THE COVID-19 PANDEMIC AND RELATIONSHIP BANKING IN GERMANY: WILL REGIONAL BANKS CUSHION AN ECONOMIC DECLINE OR IS A BANKING CRISIS LOOMING?

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ABSTRACT

By providing liquidity *Hausbanks* can support business clients to overcome the social shutdown and hence cushion the economic impacts of the COVID-19 pandemic. Germany's regional banks demonstrated such ability in the financial crisis of 2008/09 when, in contrast to large banks, they extended lending. Revisiting research on the global financial crisis and relationship banking, this note presents hints on the soundness and lending ability of retail banks, discussing their influence in the virus-related economic turmoil. Banks appear better prepared to resist the crisis than in 2008. Still, the (looming) turmoil of the real economy at large tends to stress all banks and regional banks in particular, owing, among other reasons, to their leading position in business lending. The crisis represents a chance for *Hausbanks* to prove their commitment to business clients and provides a possibility for researchers to analyse the performance of different types of banks.

Key words: Relationship banking; COVID-19 pandemic; regional banks; enterprise finance; economic and banking crisis

INTRODUCTION

In relationship banking, *Hausbanks* offer implicit liquidity insurance to business clients as patient lenders. By providing additional loans and advice to clients in financial stress, *Hausbanks* keep companies in business and contribute to their restructuring (Boot 2000; Handke 2011). Examination of the global financial and economic crisis of 2008/09 reveals that especially the regional savings and cooperative banks increased lending in this crisis and cushioned the economic shock in Germany (Gärtner 2011; Hardie & Howarth 2013; Klagge *et al.* 2017). The shutdown of social life in order to slow the COVID-19 pandemic causes immediate financial stress to a wide range of companies. Notwithstanding government support, many companies are likely to need new loans and/or credit deferrals from their banks to overcome shortfalls in earnings. The extent of earnings shortfalls promises to be exceptional, affecting almost all industries, presumably the domestic services sector in particular. Therefore, banks are at risk of experiencing financial difficulties if too many loans default, which could constitute the onset of a new banking and financial crisis. Given the fact that the extent and long-term impact of the social shutdown on the economy remain unclear, banks' lending behaviour is crucial and challenging. On the one hand, if banks remain too tentative,

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they damage the economy and amplify defaults, since they neglect their liquidity insurance function. On the other hand, banks are at risk of default, and overdoing lending may trigger a banking and financial crisis, which would further amplify the economic crisis.

Written in April and May 2020, the note in hand explores the possible role of retail banks, especially regional savings and cooperative banks, in the economic turmoil caused by the measures taken to slow the spread of the COVID-19 pandemic. Revisiting findings on regional and relationship banking in the global financial and economic crisis of 2008/09, we examine the current situation to identify research opportunities and discuss possible policy means to cushion the economic impact of the crisis in the context of banking. Arguments for and against the risk of a retail banking crisis and the ability of regional banks to support business clients during the pandemic are discussed. Preliminary findings from seven qualitative telephone interviews with five enterprises and a savings bank supplement the discussion. The authors and other interviewers conducted the interviews as part of an ad hoc research project on the economic impacts of the pandemic with a focus on government support schemes and the lending behaviours of *Hausbanks*. The interviews lasted between 20 and 70 minutes and were conducted in April and May 2020. Germany is the country of enquiry. Though, as banking regulation is a European affair and the research questions tend to be similar across Europe, the relevancy of this note goes beyond the German case.

The note is structured as follows. The following section revisits the theories and findings on relationship banking and outlines why a (geographically) diverse banking system and regional banks are considered to be desirable in an economic crisis. The section also briefly introduces peer-to-peer lending as a digital alternative to relationship banking. The third section gathers arguments concerning the possible performance of retail banks in this crisis in terms of their soundness and ability to support enterprises with liquidity. Special attention is paid to the regional savings and cooperative banks. Finally, the fourth section discusses the arguments for regional banks either cushioning the economic crisis or triggering a banking crisis and advances research questions and possible policy recommendations.

RELATIONSHIP BANKING, REGIONAL BANKS AND THE GLOBAL FINANCIAL CRISIS OF 2008/09

Typically, relationship banking is associated with exclusivity, that is business clients purchase most financial products at their *Hausbank* (i.e. main bank, with which the client forms a long-term relationship). In turn, the *Hausbank* offers flexibility, customised products and implicit liquidity insurance to borrowers in close relationships, that is, they also stand by their borrowers in bad times when firms need liquidity most urgently (Boot 2000; Udell 2008; Handke 2011). The ability to reuse information and learn from each other in close banking relationships gives *Hausbanks* information advantages and allows them to act flexibly and quickly if needed (Handke 2011). As Flögel (2019) shows in his ethnographical study of German savings banks, *Hausbanks* are able to grant new loans almost instantly in existing business relationships, because the required documents (e.g. annual financial statements), risk analysis/rating score and securities (e.g. land charge entry) already exist.

