Deutscher Städtetag

Current challenges for Sparkassen

Position paper by the Association of German Cities

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Preface

In their role as trustees of the Sparkassen, cities are required to deal with the regulatory framework as well as the conditions of the market and competition of their institutions. These conditions change continuously. Therefore it is paramount to come to a common understanding of the principles and guidelines for the further development and realignment of the institutions within the committees of the Association of German Cities. To that end, the cooperative dialogue with the German Sparkassen finance group is instrumental.

The orientation of the European Banking Authority, the proposals of the European Commission for a European deposit insurance scheme and the European corporate governance principles for banks rank among the most current topics from the perspective of the responsible local authorities. In that context the business relations between Sparkassen and municipalities, possible reactions to changing conditions of the market and competition by the means of new business strategies as well as the public welfare orientation of the Sparkassen, which is inherent in the public mandate, are especially important to us.

From the cities' point of view, the following touchstones are decisive for the future business orientation of the municipally backed Sparkassen: the public service which is enshrined in the principle of local self-government and the therewith attached public service duties of the Sparkassen – respecting the regional principle throughout.

With this position paper the Association of German Cities wants to emphasise the special status of the Sparkassen in the interaction with their trustees, the municipalities. Furthermore, it wants to illustrate the special features of the "Sparkassen model" to political actors on the national and international level. Finally, we want to advocate for securing and strengthening this model.

The Board of the Association of German Cities has adopted this position paper on current challenges for Sparkassen during its 218th meeting in February 2017 in Osnabrück.

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Current challenges for Sparkassen

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Sparkassen are a vital part of local public service. Their public mandate, their compliance with the principle of regionalism and their municipal ties are fixed points of leverage for any sustainable developments of Germany's municipally backed savings bank model.

Sparkassen are indeed facing some major challenges. In particular, the rollout of highly complex regulations is causing a substantial volume of work while the European Central Bank's (ECB) current low-interest policy is also putting pressure on profits.

Internationally, the standards for banking have been – and still are being – reworked. At European level, the rules for financial service providers are continually being updated. These rules apply to the entire banking sector across the board. This means that even if rules are not directly applicable to the national level, agreements made at the international level still impact on national banking oversight. These international rules take no, or hardly, any account of the special nature of Germany's present banking system with its three pillars of private, public and cooperative banks.

Economic globalisation and digitalisation appear to cast doubt on decentralised and regional models in general. Germany's Sparkassen thus see themselves up against growing competition and are having to accommodate changes in customer demands. We are not talking about a single development push that has to be accommodated in the short term, but about challenges that affect the fundamental nature of the Sparkassen system. The upshot: we cannot take our eyes off the ball but need to constantly keep track of these changing conditions.

From the perspective of their municipal trustees, current topics include, in particular, the direction European banking regulation is heading in; proposals for a European deposit insurance scheme put forward by the EU Commission; the business ties between Sparkassen and municipalities; possible reactions to changes in market conditions and the competitive environment; the orientation to public welfare deriving from the public mandate of Germany's Sparkassen; and the European guidelines on corporate governance.

1. European banking regulation

The tighter controls intended for banking supervision in Europe are essentially geared to regulating major international banks. These European rules are not appropriate for the business models of banking institutions that operate exclusively on a regional basis. In keeping with the core European principle of subsidiarity, differentiation and proportionality are legitimate and necessary in banking supervision.

Financial system reforms are necessary by way of a response to the financial market crisis – and in order to prevent it happening again. And we welcome any corresponding efforts at European and national level. But these reforms need to enforce stricter banking regulations at those places that proved particularly fragile and problematic in the past.

In spite of the devastating effects the bank crisis had on the European economy, Germany's Sparkassen were still able to guarantee the safety of their customers' assets throughout. Sparkassen are not primarily profit oriented but act in the general public interest. Their main objective is to strengthen local businesses and to promote the interests of the local population. In cooperation with the local authorities, they are major contributors to the construction and maintenance of basic infrastructure and also to financing for SMEs, micro businesses and startups.

In its regulatory proposals in recent years, the EU Commission has essentially adopted the recommendations the Basel Committee formulated for international banks. EU regulations thus regularly run the risk of overshooting the mark in that they do not just target those institutions that were identified as being 'systemically important’.

European banking regulations have to be proportionate. Even in the acute phase of the financial crisis, Germany's Sparkassen and cooperative banks had a stabilising effect on the national economy. In particular, the Sparkassen – as public, decentralised banking institutions under municipal trusteeship – are committed to their given region to considerable degree.

