

**Dr Andreas Dombret**  
**Member of the Executive Board**  
**of the Deutsche Bundesbank**

**The challenges facing the European banking sector**  
**in the low-interest-rate environment**

Speech delivered at the  
Fundacao Fernando Henrique Cardoso  
in São Paulo  
Wednesday, 26 October 2016

## Table of contents

1	INTRODUCTION .....	2
2	EUROPE'S BANKING SECTOR – IN DECENT HEALTH... ..	4
3	... BUT NOT YET IN OUTSTANDING SHAPE .....	6
4	FURTHER CHALLENGES LIE AHEAD .....	7
5	WHAT IS TO BE DONE? .....	11
6	CONCLUSION.....	13

## 1 Introduction

Ladies and gentlemen

I would like to begin by thanking the Fundacao Fernando Henrique Cardoso and its executive superintendent, Mr. Sergio Fausto, for the invitation. I am very pleased to give a speech on the challenges of the European banking sector.

There has been a lot of talk about European banks in the news – and it hasn't been flattering.

Many European banks were accused of being only half-hearted in their efforts to clean up the mess exposed by the financial crisis. Critics alleged that, so to speak, some of the dirt was swept against the wall, some under

the carpet, and the rest thrown out. What was lacking, however, was a full-scale clean-up operation, a spring clean.

Put simply, a lot of banks are being accused of having missed the opportunity to put themselves on a sustainable footing – to get their houses in order so that they don't constantly trip over the carpet because of the piles of dust buried underneath it.

The harsh words by the International Monetary Fund in early October were not the first criticisms of banks' business models – but they fanned the flames of public debate.

A debate which is growing more and more important. Although, thanks to a quick rearranging of furniture, banks were just about able to survive the disorder caused by the 2008 financial crisis, new storms are now on their way, and they will present challenges to the fundamental viability of business models.

The low-interest-rate environment is not the only such event – think of digitalisation, demographic change and global economic instability.

If these challenges are met by business models which are not up to the task, the results could be highly problematic. This is why many are concerned that banks have only done the bare minimum for survival – but that many missed the chance to prepare for a stormy future.

I do not concur with the exaggerated negative public perception of the banking industry voiced over the past few weeks. However, apart from these exaggerations, I am critical of the fact that many institutions regard the coming challenges as temporary problems that can be “waited out” by continuing to put off unpleasant decisions.

This is why I wish to discuss these challenges and the need for fundamental change to European banks’ business models – although, in a globalised financial world, the low-interest-rate environment is affecting banks all over the globe.

## **2 Europe’s banking sector – in decent health...**

However, back to the European banking sector: In the last few months, concerns about European banks span out of control. While there was no panic, the media discussion sometimes made us feel as if there was.

Now, let’s take a sober and realistic look at the facts. Over the course of this year, European banking stocks have had to weather strong headwinds. While the overall European stock market, as represented by the Euro Stoxx 50 index, remained more or less unchanged, the Euro Stoxx Banks index dropped by more than 30%. At the same time, the volatility of bank stocks remains high, although that seems to be closely related to post-Brexit jitters.

Such market movements suggest some sort of doomsday scenario. Is this justified?

Clearly not. Current concerns about the European banking sector are overstated. Yes, the sector is not yet ready to be successful in the new post-crisis environment. And market sentiment reflects just that. But – and this is where exaggeration comes in – the sharp movements do not take into consideration that the solvency of the sector in Europe is not in doubt.

In other words, while Europe's banks are still struggling to come up with long-term strategies to succeed in the new, different and truly challenging economic environment, in the short to medium term they would pass any health check – as the recent stress test by the European Banking Authority confirmed.

But banks also reveal traits and habits that can, in the long run, result in serious health issues – unless a change of lifestyle can be achieved.

Let's consider the health facts. EU banks have strengthened their capital base – though non-performing loans do remain a problem for some institutions: the aggregate tier 1 capital ratio of the banks in the euro area today stands at around 15%. This exceeds pre-crisis levels in early 2008 by six percentage points. Another sign of good vitality and higher resilience is the improved ratio of common equity to total assets. Before the crisis, European banks held around 3.6% of unweighted common equity; today, the average stands at 5.5%.

Banks also broadly meet the new health standards of sufficient liquidity – to be prepared for times of market distress.

And the euro area's new bank supervisor, the Single Supervisory Mechanism, has contributed to more rigorous supervision and to stronger banks.

So for the time being, the European banking sector is nowhere near the brink of collapse. The reform efforts of policymakers and bankers alike have led to substantial progress – even if important reforms, like ending the sovereign-bank nexus, remain to be finished.