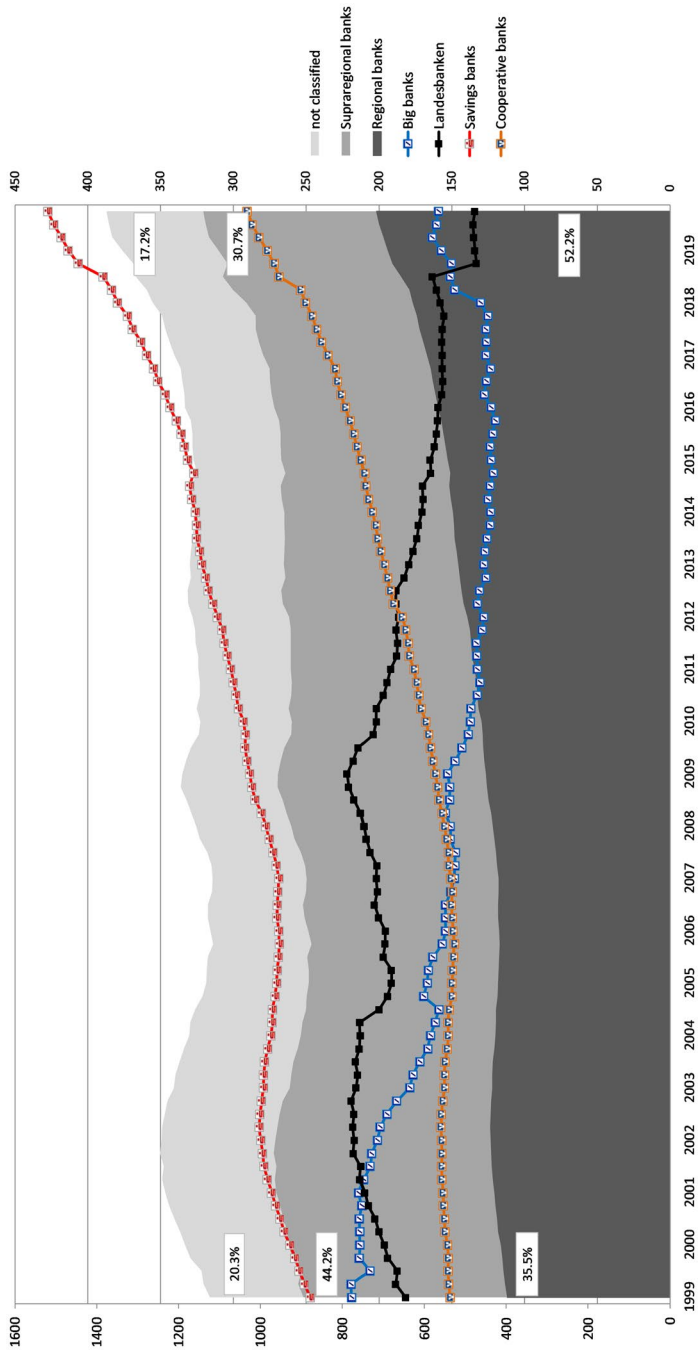
Relationship banking is frequently associated with small and regional banks (Gärtner 2009; Handke 2011; Flögel 2019; Ferri *et al.* 2019). Theories on asymmetric information in small firm finance depict the distance dependency of information gathering when information is soft (Stein 2002; Pollard 2003; Gärtner 2009; Alessandrini *et al.* 2009). According to Stein's (2002, p. 1982) definition, soft information 'cannot be directly verified by anyone other than the agent who produces it'. Short distance eases the transmission of soft information, wherefore regional banks that operate in proximity to regional clients tend to be superior in small firm finance (Stein 2002). As Stein's (2002) model predicts, numerous empirical studies show that a short distance to decision-makers reduces the financial constraints of small and medium-sized enterprises (SMEs) by facilitating the consideration of soft information in lending decisions (Alessandrini *et al.*

2009; Behr *et al.* 2013; Lee & Brown 2017; Zhao & Jones-Evans 2017). As the ethnographic study at the savings banks indicates, soft information does not substitute hard information in lending decisions (Flögel 2019). Rather, banks use it to understand critical hard information. Therefore, soft information matters most for firms in financial turmoil when hard information (e.g. cash flow, profitability, etc.) tends to become critical. These findings explain why regional banks gain advantages in soft information-based relationship banking in times of crisis, compared to their larger competitors.

In Germany the so-called three banking pillars 'private', 'public' and 'cooperative' still exist, leading to Germany's banking landscape being nearly a European exception today (Hackethal *et al.* 2006; Schmidt 2018). The large number of regional and independent banks, in the form of 379 public savings banks and 842 cooperative banks (Deutsche Bundesbank 2020), are similarly unusual, especially since the regional banks together achieve large market shares (see below). These regional banks predominantly operate in geographically bounded market areas (e.g. in a municipality) as stipulated by the regional principle in the savings banks laws. Most cooperative banks also operate on a regional scale on a voluntary basis (Bülbül *et al.* 2013).

Several scholars consider the business lending of the regional banks as one reason for the strong performance of the German economy in the aftermath of the financial crisis in 2008/09 (Gärtner 2011; Hardie & Howarth 2013). Figure 1 illustrates the credit volumes that all banks lent to non-financial firms and the self-employed for the period of 1999–2019. The credit volume of all banks together exhibited conjectural movements and steady expansion from €1,171 billion in October 2015 to €1,376 billion in October 2019 (plus 17.5% in four years). A nuanced picture emerges when differentiating between regional and supraregional banking categories. Owing to their regional market segregation, savings and cooperative banks are grouped as regional banks. Due to their national or international market reach, big banks, branches of foreign banks, *Landesbanken*, cooperative central banks and special purpose banks (e.g. promotional banks) are grouped as supraregional banks. (The 'not classified' category of banks consists of 'other commercial banks' and 'real credit institutes' owing to differences in the geographical reach of the banks summarised in this statistical category). Since 2002, regional banks have almost continuously increased their market share at the expense of supraregional banks. Concerning the financial crisis, from the lending peak in 2008 to the lowest value in 2010, banks reduced overall lending by €47 billion (left-hand scale of Figure 1). While the big banks and especially the *Landesbanken* reduced credit (right-hand scale), the regional banks actually increased volumes by €13.7 billion, thus attenuating overall credit reduction. Since the financial crisis, regional banks have steadily increased market shares to the extent of supraregional banks (except for the statistical break in 2018), accounting for 52.2 per cent of all business lending in October 2019.

Besides superior information, independence from capital markets is seen as an additional reason enabling regional banks to extend lending during the global financial crisis (Hardie & Howarth 2013). According to Allen and Gale (2000), banks' ability to smooth returns intertemporally (i.e. retain earnings in good times for bad times) allows them to act less procyclically than capital market funding (e.g. bonds and shares), that is, they can extend lending in crisis times when other investors must liquidate assets. However, according to Hardie and Howarth (2013), most modern banks have lost this ability because banks refinance on the capital market and link assets (including loans) directly to market price movements with mark-to-market accounting. Therefore, many banks all over the world faced difficulties in the financial crisis as they had directly or indirectly invested in US-mortgages (Aalbers 2009; MacKenzie 2011; Martin 2011). Remarkably, banks without US-mortgage investments also failed, like Northern Rock, due to their refinancing at the interbank lending market, which dried up in the crisis as the banks lost trust in one another's solvency (Shin 2009). In contrast to such market-based banking, Germany's regional banks predominantly follow a traditional banking business model, that is, they collect deposits and lend to



Source: Authors' compilation, Deutsche Bundesbank (2020).

Figure 1. *Lending to non-financial firms and the self-employed by categories of banks in billion euro.*

enterprises and other customers – a business model that was hardly affected by the global turmoil (Hardie & Howarth 2013).