Differentiation and proportionality are justified in banking regulation.
Referred to as 'Basel IV' for short, negotiations are currently ongoing to upgrade regulatory equity capital requirements. One consequence of the Basel IV negotiations could be yet another increase in capital requirements for Sparkassen, too. When evaluating all new proposals by the Basel Committee and the EU Commission, we need to apply the following yardsticks:

- European banking supervision and banking regulation must be geared primarily to banks defined as globally or otherwise systemically important.
- Not only the economic but also the social and political consequences of legislation and control guidelines need to be assessed. This is necessary in order to avoid any unwanted knock-on effects. The regulatory regime to be agreed by 2018 has to allow for investments in public and specifically in the municipal infrastructure in future, too.
- Any proposals by the EU Commission must be reconcilable with the principles of subsidiarity and proportionality. Banks defined as being systemically important need to comply with a clear and uniform set of international rules and regulations and be subject to prudential supervision by a European authority. Banking regulations have to be tailored to the banks' complexity, size and business profile. In the case of banks that are smaller and less complex, there are justifiable grounds for a staggered system of regulatory requirements. It is both justified and necessary for banking supervisory law and the actual practice of oversight to exercise greater differentiation. What we need is a 'small and simple banking box'.

EU supervisory requirements must not put Germany's Sparkassen at a disadvantage. This applies in particular to additional capital requirements from recent risk-bearing capacity concepts (SREP guidelines). Small regional institutions need to be protected against an excessive workload and additional costs. As such, we welcome the fact that, to all intents and purposes, the EU Commission is currently seeking to accommodate the principle of proportionality to a greater extent.

2. Europe-wide deposit guarantee system

We need to further strengthen the guarantee system used by the Sparkassen-Finanzgruppe. We cannot allow existing institutional guarantee mechanisms that work well to be jeopardised by European deposit guarantee systems. We therefore reject the proposals put forward by the EU Commission in November 2015 concerning the creation of a European deposit insurance scheme.

EU proposals concerning a European deposit insurance scheme (DIS) must take account of existing schemes. Systems created to implement the 2014 EU directive on deposit insurance schemes must not be undermined. More to the point, proposals for a European DIS should aim to strengthen the confidence of Member State citizens in the European banking sector to the same extent across the board. If we weaken a working DIS, we cannot expect this to happen. For this reason, we reject the Europeanisation of deposit insurance schemes in the manner recently proposed by the EU Commission.

A European deposit insurance system must not foster or in any way support high-risk speculations. Instead, support should mainly focus on promoting sustainable business models. People have confidence in the proven institutional schemes currently in operation. This has to do with the fact that, in the worst-case scenario, support from affiliated banks not only protects the savers' assets but the entire institution. Secondly, if push comes to shove, . these systems can aid restructuring and thus help minimise any potential impact on the markets.

3. Response to changes in market conditions and the competitive environment

In response to changes in market conditions and the competitive environment, German Sparkassen are also having to align and upgrade their business strategies. Working in close cooperation with their municipal trustees, they have to adjust their branch network and develop viable sales structures and product offers. The public mandate and compliance with the attendant principle of regionalism – which are legally enshrined in this business model – are the forces that shape its strategies.

Sparkassen are currently facing changes in the market conditions and competitive environment. The negative interest rates are making themselves felt. Sparkassen are tasked with providing the people and in particular businesses with money and banking services, particularly in its local area. Sparkassen thus serve a public purpose. They strengthen competition and ensure all population groups and businesses, in particular medium-sized enterprises and the public sector, have access to appropriate and adequate financial and lending services across the board. In so doing, they assist the municipalities to fulfil their economic, regional policy, social and cultural duties. Sparkassen encourage large groups of people to save and build up their capital assets and they foster youth's financial literacy. The high social value of Germany's Sparkassen is reflected in the large proportion of these institutions that engage in: lending to medium-sized enterprises and artisans; mortgage provision for private house construction; and the inclusive delivery of banking services (such as the 'current account for everyone' which other banks essentially refused to provide prior to the legal regulation to this effect).

The actual form the public mandate takes, given all the forces acting on it as regards market situation, municipal interests and management projects, is something that needs to be developed and carried forward through joint local dialogue.

The regional principle is enshrined in the constitution.
For Sparkassen, being anchored in a given region has a decisive impact on their business strategies. Sparkassen are autonomous institutions that fulfil key public service duties. Their responsible public bodies – but not owners – are the local municipalities, meaning Sparkassen are grounded in the constitution. The regional principle, municipal trusteeship and the public welfare mandate form a whole. And regionalism in particular was one of the main reasons why, in the financial market crisis especially, the Sparkassen were able to

remain strong and have a stabilising effect. New business strategies and offers have to be reconciled with the Sparkassen principle of regionalism, which is anchored in the constitution. It is up to the Sparkassen control committees, the supervisory boards, to actively support the changes that need to be made, whereby the decisive criterion here is their legal anchor in the form of the constitutional right to local self-governance.