### **3           ... but not yet in outstanding shape**

However, being healthy is one thing. Being in outstanding shape, being prepared for whatever challenges the future may throw at you, is another. Banks still have a long way to go before they reach that level of health.

At present, the efficiency of euro-area banks is too low, and many institutions are still struggling to achieve a steady stream of sustainable profits with a minimum of volatility – although both efficiency and profitability vary across individual countries and financial institutions. Profitability is not a goal in itself, but a means to an end – and this end is the stability of a bank and its capacity to meet regulatory capital requirements. That's why supervisors are concerned about falling profitability. Efficiency, in turn, is a means to the end of profitability – where increased cost efficiency improves the return.

To be in really good shape for the challenges that lie ahead, banks in the euro area must work on their operational efficiency and need to adapt their income sources. This is true for many, if not most, financial institutions.

#### **4 Further challenges lie ahead**

Thus: The condition of the sector is healthy, but it could be better. This is problematic, as banks face a truly demanding future, one that holds in store several massive – if not Herculean – tasks.

There were 12 Herculean tasks, but I will only take on four today – and I will try to keep it short, so that listening does not become another dreadful task.

The first lies in demographic change. The workforce is set to decline, while the number of non-working persons will grow. This will most likely be a burden on investment and on prospects for growth – both of which will weigh heavily on banks' business. For banks' business models, this will mean extremely challenging medium to long-term changes: the population will shrink, overall economic growth will fall, the savings rate will rise, investments and consumption will drop. The change in investment opportunities and in customer needs will present European financial institutions with completely new issues and problems.

All the more so given the second challenge: digitalisation. Although this is by no means new,<sup>1</sup> it has now developed into a broad mass phenomenon which is making ever-greater inroads into our everyday lives – which means it is also increasingly entering the financial sector.

Why is this such a massive challenge for the business models of banks? Because it is eroding their customer base, and the expectations of younger customer cohorts are very different from those of today's bank customers – and even those are changing. Competition from “fintechs”, using innovative models, is now already taking away some of the banks' market share.

Furthermore, the old financial value chain is already lying in pieces and is being reassembled by the new fintech competitors. This means that services which used to be provided by one institution as a whole package are now being provided by several institutions, with various intermediate products being offered by firms outside the traditional sector.

Consider, for example, loan brokerage platforms: most of the intermediate products offered there, such as borrower classification, are not provided by those running the platform. This is also a good example of why banks are in danger of providing, in future, only the less attractive parts of the new value chain.

---

<sup>1</sup> What is known as the “digital revolution” was already complete in 2002. This is regarded as the first year in which humanity was first able to store more information in digital than in analogue form. Meanwhile, over 90% of the global storage capacity is now digital, although this only describes digital possibilities and not their actual use. See M Hilbert & P López (2011), The world's technological capacity to store, communicate, and compute information. In: *Science*, 2011, 332(6025), pp 60-65.

On the other hand, digitalisation offers banks enormous opportunities to be in better shape in future. I will return to this in a moment.

Third, and perhaps the biggest medium-term challenge, are the ultra-low interest rates. They weigh heavily on banks with interest-focused business models. As it is difficult to pass negative central bank rates on to retail customers, deposits have ended up being a drag on income. This presents problems for many banks. Small and medium-sized banks used to be praised for their stable business models, which relied on taking deposits and earning higher interest margins by lending on capital markets. In an ultra-low-interest-rate environment, this virtue becomes a challenge.

We can visualise this challenge with just one simple number: net interest income currently makes up around 75% of the operating profit of German banks. A persistent low-interest-rate environment means that a basic component of their business model no longer works: it means, quite simply, that it is no longer possible to earn enough money by focusing on maturity transformation.

For many years, institutions used the very favourable financial market conditions and their deposit holdings in order to cross-finance their customer services. They were able to offer current accounts free of charge because earnings could be made on the financial market using the money in the accounts.

This is likely to be significantly harder in future, since – in all probability – the interest rate will remain low for a long time. Even if central banks were to

raise interest rates again – upon closer inspection, we see that it is not monetary policy alone which is responsible for low interest rates. Rather, fundamental social shifts such as demographic change have also caused the interest rate to fall continuously since the 1980s.<sup>2</sup> This means that institutions can no longer support their business models with earnings from financial market refinancing, since the earnings from maturity transformations will not be sufficient. This requires enormous rethinking.