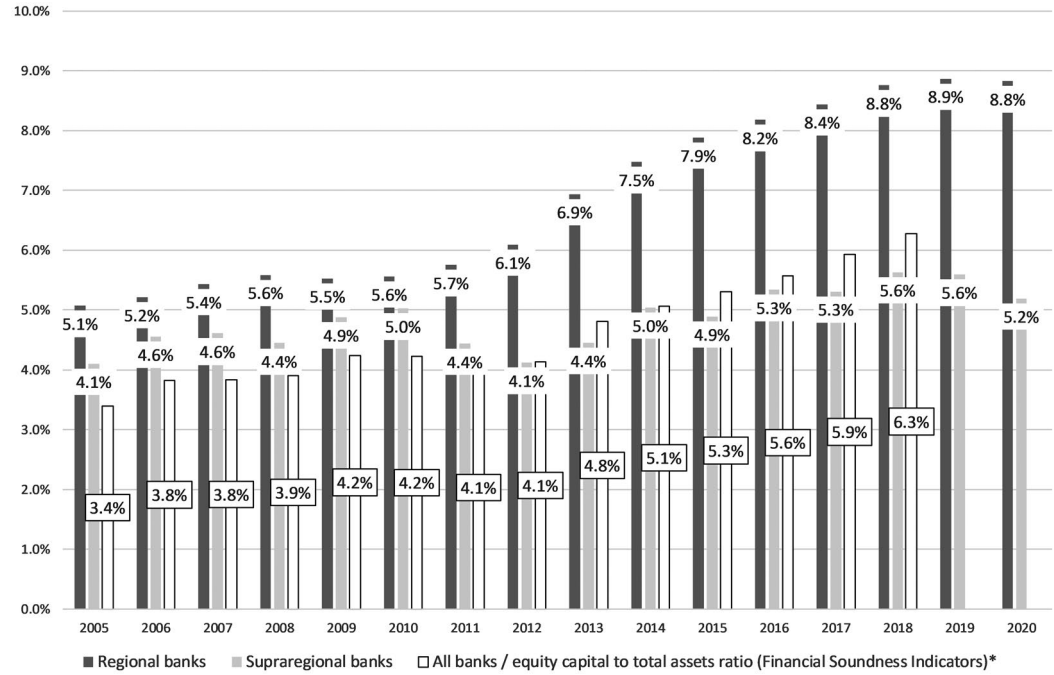
To reduce the procyclicality of global and highly connected finance, many scholars called for increased diversity in banking after the global financial crisis (Ayadi *et al.* 2009; Haldane & May 2011; Michie & Oughton 2013; Schmidt 2018). Diversity tends to reduce the contagiousness of financial crises and thus increases the stability of the overall financial system. Ayadi *et al.* (2009, p. ii) argue that different models of banks have advantages and disadvantages, whereas there 'is a systemic advantage in having a mixed system of models'. The importance of diversity is also acknowledged by the high-level expert group on reforming the structure of the EU-banking sector (Liikanen *et al.* 2012). Diversity is measured in several dimensions like ownership structures (Ayadi *et al.* 2009, Schmidt 2009), business models (Ayadi *et al.* 2019) and the geographical structure of the banking system, namely, the existence of regional banks (Michie & Oughton 2013). As indicated above, the public and cooperative regional banks account for the high diversity of the German banking system compared to other European countries (Schmidt 2018). As Table 1 shows, the number of regional banks declined after German reunification in 1990 and continued to do so after the global financial crisis, questioning the persistence of regional banks in the long run (Gärtner & Flögel 2017). Mergers within the savings banks and cooperative banks pillar have driven the decline, as individual banks attempt to form larger organisations. Tough competition, the ongoing low interest rate environment and tightened banking regulation (to prevent a new financial crisis) challenge all banks. However, extensive reporting requirements generate fixed costs that burden small regional banks disproportionally (Alessandrini *et al.* 2016; Schiele *et al.* 2017). Against this background, some authors see regional banks and, more generally, banking diversity as being at risk in Germany and Europe (Ferri & Neuberger 2018; Schmidt 2018), also because of rising new competition from fintech companies (Schackmann-Fallis & Weiss 2018; Flögel & Beckamp 2020).

With the so-called Basel III framework, the Basel committee on banking supervision agreed on tightened banking regulation

Table 1. *Number of banks by regional and supraregional banks.*

Number of banks	1990	2000	2010	2020	Change from 1990 to 2000	Change from 2000 to 2010	Change from 2010 to 2020
All banks	4,209	2,987	1,938	1,532	–29.0%	–35.1%	–20.9%
Regional banks	3,803	2,602	1,588	1,221	–31.6%	–39.0%	–23.1%
Supraregional banks	97	122	137	136	25.8%	12.3%	–0.7%

Source: Authors' compilation, Deutsche Bundesbank (2020).



Note: The equity capital aggregation of the financial soundness indicators need not equal the bank capital aggregation of the bank balance sheet statistics of Deutsche Bundesbank as banking supervision applies specific equity capital definitions.
Source: Authors' compilation, Deutsche Bundesbank (2020).

Figure 2. *Bank capital to total assets ratio by regional and supraregional banks.*

to prevent future financial crises (Höpfner 2014). Basel III has been adopted several times in the last decade and is still in the process of implementation. The European Union has implemented the Basel recommendation for its member states. To make banks crisis-resilient Basel III stipulates an increase of minimum equity capital, enacted with the Capital Requirements Regulation (EU 2013, regulation 575/2013). In essence, banks must hold a larger quantity (and better quality) of minimum equity capital compared to 2007. Several rules determine the amount of minimum capital required and banks can select different approaches for its calculation (Paul 2011). Tendentially, more risky assets, also including loans to enterprises, require a higher proportion of equity capital, which makes capital availability a limiting factor for banks' ability to lend. With the regulation (EU) 2019/630 (EU 2019), the capital requirements for non-performing loans (e.g. loans where payments of interest and principal are past due by 90 days or more) were increased in 2019 to reduce the high level of non-performing loans in some European countries (Büchel 2019). Overall, the new regulations caused a visible increase of bank capital in most European countries (Kotz & Schäfer 2018). In Germany, all banks together increased the ratio of equity capital to total assets by 2.9 percentage points from 2005 to 2018 (Figure 2). With 8.8 per cent, regional banks hold more bank capital in relation to total assets than supraregional banks (5.2%) in 2020, though both categories of banks hold more capital in 2020 than in 2007. Accordingly, the tightened banking regulation has led to an increase in the equity capital of German banks.