Equity capital quotas and risk-bearing capacity of German banks has risen substantially overall.
At present however, the Deutsche Bundesbank states that the German banking sector is experiencing weak profitability, aggravated by the low interest rates. For banking institutions whose business models have a strong interest orientation (such as Sparkassen and the cooperative banks), this could create business management problems in the medium to long-term. Sparkassen are therefore now responding to this new situation. Commission revenues (in particular account management fees and payment transaction fees) are being extended and big customers are increasingly being charged custodial and safekeeping fees. Institutions are also responding by reviewing their business strategies, engaging in mergers and restructuring their branch network amongst other cost-saving measures**.**

The Sparkassen sector is looking into mergers and other forms of consolidation.
The number of local banks in the German Sparkassen sector is declining. In January 2017 there were 396. In spring 2015 there were still 416 institutions. Out of all banking institutions, Sparkassen continue to operate the densest branch network. However, the number of branch offices is definitely going down. The reorganisation of local Sparkassen branch networks thus reflects the banks' recognition of the need to consciously drive forward a process of transformation in response to changes in market conditions. At any rate, this calls for a local debate about the appropriate density of the branch network, taking account of the banks' public mandate, business requirements and customer behaviour.

For many institutions, the key factors driving their reorganisation process include the digital economy and changes in customer demands.
For many Sparkassen, the advanced pace of digitalisation and the attendant alignment of sales strategies are their key point of departure when it comes to securing their long-term viability. In addition to strong upward cost pressure, the main incentive for their push for digital transformation are the changes in customer behaviour, especially amongst younger customer groups. There is no one-size-fits-all solution as to how many services in a given region should be analogous and how many digital. User habits not only vary with respect to age, but also, for example, with regard to level of education, gender or time available. As with other financial service providers, Sparkassen are complying with their customers' wishes for a wide variety of service channels. Given the new internet-based business and contact options, customers now expect more flexible contact services. Stationary sales networks need to be networked to maximum effect with the new options afforded by a multi-channel banking strategy. Customer access to Sparkassen services is at the forefront, whether personal (service, consultancy) or digital (payments, video consultancy, text chat or self-service). In keeping with their reputation and public mandate, Sparkassen should aim to ensure uniform quality standards across all channels.

Sparkassen also have to ensure data protection and data security in their digital spaces.
This applies in particular to payments transactions where other market players spy on customers' habits and pass on this information to third parties for money.

Municipal authorities are joining and shaping the digital transformation process.
Municipalities are developing and realising strategies for e-government. As such, the digital evolution underway in the Sparkassen-Finanzgruppe is impacting the municipalities and it is up to both sides to harness possible synergies.

4. Sparkassen – key partners for financing municipal tasks

In line with their public mandate, Sparkassen are key financing partners for the local authorities. Municipal financing was – and still is – a low-risk business for banks. Bank controls that undermine low-risk business thus pose a risk to municipal lending.

In keeping with their public welfare mandate, Sparkassen are reliable financing partners in their respective regions. They are tasked with providing money and banking services to people and businesses, especially in the administrative areas of their local municipality. As a result, and indeed to a special degree, the Sparkassen are also mandated to finance local public sector spending. This is a major area of Sparkassen operations, especially since municipalities are the main drivers of public investment. There is thus no need to undermine the business connections between the municipalities and their Sparkassen. German municipalities mobilise a major share (around 98 per cent) of their refinancing resources from direct loans from banking institutions. Sparkassen provide around 22 per cent of these direct loans. In the case of short to medium-term loans, Sparkassen have a 26 per cent stake in municipal financing; with respect to long-term funding, the figure is around 20 per cent.

Municipal financing has always constituted low-risk business for banks in Germany.
Municipal debt in Germany accounts for around 7 per cent of general government debt. Relative to GDP, municipal debt accounts for 4 per cent.
There have never been any defaults on municipal loans at any point in the history of the Federal Republic of Germany. Furthermore:

