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# Low rates hobble Germany's public banks

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Germany's public-sector banks are not meant to be profitable – they have a social function – but even though stresses will continue, savings banks have found ways to work with the Landesbanks.


*Reflective mood: More than 900 Sparkassen branches closed in 2016*

Reichenau am Bodensee, which lies about 10 kilometres west of Konstanz in southern Germany, is a pretty little town. It has an eighth-century Benedictine monastery, picturesque half-timbered houses and a handful of welcoming Gaststätten. And like every German town and city, it has its obligatory savings bank, Bezirkssparkasse Reichenau.

With assets of a little over €1 billion at the end of 2016, deposits of just over €600 million, loans of €950 million and a workforce of 132 employees, Reichenau's savings bank is hardly a global systemically important bank. But it is remarkable in one respect. According to one recent study, it is the most efficient savings bank, or Sparkassen, in Germany among those with a balance sheet of more than €300 million.

The survey of productivity among German and Austrian savings and cooperative banks was undertaken by Confidum, a Swiss financial management consultancy. Its managing director, Christof Grabher, says that in today's interest rate environment, traditional measures of efficiency in the banking industry have lost their relevance.

The most popular of these yardsticks is the cost-to-income ratio, which collectively hovers at over 60%.

"Firmly entrenched among the worst in Europe", is how they were described in a recent speech by Andreas Dombret, member of the executive board of the Deutsche Bundesbank.

Confidum's measures of productivity in the German banking sector are even less flattering. "Cost-to-income ratios are an imperfect efficiency indicator because the calculation is based on net interest margins, which are a reflection of accommodative ECB policy, rather than real productivity," says Grabher. "Our survey compares cost-efficiency ratios, which take into account total operating expenses relative to customer business volumes."

*Christof Grabher, Confidum*

The Confidum ratios make uncomfortable reading for Germany's savings banks. Grabher says that a ratio in excess of between 110 and 115 is unlikely to be sustainable in a low interest-rate environment. Under this methodology, Reichenau's savings bank will have little to worry about, with a ratio of 86. Nor will larger Sparkassen in cities such as Hamburg and Munich.

But with only 29 savings banks scoring 114 or lower in the Confidum rankings, the majority remain ill-equipped to navigate an extended period of low rates.

## Policy

Of course, rates will not stay low for ever. But as Grabher says, it is not just today's abnormal monetary policy environment that is creating headaches for Germany's Sparkassen. Recent regulatory changes are making it easier for the small savers that are their lifeblood to switch accounts. That will give fresh impetus to internet banks like ING DiBa, which, with 8 million customers, is already the third-largest retail bank in Germany.

ING DiBa says it has a strategy so simple it can be illustrated on a beer mat and its no-branch, no-frills business model clearly gives it a cost advantage that few other retail banks can match. It has a cost-to-income ratio of 40%, versus 64.3% among member banks in the Sparkassen-Finanzgruppe and 67.9% for the cooperative banks. Confidum gives ING DiBa a cost-efficiency ratio of 36, compared with 129 for the Sparkassen and 138 for Commerzbank.

However, Georg Fahrenschon, the former Bavarian finance minister who is now president of the German Savings Banks Association (DSGV), argues that the Sparkassen are well-equipped to counter the competitive threat of the direct banks.

"Sparkassen are the biggest internet banking providers in Germany," he tells Euromoney. "The Sparkassen app has more than 13 million users, making it the most popular in Germany, and there are now about 500,000 people using our peer-to-peer payment service."

Besides, says Fahrenschon, it is not all about costs.

"Direct banks are fine for customers who want a very fast decision on a standard product from a big computer system," he says. "But the reality is that if they want a personalized service and have individual questions that need to be answered, there is still no substitute for the Sparkassen."

This proximity to the customer, which has been at the heart of the savings banks' ethos for well over 200 years, is regarded as a red line by the DSGV.

"We recognize that, on average, customers visit their branches only once a year, which is why Sparkassen are digitalizing the way they interact with clients," says Fahrenschon. "But we will never abandon the principle of ensuring that Sparkassen serve every community in every region of the country."

This does not mean that savings banks are deaf to the findings of surveys such as Confidum's, nor to external analysts' continuously repeated warnings that with almost 1,900 banks, Germany is overbanked and overburdened with costs. More than 900 Sparkassen branches closed in 2016 and a number of recently-published surveys suggest that the universe of savings banks will continue to contract over the next five years. Frankfurt-based finance-market specialist Investors Marketing has forecast that by 2025, around 320 will remain active, compared with close to 400 today.