The credit crunch in the financial crisis and restrictive lending to SMEs after the crisis increased interest in alternative forms of finance for enterprises. Fintech, especially peer-to-peer (ptp) lending platforms, tend to positively influence the supply of finance for SMEs by

offering small firms an alternative to bank loans (Philippon 2016; Jagtiani & Lemieux 2017). For example, the UK government invested in ptp platforms to improve access to finance for SMEs (van der Schans 2015). Rather than holding the savings of clients and offering loans directly (as banks do), the platforms just match individual borrowers with individual investors and hence do not carry the risk of loan default. Business lending has only recently become of interest for German ptp lenders, for example, auxmoney started a business client product line with loans of up to €750,000 (Auxmoney 2019). Hence, competition between (regional) banks and ptp lenders for SME clients has only just started. The current economic uncertainty presumably challenges the new ptp business lenders because peer investors may fear increasing credit defaults and withdraw investment, as reported from the UK (P2P Finance News 2020). Overall, as the pandemic and the social shutdown seem likely to cause a demand for liquidity by many SMEs, it will become observable how different types of banks and alterative financial providers supply the economy with liquidity in this virus crisis.

VARIETY OF RISKS FOR RETAIL BANKS, LENDING TO COMPANIES AND THE POSITION OF REGIONAL BANKS

According to the MaRisk banking regulation, banks must manage at least these following types of risks (BaFin 2017):

- market risk (risk of price changes, e.g. strong increase in the interest rates);
- operational risk (risk of disruption in the organisations, e.g. ICT blackout);
- liquidity risk (risk of refinancing, e.g. a bank run); and
- counterparty and credit risk (e.g. risk of credit default).

The COVID-19 pandemic and the measures taken to slow its spread tend to stress retail banks in all four types of risks. The following section discusses market, operational and liquidity risk. Then credit risk – arguably the most apparent risk for retail banks – is examined and banks' possible lending behaviour to enterprises in the virus pandemic is explored.

Market, operational and liquidity risk – Market risk has likely materialised, as the trading assets of retail banks have been stressed by the stock markets slump. In January 2020, securities accounted for 21.4 per cent of all assets for the regional banks and only 9 per cent for the supraregional banks in Germany (Deutsche Bundesbank 2020). It is important to note that superregional banks hold other market-price dependent assets, especially derivatives and lending to banks, making them prone to market risk. Still, regional banks face the risk of losses on their securities and such losses would reduce profit and bank capital and hence may endanger lending. Interestingly, banks also profit from market turbulences in the segment of wealth management as clients modify their portfolios. For example, Deutsche Bank reported that client interaction increased by 50 per cent in its asset management subsidiary (Deutsche Bank 2020) and the interviewed savings bank also observed an increase in client interaction and revenues from wealth management (savings bank, 23 April 2020).

Operational risks arise from the shutdown of social life and specific arrangements for bank employees (e.g. home offices to slow the spread of the virus and/or care for children after the closure of schools and kindergartens) and to protect customers. Hence, staff availability is challenged at a time when extra work arises for the customer management in the branches and in the treatment of clients experiencing financial difficulties during the crisis. Though most banks have been kept open in Germany (as an essential service), retail banks probably have fewer visitors to their branches. In response to the decline in demand, the interviewed savings bank has temporarily closed 50 per cent of its branches, also to enable strict hygienic standards to be met in the remaining branches (savings bank, 23 April 2020). Digital distribution channels have experienced a boost in the pandemic. The ICT provider of the Savings Banks Finance Group has upgraded the online banking system which now allows more contracts to be conducted online. Furthermore, the interviewed savings bank introduced snapchat and other social media for client communications (savings bank, 23

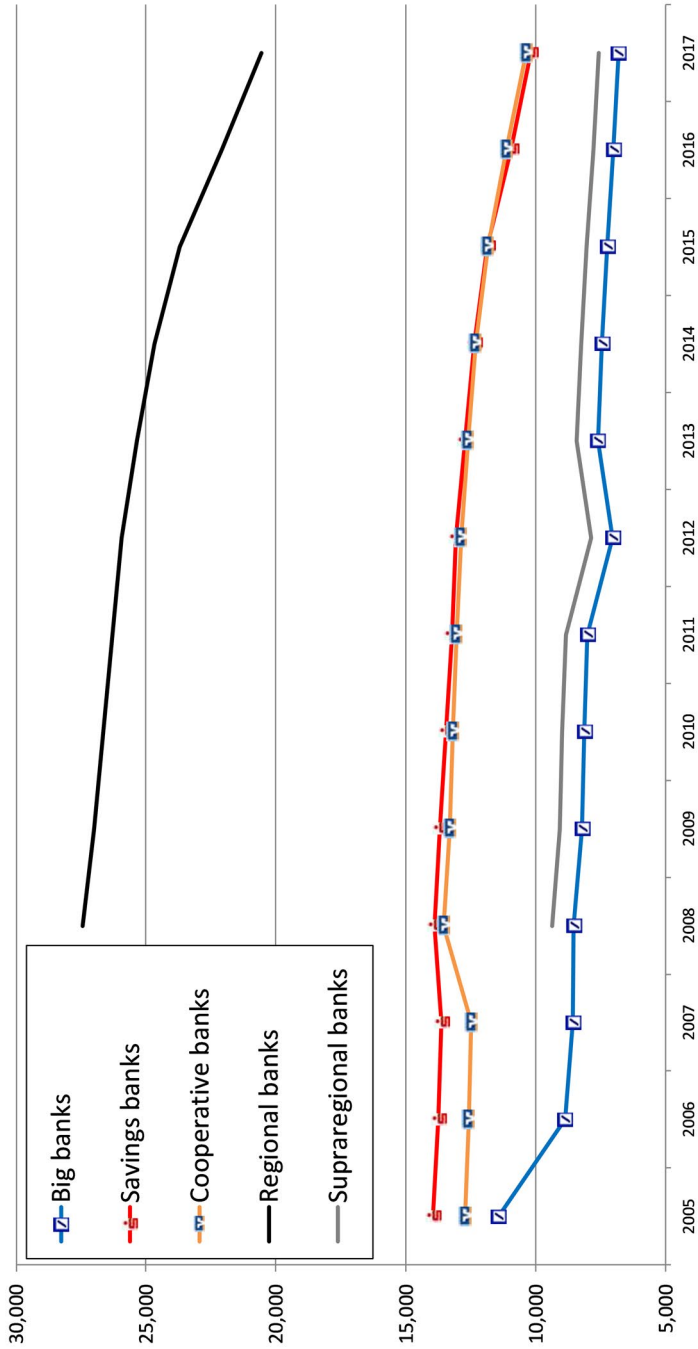
April 2020). If more customers become accustomed to such branchless services in the pandemic and change their behaviour permanently, then the dense branch networks, which were already of limited profitability (Conrad *et al.* 2018), will be further challenged. Today, the regional banks still operate by far the most branches in Germany, though thousands of branches have closed in recent years (Figure 3). An amplification of this decline can be expected.