- German municipalities cannot become insolvent.
  In the wake of the financial market crisis and the government measures rolled out afterwards (to strengthen the real economy, mitigate the social impacts of the crisis and save struggling banks), German municipalities have also had to wrestle with record deficits. Efforts were - and still are – required, particularly to curtail lending for the purpose of municipal liquidity. Commensurate with their responsibility, federal states with high municipal debt have in the meantime set up municipal debt relief programmes.
- The constitutional courts have stated in unequivocal terms that it is the prime responsibility of the federal states (*Länder*) to ensure their municipalities have appropriate financial resources. And the responsibility of Germany's federal and state administrations (*Bund und Länder*) for the municipal level was made clear in the negotiations on the fiscal package. Since 2012, any surpluses have been assigned to German municipalities. In the meantime, not only the individual federal governments, but the national government too is organising special programmes for financially weaker municipalities.
- In Germany, municipal budget management is subject to municipal oversight by the responsible federal states..
  The municipal budget law enforced by the federal states lays down clear standards for municipal financial policy. Indeed, the accounting practices used by German municipalities already correspond to a large extent to the standards that are now to be rolled out at European level (as a consequence of the financial and sovereign debt crisis).

For the European Banking Authority (EBA), credit risks accruing from exposures to German municipalities are the same as exposures to the German central government.
The database published by EBA in summer 2014 confirms that exposures to German municipalities are treated as exposures to German central government. Thus, at present, there is a zero per cent risk weighting for exposures to German municipalities. Questioning the Sparkassen´s business focus on municipal financing would therefore be misguided and inappropriate.

Introducing a bank regulatory regime that would undermine low-risk operations would jeopardise municipal lending.
Current revisions to European banking supervision risk replacing risk-less and low-margin banking transactions – like municipal loans in Germany – with higher profit-earning but also riskier dealings.

If traditional municipal financers – like Sparkassen – have to artificially curtail their volume of financing to local authorities, because of sweeping new banking parameters, initiatives by the EU Commission to boost the European economy as well as national investment initiatives, will come to nothing.

Thus, we cannot accept low-risk business being undermined in the name of banking regulations. Bank control should be obliged to take appropriate account of the level of business risk involved in order to ensure banking institutions remain incentivised to engage in low-risk and low-margin business in future, too.

5. Sparkassen and their orientation to public welfare

The public welfare orientation of Germany's Sparkassen is a core element of their public mandate. And customers and local businesses are right to place substantial trust in their Sparkasse. After weighing up the economic performance capacity of the given Sparkasse on the one hand and the municipal trustee's interests on the other, the responsible committees in the individual Sparkasse decide on possible dividend payouts. The Sparkassen policy of transparency in all services executed in compliance with their public welfare mandate serves to strengthen the bond between the savings banks and their local public bodies.

Historically, Sparkassen were founded as a means of advancing social progress, and especially to make bank services accessible to low-income earners. And today too, their structure and operations are not primarily profit oriented but are driven by a sense of responsibility toward the community. Sparkassen do not see the main purpose of their business operations in profit making, but in the fulfilment of their public mandate. A Sparkasse can only be established and operated within the scope of the constitutional provisions governing municipal activities. Sparkassen cannot invoke constitutionally guaranteed rights to commercial liberty, but act in accordance with competences that have been assigned to them under public law.

Where they are economically meaningful, any payouts or donations by Sparkassen to municipal bodies are also an expression of their public welfare orientation and mandate.
Transparency strengthens the bonds between institutions and public bodies. In recent years, Sparkassen have paid out high three-digit sums to promote social transfer projects. Furthermore, and to varying extents, Sparkassen pay dividends to their public trustees. The federal states have different regulations in force governing the level of capital a Sparkasse must have at its disposal in order to pay out dividends. If dividends are paid to public bodies, they generally account for only a portion of the net profit, thus enabling the Sparkassen to continue to build up their own equity capital. Sparkassen with substantial equity capital pay out dividends more frequently. High earnings also make it more likely for a Sparkasse to distribute profits. Payouts can certainly be expedient, say if the respective Sparkasse can make a contribution that is economically viable and necessary to help stabilise the respective municipality. Clearly communicating what the Sparkasse does for and in its given region can play a major role in securing customer loyalty.

6. European guidelines on corporate governance in the banking sector

The close ties between the municipal trustees and their Sparkassen have proved their worth – unreservedly. European and national regulatory regimes directed to Sparkassen supervisory board members have to take account of the banks' specific business model and regionality.

At present the European Central Bank (ECB) and the European Banking Authority (EBA) have put forward several draft guidelines on corporate governance for consultation. These European proposals contain demands on supervisory board members that are not reconcilable with Germany's public banking system. They fail to take account of the specific structural elements of the municipally backed Sparkassen; for example, in the case of a suspected conflict of interest amongst people with political influence – here the ECB only provides for exceptions for representatives of shareholders. However, in order to maintain a fair and equal balance, at least one exception must be made for municipal representatives, given that Sparkassen operate under the principle of municipal trusteeship.

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