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> \- Sven Matthiesen, Helaba

In the meantime, Fahrenschon says that savings banks are continuing to address inefficiencies and diversify their earnings.

"All Sparkassen are working on several programmes to address their cost base by reviewing their infrastructure and their payrolls," he says. "They are also making good progress in introducing new offers by building on their interaction with DekaBank, the Wertpapierhaus [securities firm] that is 100% owned by the savings banks. In recent years, the Sparkassen have consistently made relatively good profits and increased their contingency reserves, so we are in a stable situation."

Alexander Hendricks, associate managing director at Moody's, agrees: "Of course the low interest-rate environment is putting pressure on the savings banks because there is a duration mismatch between their assets and liabilities," he says. "But as a group, they are reasonably profitable. The relatively high elasticity of pricing on their deposits creates an initially positive effect on their interest margin, while low rates and the strong economy have kept non-performing loans low. Compared to the situation before the financial crisis, savings banks have materially lower loan losses to absorb.”

The bottom line, adds Hendricks, is that German savings banks are now more profitable than they were before the crisis and have built up a far stronger capital base. Over the last four years, he says, the Sparkassen have generated earnings before reserves-building of around €6 billion a year, compared with closer to €2 billion to €3 billion between 2005 and 2007, while their capital has doubled since the crisis, from just over €50 billion to €102 billion.

## Profits

Whether a larger share of profits at the Sparkassen should be retained by the banks to safeguard against the impact of a normalization of monetary policy or be recycled into projects for the good of the local community has become a subject of increasingly lively discussion in Germany.

Nowhere is the debate more animated than in Germany’s seventh largest city, Düsseldorf, where the then chief executive of Stadtsparkasse Düsseldorf, Arndt Hallmann, picked a fight with the city’s mayor, Thomas Geisel.

The argument was prompted by Hallmann’s insistence that the lion’s share of a windfall profit in excess of €100 million should be retained as equity, rather than paid to the bank’s municipal owner.

Hallman, once of WestLB, ultimately lost his fight – as well as his job – and has since decamped to the Düsseldorf-based Black Horse Investments.

Fahrenschon says that the row in Düsseldorf in 2015 was a one-off event occasioned by the exceptional profits generated by the sale of the Sparkasse’s property development fund. Others are less sure and say that the Düsseldorf episode may be indicative of two trends in the public sector of Germany’s banking industry.

The first is that it exposes tensions between savings banks and their municipal owners, which may be simmering throughout the country.

“This might be a subject elsewhere because communal finances in Germany are sometimes very stretched,” says Norbert Reis, head of global banking and member of the management board at HSBC in Düsseldorf. “Also, because of negative interest rates, the contribution of the Sparkassen to the public coffers is not what it used to be.”

A second trend that may have been exposed by the personality clash between Hallmann and Geisel is the emergence of a new generation of bankers in the public sector of the German banking industry. More entrepreneurial than their predecessors and sometimes more prepared to challenge the status quo, these new industry leaders are a powerful response to those who say that German public sector banks are run by pen-pushing Beamten (civil servants).

## Generation

Over the longer term, this new generation may drive lasting cultural change in Germany's three-pillar banking system. In the short term, however, the principal preoccupation among the Sparkassen will be with the immediate outlook for monetary policy and the corrosive impact that low rates are having on their net interest income. This fell by 3.7% last year, according to Moody's, and is almost certain to slide again in 2017.

This is why Fahrenschon says he is more than ready to embrace the different challenges that higher rates will bring, as long as monetary policy is adapted "gradually and carefully". In part at least, this is because savings banks can still count on enormous reservoirs of goodwill from the German public, which welcomes their commitment to sponsoring community projects as well as providing banking services.

But Confidum's Grabher cautions that this goodwill may be jeopardized by the recent increases in charges that the Sparkassen have been forced to introduce for some basic banking products. Their popularity could be put to an even sterner test if low rates were to force the Sparkassen to do the unthinkable and start paying their customers negative rates on their deposits, as some savings banks in the former East Germany have started to do for their corporate clients.

Fahrenschon is adamant that this is something that his members will avoid. "We will do everything in our power to ensure that savers are never paid negative rates," he says. "This may be hard work, but it is part of our special promise to savers in Germany."

Fahrenschon insists that the ECB's monetary policy is not just unorthodox, he says it is also dangerous. "More of the same is not the right policy, given eurozone inflation indicators," he says. In warning against the dangers of continued monetary easing in Europe, he echoes Dombret of the Bundesbank, who declared in a recent speech that "persistently low interest rates are rocking the very foundations upon which many German institutions have erected their business models."