Liquidity risks would materialise if trust in the robustness of banks erodes to a point where the interbank market dries out (as happened in the global financial crisis) and/or bank runs by private clients occur. Measuring trust in terms of the Euribor – Euro Interbank Offered Rate – the interest rates have risen slightly since 12 March 2020 (the day before the shutdown in several European states including France and Germany). Though with a rate of –0.078 per cent (7 May 2020), lending banks remain willing to pay interest to borrower banks for loans with a duration of 12 months. In the financial crisis in 2008 the rate was above 5 per cent (www.euribor-rates.eu). The expectation of intervention by the central banks in case of serious market interruption probably shelters the interbank market. Customer deposits (deposits of non-banks) are the most important source of refinancing for regional banks, accounting for 74.9 per cent of total assets in 2020, making them less dependent on the interbank lending market than their supraregional peers (27%) in Germany (Deutsche Bundesbank 2020). In turn, a bank run, that is, a strong withdrawal of deposits, would affect regional banks disproportionally. One possible reason for a bank run could be strong inflation, which is expected by several experts as a result of the expansionary fiscal policy applied by many states to curb the economic effects of the pandemic (Der Spiegel 2020). Whereas shortfalls in liquidity caused the actual default of several banks early in the global financial crisis, liquidity currently appears to be the lowest risk in the pandemic. Only if strong macroeconomic faults occur, like strong inflation, may liquidity block banks' lending abilities and solvency; here regional banks depend more on deposits and supraregional banks more on interbank lending.

Credit risk and lending to enterprises – Arguably the most apparent risk for retail banks arises from defaults on loans to enterprises and business clients facing strong revenue decline due to the domestic and global shutdown of social life (Hage *et al.* 2020; Luttmer 2020). As Figure 4 shows, the ratio of non-performing loans decreased steadily after the financial crisis in 2009 and amounted to only 1.2 per cent in 2018. At first glance, this ration, low by international standards (Kotz & Schäfer 2018), indicates the soundness of existing credit portfolios. However, retail banks may have become careless during the long phase of economic growth and have charged insufficient risk premiums on existing loans. Insufficient risk premiums endanger loss absorption capacities in case of rising credit defaults. In addition, total lending to non-financial firms has increased substantially since 2016 (Figure 1) and the indebtedness of German companies has risen since January 2018 to 92 per cent of equity capital in July 2019 (Deutsche Bundesbank 2020). Still, the indebtedness of companies remains moderate, as during the financial crisis the ratio was 138 per cent in 2009.

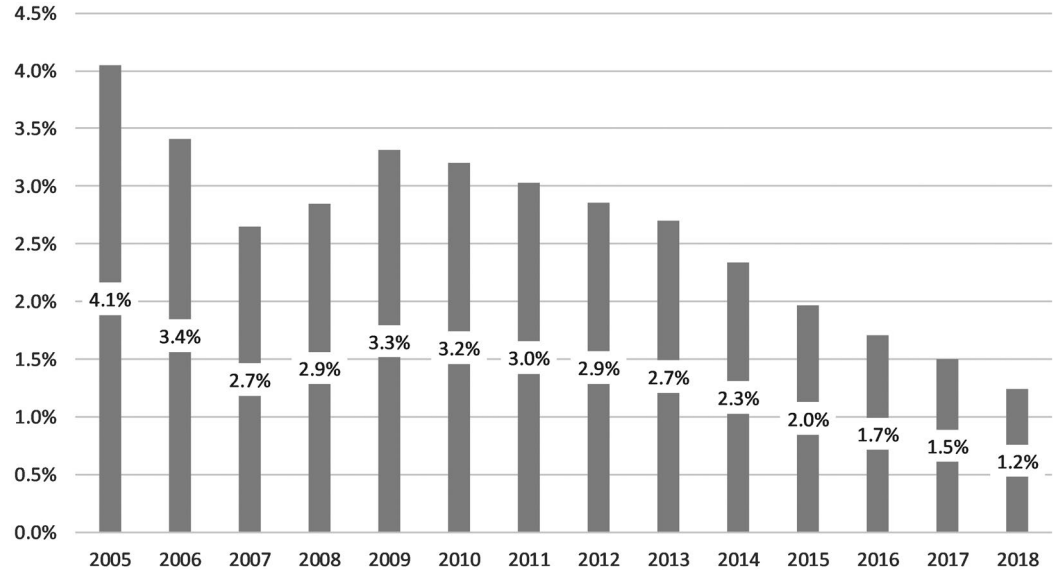
The social shutdown is likely to affect the economic sectors differently. Unsurprisingly, the interviewed business client team leader of the savings bank reported that travel agencies and gastronomy companies were among the first clients that requested advice and liquidity. In total the team of seven advisors received over 300 pandemic-related inquiries in the first weeks of the shutdown, mostly from enterprises catering for local demands that had been closed like hairdressers or those that involved close contact with customers like audiologists. Surprisingly, medical firms were among those inquiring, as resident doctors and hospitals lack ordinary patients. In contrast, the food industry benefited from strong demand at the beginning of the shutdown (savings bank, 28 April 2020). Overall, many enterprises, especially from the services sector, face abrupt declines in earnings, which quickly endangers their solvency and increases the need for extra bank liquidity.

Looking at the different categories of banks, regional banks are likely to receive most liquidity inquiries and face most possible



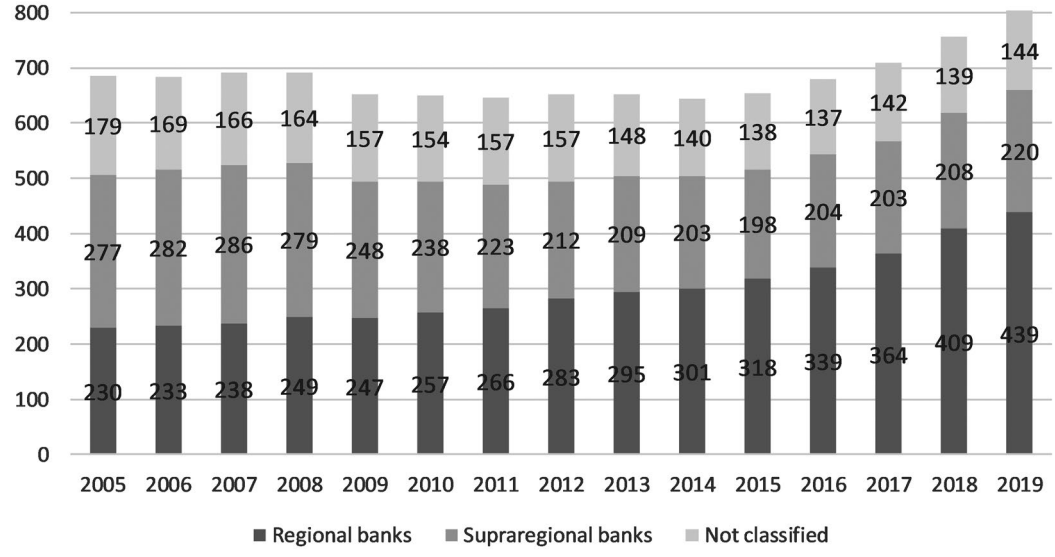
Source: Authors' compilation, Deutsche Bundesbank (2020).

