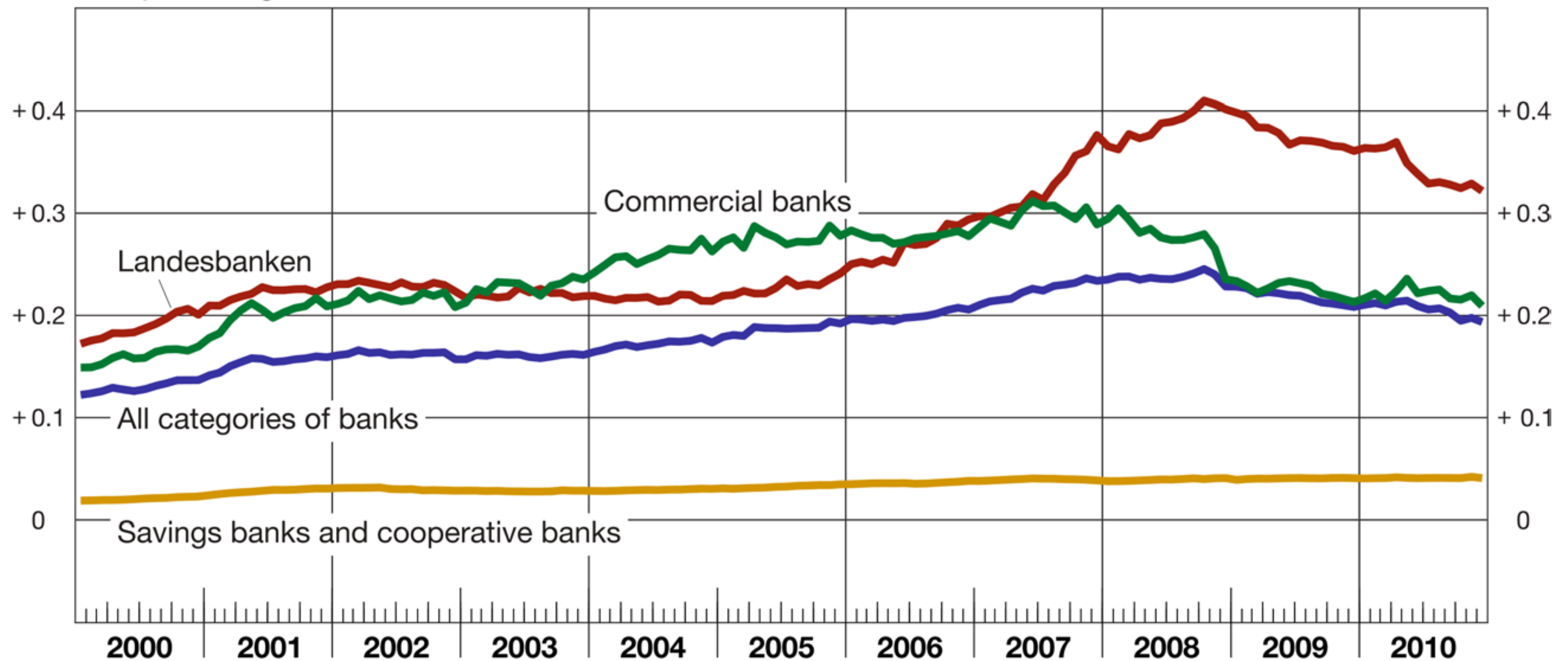

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