Another threat to the Sparkassen flagged by Fahrenschon is over-zealous bank regulation, which he says is now inappropriately bureaucratic for smaller banks and, by extension, for the small and medium-sized enterprises they serve.

"If regulators fail to recognize the importance of proportionality and maintain a one-size-fits-all system, we will be unable to address the problem of 'too big to fail', and will create a new problem of 'too small to succeed'," he says.

Again, in this battle Fahrenschon has influential allies in the Bundesbank. Dombret has argued passionately for the creation of a Small Banking Box, applicable to banks with assets below a minimum threshold (of perhaps €3 billion), and which have no international or proprietary trading operations. "We need to relieve small, regional, less-risky banks of the operational burden associated with regulations that were established with large international banks in mind," Dombret has argued.

Relaxing the regulatory regime for banks with assets of below €3 billion would be convenient for the German financial services sector, given that 82% of credit institutions have assets below this threshold. But Fahrenschon rejects the suggestion that the main agenda behind the Small Banking Box idea may be the preservation of the German public-sector banking edifice and the employment it generates – there are over 224,000 staff in the savings banks alone.


Georg Fahrenschon, DSGV

"SMEs are the engine of industrial stability, not just in Germany, but throughout Europe," he says. "They are financed in many cases by savings and cooperative banks, which are facing an unnecessary regulatory burden."

Germany's savings banks' business model may not be especially dynamic. Nor (by design rather than accident) is it the most profitable. But it is a well-defined and consistent model that proved its worth during the financial crisis.

That is more than can be said for some of Germany's Landesbanks, often regarded outside Germany as banks that lost their way when they were stripped of their Anstaltslast and Gewährträgerhaftung guarantees in 2001.

It was those guarantees that provided Landesbanks with the cocoon of triple-A ratings, allowing them to fund cheaply in wholesale markets and on-lend, sometimes sensibly and sometimes considerably less so, at chunky spreads. With those guarantees a thing of the past, it is questionable whether some of the six remaining Landesbanks have a viable long-term strategy.

"Do the Landesbanks have a sustainable business model? The short answer is mostly 'no'," says Sam Theodore, who spent 20 years rating European banks at Moody's and DBRS, and is now managing director of the financial institutions group at Scope Ratings.

The Association of German Public Sector Banks (VÖB) dismisses the suggestion that Landesbanks have lost their collective raison d'être with a self-assurance that borders on insouciance.

"The Landesbanks have reduced the size of their balance sheets, de-risked, cut costs and are generally doing quite well," says Georg Baur, member of the VÖB's management board. "They have a good working model and still conduct the classical banking business of lending to industry and municipalities that they have followed for over 200 years."

Baur adds that the Hausbank principle remains alive and well in Germany and that long-termism among corporate Vorstände ensures that bank lending is still the financing mechanism of choice.

That may be. The trouble is that Germany's corporate banking market is horribly overcrowded and that, in today's atypical monetary environment, classical banking is vulnerable. "The traditional banking model no longer works in Germany," says HSBC's Reis.

## Targeting

HSBC is one of a number of overseas banks that is energetically targeting the German corporate market, recognizing that it can only do so profitably by offering products that extend well beyond plain vanilla lending.

Specifically, Reis says that HSBC sees opportunities in areas such as on-balance sheet management of pension liabilities, acquisition finance and the application of digital solutions to working capital and supply-chain management. “Undrawn revolvers are structurally unprofitable, but they are the entry ticket to a range of profitable banking services that clients want to buy,” he says.

Some Landesbanks certainly have successfully rebuilt their franchises since the crisis. LBBW has more than halved the size of its balance sheet since 2008, cut its non-performing loans to below 2% and built a thriving and innovative capital markets business.

Bayerische Landesbank, meanwhile, has recently repaid the last outstanding €1 billion of its state aid ahead of schedule, which Bavarian state finance minister Markus Söder has somewhat hyperbolically described as “a herculean effort unprecedented in German history.”

Whether the rehabilitation of LBBW and Bayerische Landesbank has been driven principally by strategy or geography is open to question. After all, the two banks enjoy the advantage of having Germany's most prosperous Länder as their backyards.

Baden-Württemberg, says LBBW's latest investor presentation, has GDP per capita 44% higher than the EU average and an unemployment rate lower than Japan's. Bavaria's GDP, meanwhile, puts it ahead of 21 of the 28 EU member states, according to the Land's investment promotion agency.

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> - Michael Dawson-Kropf, Credit View

As Commerzbank puts it in a recent research bulletin, however, there is “a clear north-south divide” in the German Landesbank community. Hanover-based NordLB is busy managing its troublesome portfolio of shipping loans and integrating the loss-making Bremer Landesbank, which it has fully controlled since the start of this year.