Figure 3. *Number of branches by categories of banks.*



Source: Authors' compilation, Deutsche Bundesbank (2020).

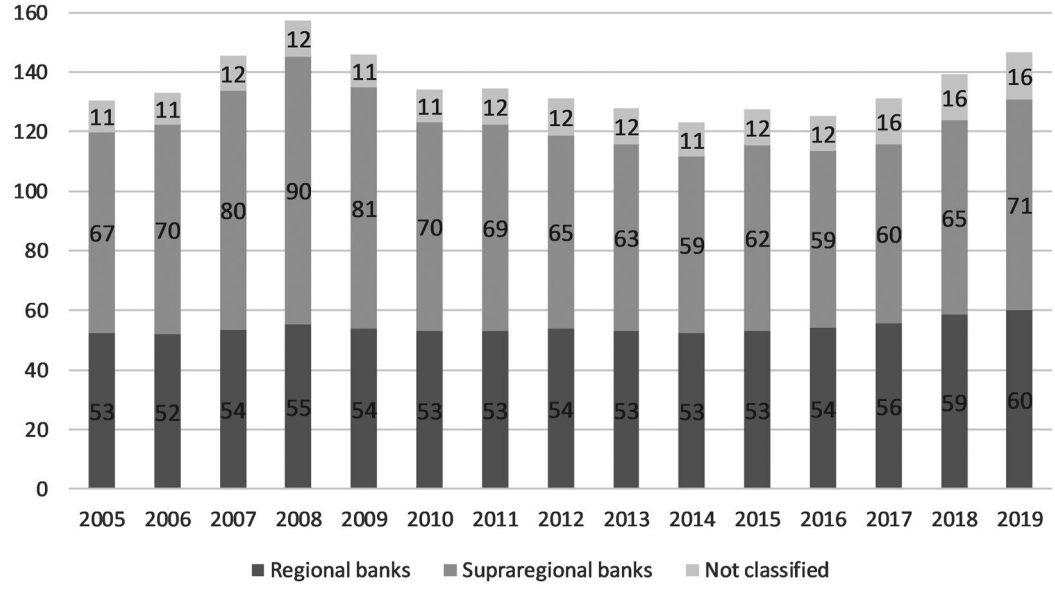
Figure 4. *Non-performing loans ratio/ all banks.*



Source: Authors' compilation, Deutsche Bundesbank (2020).

Figure 5. *Lending to the services sector by regional and supraregional banks in billion euros.*

defaults because they lend the most money to non-financial firms, accounting for 52 per cent of all lending (Figure 1). Furthermore, they disproportionally lend to the services sector, which is by far the largest sector in terms of total credit volume (Figure 5). In 2019, regional banks loaned credits of €439 billion, whereas the superregional banks lent €220 billion. The regional banks have strongly increased lending to services at the



Source: Authors' compilation, Deutsche Bundesbank (2020).

Figure 6. *Lending to the manufacturing sector by regional and supraregional banks in billion euro.*

expense of supraregional banks in the last decade. A possible explanation for this trend is the small size of most service companies, as many supraregional banks lost interest in smaller business clients. Regarding possible credit defaults of local services companies, the critical questions are how long the shutdown will hinder local consumption and to what extent the initiated support schemes prevent large-scale defaults.

Beside services, the overall scope of lending losses depends on the impact of the crisis on two other credit markets: export companies and mortgages. As the pandemic is global, a decline in demand for cars and other consumer goods has already materialised and is likely to continue. For example, Volkswagen closed their production lines in Wolfsburg to protect their workers, but this is probably also forward looking to avoid overcapacities. The government *Kurzarbeitergeld* scheme is helpful in this respect, as workers receive most of their pay from public funds and hence can keep consuming, paying mortgages, etc. Demand for certain export goods has apparently increased, like medical equipment and biotechnologies. For export companies the telling question is how strong and persistent the global decline will be, as a continued reluctance to invest endangers manufacturing exports. We interviewed a medium-sized mechanical engineering company with global subsidiaries. According to the interviewed CEO, the company has received no new orders since the shutdown and their service business is frozen because international business travel is impossible and client companies have banned external (service) workers from their factories. The cancellation of a large industry fair further contributed to the lack of orders. The company expects a certain catch-up effect once the shutdown is over, but predicts a lower level of sales because some client companies will not survive the crisis and the remaining companies are likely to be reluctant to invest (manufacturing company, 5 May 2020).