Forth and finally, there is regulation. Many complain that regulation has become tougher. However, I think that it is akin to complaining of indigestion after being caught with one's hands in the cookie jar. Tougher rules and more stringent supervision are not only necessary, but long overdue. Complaining about their negative implications is confusing cause and effect. The light-touch approach before the crisis was simply wrong. We are correcting that mistake now. But of course, getting into shape to successfully comply with these new rules is a demanding task.

So, if we take a panoramic view of the sector in Europe, what do we see? Well, first of all, we see how the landscape has been cleaned up and danger zones secured. The European banking sector has made progress in improving both its solvency and its governance.

Yet, when we zoom into the picture, we see that the landscape is still dotted with contaminated spots.

---

<sup>2</sup> See eg L Rachel & TD Smith (2015) Secular drivers of the global real interest rate. Bank of England Working Paper No 571.

Obviously, the reform process is not over.

## **5 What is to be done?**

What must be done then, to complete the reforms in the European banking sector?

In my opinion, banking must return to being a normal economic sector, one in which earnings are generated through sound business models which are closely orientated to customer needs.

To do this, there is no need for banks to set over-ambitious earnings targets, which ultimately only lead to short-term profitability. Short-term earnings which come at the expense of long-term profitability weaken institutions rather than strengthening them. Instead, banks must set earnings targets which are realistic and geared to continuity.

Banks will have to work out for themselves exactly what this means for them. Banking supervisors are not the “better bankers”.

But it is likely that the sector’s problems can only be solved by a triad of increasing efficiency, renewal and scaling back.

Let's begin with increasing efficiency. The cost efficiency of Euro area banks is below the international average.<sup>3</sup> This means that, despite a significant reduction in the number of branches and institutions in the last few years, the efficiency of these institutions still leaves a lot to be desired.

It is important to make operations more efficient so that economies of scale on the cost side can take effect. Here, digitalisation can contribute one of its two keys to success: By helping to reduce costs through systematic process optimisation. For example, processes can be rebuilt systematically with the aid of new information technology, enabling them to be organised far more efficiently.<sup>4</sup>

Let's look now at the second element of the triad: Renewal. Business models must be rethought and in many cases reorganised, because the economic environment for which they were developed has changed.

For this reorientation, banks have to master a tough balancing act: Finding a sound business model, on the one hand, and countering new and innovative fintech rivals with innovations of their own, on the other.

I have already mentioned that earnings from maturity transformation will not be sufficient. This means that the low-interest-rate environment is weighing additionally on interest-focused business models. But it is not just these institutions which should consider whether they can earn the money required

---

<sup>3</sup> Dombret, Andreas (2016): Gibt es zu viele Banken? Der Sektor nach der Finanzkrise. Speech given to the general meeting of the Austrian Society for Bank Research in Vienna, 27 September 2016.

<sup>4</sup> Dombret, Andreas (2016): Konsequenzen der Digitalisierung für Banken und die Bankenaufsicht. Speech given at the 16th Norddeutscher Bankentag at Leuphana Universität Lüneburg, 8 June 2016.

to provide services for their customers – as, after all, other sectors of the economy do.

The second digitalisation key can also be useful for reorientation: To a limited extent, this can help to tap new sources of income. Institutions can tap such new sources of income and use existing sources more efficiently by cooperating with fintechs. This might make the balancing act easier to accomplish.

Completing the triad is a moderate, structural scale-back of capacities in the banking sector. Ultimately, renewing the institutions and increasing their efficiency will expedite this structural change. The result: Capacities and structures which meet the needs of the real economy. This will enable the banking sector to fulfil its supporting role once again.

## **6 Conclusion**

Ladies and gentlemen

The health of Europe's banking sector could be better, but is far from disastrous. However, when the market sneezes, expect some banks to catch a cold.

If we want to prevent unjustified contagion, the first thing we need to do is to stay calm. We should take the time to consider the facts instead of piling on what is clearly exaggerated sentiment.

And yet we live in challenging economic times. Doing business successfully and sustainably in this environment is an enormous task.

The ultra-low-interest-rate environment poses a particularly demanding challenge – especially since it is likely to stay for the foreseeable future.

Many banks have begun to address their deficiencies in facing the problems created by demographic change, digitalisation, ultra-low interest rates and tougher banking regulation.

But clearly, they have not yet undertaken a thorough renewal of their business models. In that regard, a lot remains to be done.

Ultimately, all institutions will play different versions of the same triad: operational processes have to be made much more efficient; business models have to be rethought, and in many cases revamped; this will lead, on the whole, to a moderate structural reduction in capacity.

And the banking sector will revert to its role of supporting the real economy – with such a sustainable strategy, banks will be able to rise to the challenges of the new economic reality.

Thank you for your attention.

\* \* \*