HSH Nordbank, meanwhile, which is also wrestling with a portfolio of problem shipping loans and is unkindly described by some bankers as a zombie organization, has been given until February of next year to attract a buyer or go the same way as WestLB.

While Fahrenschon says he is confident that HSH Nordbank will find a buyer, he appears to be in the minority. NordLB has ruled out bidding for HSH, telling Euromoney that the management of its shipping portfolio leaves it with “little to no leeway for acquisitions.” The usual suspects in the market for distressed European banking assets – such as Apollo and Cerberus – are said to be interested in paying the minimum asking price of one euro for control of the healthy parts of HSH Nordbank. But there are strings attached.

"I expect the private equity guys to want some protection from the government for about €4 billion of shipping loans which aren't covered by government guarantees, which is unlikely to be given," says Michael Dawson-Kropf, senior credit analyst at the Zurich-based Independent Credit View. "So I can't see HSH Nordbank finding a buyer for the entire bank by February."

Of all the banks in the sector, it is Landesbank Hessen-Thüringen (Helaba) – the only large Landesbank to have navigated its way through the crisis without state aid – which is regarded by some analysts as having established the most sustainable blueprint for longer-term growth. In an industry where relationships between the banks within the broader S-Finanzgruppe of 560 savings banks, Landesbanks and other public-sector institutions have been increasingly tense, this model has been beguiling simple. At its core has been the construction of a clear and mutually enriching relationship between Helaba and the Sparkassen that are its majority shareholders.

This, say analysts, is the precedent that other Landesbanks will need to embrace to safeguard their positions in an intensely competitive market. "The only viable model for Landesbanks is to merge with their local savings banks, integrate their retail and commercial banking operations and provide wholesale financing services for those savings banks," says Theodore at Scope Ratings.

*Sven Matthiesen, Helaba*

Sven Matthiesen, head of corporate strategy at Helaba, says: "Our ownership structure has an important influence on our strategy and is the key difference between Helaba and the other Landesbanks, none of which are more than 40.5% owned by Sparkassen."

The bank, which is headquartered in Frankfurt and Erfurt, operates as the central institution for 159 savings banks in Hesse, Thüringia, Brandenburg and North-Rhine Westphalia, where it absorbed the savings bank business of the defunct WestLB in 2012.

Matthiesen says that the blueprint for the cooperation between Helaba and the savings banks dates back to 2003, when an agreement was reached between the two groups clearly setting out what he describes as the rights and duties of each side.

As a consequence, corporate customers with sales of below €250 million are serviced by the Sparkassen, while all companies with turnover above this threshold are looked after by the Landesbank.

A potential downside of this arrangement is that profits are shared between the Landesbank and savings banks when both service the same customer. That means that the activities defined as the S-Group, retail customer and SME segment are not the most profitable business in the wider Helaba group.

Impacted like all other lenders by low rates, it generated income of €101 million in 2016, down from €140 million the previous year. Real estate, split roughly equally between domestic and international lending, earned considerably more (€407 million out of a total of €549 million in 2016).

But as Matthiesen says, the clarity of Helaba's relationship with its Sparkassen owners creates a range of synergies that are the bedrock of the bank's strategy and distinguish it from other Landesbanks.

"On the credit side, we can help the Sparkassen when they reach their lending limits, as well as with know-how in areas like refinancing renewables projects," he says. "Beyond the lending market, we support the savings banks' treasury operations and provide products for their retail customers, which is important for us because it generates funding."

Fair enough. But neither the success of Helaba, nor the recovery of Bayersiche Landesbank and LBBW, is likely to silence those who continue to question why Germany needs to maintain a fragmented Landesbank system made up of six (possibly soon to be five) very different players. For the time being, however, it is probable that calls for the creation of a single Landesbank powerhouse will fall on deaf ears, given the political hurdles that would stand in the way of bringing together the chiefs of the banks in the fiercely independent cities of Frankfurt, Munich and Stuttgart.

Besides, Baur questions whether further mergers in the Landesbank sector would be desirable or consistent with German federalism. "The experience of the crisis shows that big is not necessarily beautiful because it concentrated risk," he says. "Decentralization is deep in the heart of Germany's economic and banking structure."

The consequence, say analysts, is that it may take another crisis to drive change in the public sector of the German banking industry.

"The Landesbank sector only seems to be prepared to take radical action when it's under stress," says Dawson-Kropf. "And in the absence of any macroeconomic horror stories, I don't see any of the big three southern Landesbanks coming under stress in the near term."