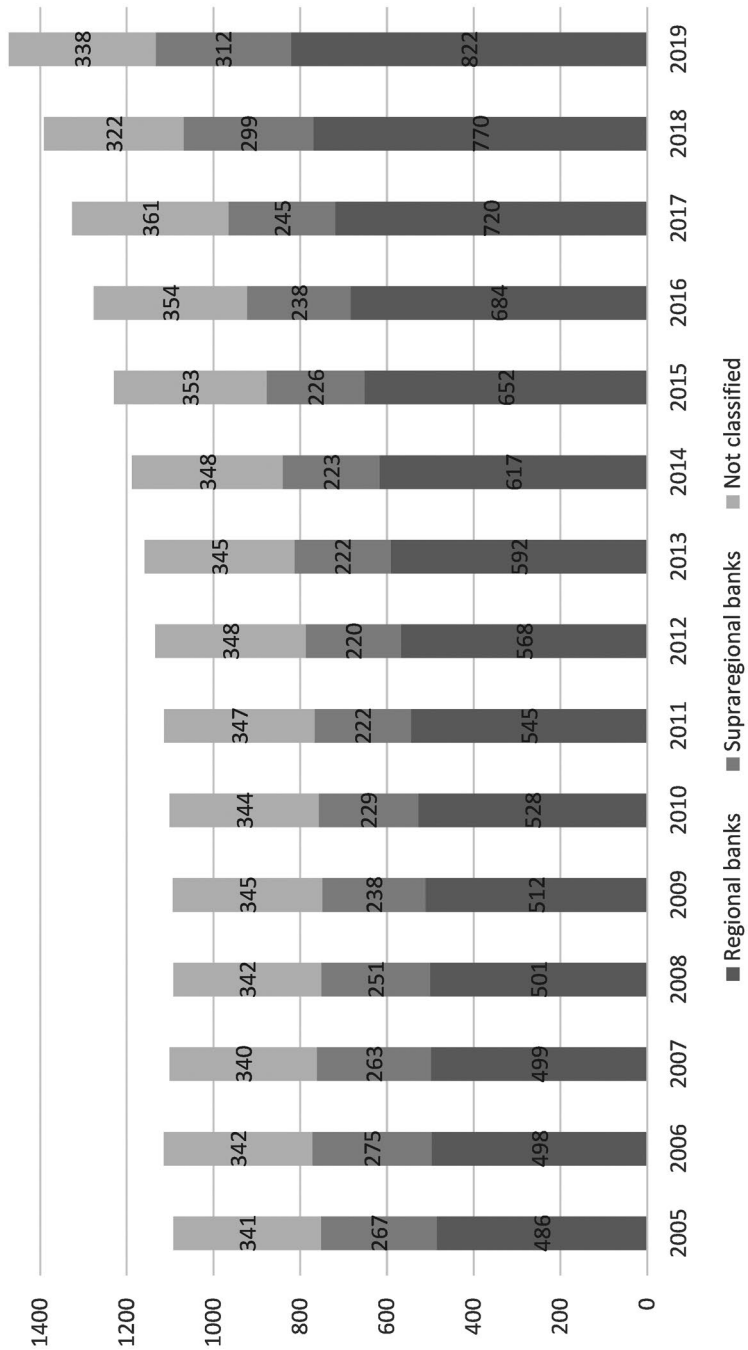
With €147 billion (Figure 6), the total credit volume in the manufacturing sector is much smaller than in the services sector (where €804 billion were lent in 2019), as large manufacturing companies like Volkswagen borrow directly from the capital market. Lending €71 billion in total, supraregional banks are relatively more engaged in the manufacturing sector than regional banks, which lent €60 billion in 2019. In

contrast to services, regional banks have not increased their lending share in the manufacturing sector since 2005. Hence, the direct credit default risk for banks from the manufacturing sector tends to be much lower in terms of credit volumes compared to the services sector, especially for regional banks. Still the (exporting) manufacturing companies are crucial for credit defaults, also because they employ many highly paid workers who are at risk of mortgage default in case of unemployment.

The other highly relevant credit market is housing loans, accounting for €1,472 billion in 2019 and hence exceeding lending to non-financial firms by €96 billion (compare Figure 7 and Figure 1). Regional banks have been market leaders in this market since 1999, steadily increasing their lending to account for 55.8 per cent of the loan volume for housing in 2019. An acceleration of total lending can be observed in the last couple of years, which is mainly powered by extensive lending of regional banks. Note in this context that housing loans and lending to non-financial firms partly overlap, for example, for mortgages to housing cooperatives, thus the increase in lending to companies is partly explained by increased business lending for housing. It remains unclear how the real estate market will respond to the pandemic in the medium term. On the one hand, shortfalls in income and rental payments hamper mortgage repayments and uncertain times tend to reduce demand for property. Falling property prices in combination with loan defaults cause losses on mortgages. On the other hand, the demand for private homes exceeds supply in most regions of Germany and alternative investments are rare, especially in light of an even more expansive level of monetary policy by the European Central Bank (ECB) to mitigate the economic effects of the pandemic. Considering the volume of mortgages, serious problems in the real estate market would hit all retail banks considerably and regional banks in particular. Business lending would also be affected directly as *Hausbanks* often use land charges (e.g. the private home of the managing owner) to secure loans and overdrafts of firms.

As indicated above, government support schemes for the economy influence the extent of possible bankruptcies and firms' need for bank liquidity, and have an indirect impact on the ability of private clients to repay mortgages. The federal government and the *Länder* have erected a range of direct subsidies and loan schemes via several promotional banks to rescue enterprises (BMWI 2020; KfW 2020). In terms of direct government aid, two of the five interviewed firms used *Kurzarbeitergeld*, the manufacturing company and a start-up. Two firms applied for direct aid under the *Corona-Soforthilfe* scheme, which offers subsidies of up to €15,000 for firms with up to ten employees (BMWI 2020) and which several *Länder* supplement with their own funds. For example, North Rhine-Westphalia extended the scheme to €25,000 (NRW 2020). *Corona-Soforthilfe* was paid promptly, however one self-employed media worker had to repay the total amount of support, as it does not cover private living expenses (self-employed, 4 May 2020). The ICT start-up further reported using the tax deferrals (start-up, 16 April 2020). Two interviewees, a self-employed nanny and an urban farmer, have not been sufficiently affected by the pandemic to require government aid.

For enterprises, the federal state of Germany offers several loan schemes via its public promotional bank KfW. Enterprises can only apply for KfW loans via a bank, usually the *Hausbank* which – depending on the scheme – conducts a credit risk assessment and keeps a proportion of the default risk. In return *Hausbanks* are rewarded for the arrangement of promotional loans and receive an interest share. The KfW instant loan scheme for enterprises with more than ten employees facilitates loans of up to €800,000 (depending on the size of the company) with a duration of ten years. The loan programme is exceptional because it releases *Hausbanks* from the total default risk and does not require a risk assessment, so that loans can be granted instantly (KfW 2020). The KfW loan programme for companies targets larger enterprises with loan volumes of up to €1 billion. The loan programme requires the usual risk assessment (however only the client's solvency before the pandemic is considered) and *Hausbanks* must cover 20 per cent or 10 per cent of the potential losses (KfW 2020). With terms of 1 per cent to 2.12 per cent, depending on the default risk of the company, the loan programme is attractively priced and very flexible according to the interviewed savings bank;



Source: Authors' compilation, Deutsche Bundesbank (2020).

Figure 7. *Housing loans to companies and private persons by regional and supraregional banks in billion euro.*

one of its clients actually applied for a loan to finance investments.

Several other loan schemes of the promotional banks of the *Länder* and the KfW exist, though the interviewed savings bank explicitly named the above-mentioned KfW loan programmes and the *Corona-Soforthilfe* as being requested by and supportive for its clients. Whereas the savings bank considered government support as suitable and commended the quick processing speed of the KfW in the pandemic, two of the interviewed firms complained about insufficient support. The self-employed media worker regretted that the *Corona Soforthilfe* does not cover the main expenses of the self-employed, which are the costs of living (self-employed, 4 May 2020) and the manufacturer mentioned that government aid only offers debt for medium-sized companies (beside the *Kurzsarbeitergeld*). His four banks pushed him towards the KfW loans, however, he refused as he is opposed to financing current losses with new debt. Rather he negotiated deferrals of principal payments to maintain liquidity. His savings bank agreed on deferrals without further negotiations and two other banks – a leasing and a big bank – followed after negotiations. Only one big bank refused a deferral of principal payments as the loan was backed by a guarantee from another bank (manufacturing company, 5 May 2020).

Our preliminary results allow an initial look at the lending practices of the savings bank interviewed. The bank claimed that they are making every effort to find solutions for clients in turbulent times and pointed out that the crisis also represents an opportunity to prove their reliability as a *Hausbank* (savings bank, 28 April 2020). For clients in trouble the deferral of principal payments and the facilitation of promotional loans are possible without reservations, also for loans with 20 per cent liabilities. The savings bank further stated that they will not withdraw existing credit lines (which is prohibited anyway when promotional loans are granted to hinder default risk transfers to promotional banks and hence to the taxpayers). However, the bank will not grant its own new loans to financially stressed clients to avoid an extension of default risk and because the promotional loans are sufficient and more attractive. This can be a problem for firms that were in trouble before the pandemic because promotional loans require pre-crisis solvency (although the definition is inaccurate). Furthermore, new corporate customers in trouble cannot access promotional or any other loans currently, as the savings bank cannot assess their riskiness and is limited by the current high workload. Ordinary lending to commercial real estate investors is unaffected by the crisis, that is, mortgage lending corresponds to pre-crisis levels (savings bank, 28 April 2020). Regarding risks for the bank, the team leader expects increasing defaults but also expressed the hope that they will not face too many loan defaults because of their proximity to and deep knowledge of their business clients.

Overall, at the time of writing, it remains unclear how strong the demand for liquidity from *Hausbanks* will be and how many credits will actually default. Apparently, the government aid helps companies with loans and direct subsidies for smaller enterprises, which correspondingly lowers the credit default risk for banks, especially for loans to smaller enterprises (also because the KfW takes 100% of default risk for the smaller instant loans but only 90% or 80% for larger promotional loans). Banks further profit from the promotional loan programmes as they can offer support to their clients without much extending their credit risk. Nevertheless, two interviewed companies feared overindebtedness as a result of the debt-based government support. How the business lending of the different types of banks develops in the pandemic will be observable in the coming months, as Deutsche Bundesbank publishes lending statistics quarterly in a timely manner.

DISCUSSION

By providing liquidity *Hausbanks* can support business clients to survive the social shutdown and hence cushion the economic impacts of the pandemic. Germany's regional savings and cooperative banks demonstrated their ability to do this in the financial crisis of 2008/09 as they extended lending while other banks withdrew loans. However, the future cannot be predicted from the past. At the

time of writing, the banking system appears well prepared. As a reaction to the global financial crisis, all banks have increased equity capital and the central banks and financial supervisory authorities stand ready to intervene quickly if necessary. Still, the pandemic differs from the financial crisis as the real economy at large is in turmoil, which is likely to cause defaults on business loans and potentially also affect the much larger housing loan market. In both lending markets the regional banks together are market leaders and have increased lending in recent years. Consequently, and in contrast to 2008/09, savings and cooperative banks are exposed to similar or even larger risks in the virus crisis than the supraregional banks, especially considering that the clients of regional banks, for example, small and local-demand-oriented firms, are likely to experience instant shortfalls in earnings. On the other hand, the higher amount of bank capital and the (presumed) superior information on clients arising from short distance relationship banking enhances the stability and lending ability of regional banks. Furthermore, government aid tends to support smaller enterprises disproportionally. Only the future will tell how the different types of banks will perform in the COVID-19 pandemic. The necessary duration of the shutdown will influence the liquidity demand and default risk of the real economy and therefore the challenges faced by banks.

When considering policy recommendations in banking, one needs to be clear that the focus must be on public health and the economy, not on banks. *Hausbanks* should accept responsibility for their (business) clients and help whenever possible with liquidity. Government promotional loans in particular allow *Hausbanks* to fulfil clients' needs for liquidity without especially inflating their own credit default risk and therefore are gladly offered by *Hausbanks*, as our preliminary interview results suggest. The interviewed savings bank also helps with deferrals of principal payments but seeks to avoid additional risk taking, especially where new clients in trouble are concerned. Accordingly, it is probably particularly difficult for companies to currently switch banks if their old *Hausbanks* refuse their support. Hence, policy-makers and the public should remind the banks of their responsibilities to clients. To improve banks' ability to lend flexibly, also to riskier firms, regulatory action to free banks' equity capital has already been undertaken with a lowering of the countercyclical capital buffer (BaFin 2020). Non-performing loans will probably increase, especially if *Hausbanks* fulfil their function as patient liquidity providers. Therefore, the consequences of the implemented capital requirement regulation of 2019 for non-performing loans should be reviewed carefully in order to ensure that it does not inhibit the implicit liquidity insurance of *Hausbanks* all across Europe.

For research on banking diversity the unique COVID-19 shock allows analysis of the soundness and business supportive behaviour of different types of banks and other financial providers like ptp lenders. The global nature of the pandemic also allows testing of the prominent assumption that diversity increases resilience as both more diverse banking systems, for example, in Germany, and more homogeneous banking systems, like in the UK, are affected by the economic turmoil. As the pandemic is likely to have varying impacts on industries and regions, for example, with respect to export orientation and the different speeds with which social isolation is relaxed, varying geographical impacts on regional banks will also become observable. Most of the necessary data will be collected in the official statistics of the ECB, Eurostat and related national authorities, like the lending and access to finance statistics. Accordingly, collecting additional information, namely, qualitative data from companies and banks on their coping activities and experiences with one another, appears profitable in order to gain a deeper understanding of business finance in times of crisis. The preliminary interview results presented in this note already indicate the usefulness of such research and more insights also from other countries would be very welcome.

The long-term impact of the pandemic, that is, the resulting economic shock, on the banking landscape remains an interesting research question in its own right. Probably the bank branch as a distribution and communication channel will continue to lose

importance, challenging the affordability of the dense branch networks of the regional banks. Additional mergers of regional banks to handle losses in the crisis and bank closures or bankruptcies of all types of banks are possible, which would cause a further homogenisation of the banking landscape as a result of the pandemic. From a diversity perspective, it is advisable for the real economy, also to support balanced spatial development, to have a diverse banking system with private, public and cooperative, but also small and large, regional and supraregional banks. A forward-looking banking and financial policy should consider banking diversity, as COVID-19 will unfortunately not be the last crisis in history.

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