Hermann Remsperger: 2007 Financial Stability Review of the Deutsche Bundesbank

Speech by Professor Dr Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, Frankfurt am Main, 29 November 2007.

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Ladies and gentlemen

The Bundesbank's Financial Stability Review has now become an institution. Nevertheless, I probably don't have to give a detailed explanation of why the authors of the 2007 edition, which we completed on 21 November, were faced with particular challenges. This was essentially due to the fact that there is still <u>ongoing uncertainty in the financial system</u>. I shall come back to that in a moment.

Let me first stress once again, however, that we – like the IMF, BIS and other central banks – had basically long been expecting a correction of risk premiums, which had been strikingly low for some time. The fact that a deterioration in the macroeconomic setting – specifically, the US mortgage market – might trigger a sweeping reassessment of financial risks was on our radar. Not least, two years ago we already pointed out the risks stemming from "exotic" types of mortgage loans. However, I don't know anyone bold enough to claim to have accurately predicted the breadth and depth or the ramifications of the current problems.

The distortions emanating from the US subprime mortgage market have been placing a strain on the international financial system now for several months in a way that constitutes a challenge for us all. That applies both to the diagnosis and the cure.

Before my colleague, Professor Zeitler, goes into detail about the banks, I would like to give you a brief outline of the main thread running through the "Financial markets" section of the Financial Stability Review. This key idea links (1) the causes of the financial market turbulence with (2) the current situation and (3) the possible lessons that we can draw from the distortions.

I Transparency has suffered

Put concisely, in our Stability Review we conclude that the financial market turbulence is due, not least, to a decline in transparency in the financial system. Contributory factors in this have been, first, new financial instruments that are frequently opaque; second, market players that are new or that have gained in importance and that are often not supervised or hardly supervised at all; and, third, a new business model in which loans are originated, securitised, and then, finally, sold to investors.

Above all in the USA, this "originate-to-distribute" model was partly responsible for too many excessively risky loans being granted. Only now is it gradually becoming clear in what portfolios these risks ultimately end up. These structural developments took place in a setting of abundant monetary liquidity and increasing financial globalisation.

II Ongoing uncertainty

We have given a detailed account of the tense situation in the financial markets in our Stability Review. Today's press conference gives me the opportunity to look at the situation somewhat more from the current juncture. In doing so, I would like to highlight the following three points.

My <u>first</u> point goes somewhat beyond the current juncture, in fact, because it relates to the macroeconomic projections. What is crucial is that at least some potential developments already incorporated in the risk scenario have now become a reality and are therefore of greater relevance to the baseline scenario. That applies especially to the exchange rate and the massive increase in the price of oil. The resulting dampening effects for Germany will lead to a flattening but not a cessation of growth. The degree of flattening is likely to depend, not least, on the future development of global growth. The direct impact of the financial market disruptions on growth in Germany will, in our view, be limited.

In making my second point, having discussed the macroeconomic risks, I am directly revisiting the financial markets. The last few days, in particular, have made it clear to us here that we are essentially dealing with two overlapping developments. One of these developments is characterised by the fact that the problems emerging in the third quarter are still having an impact. An end to the necessary adjustments in the US real estate market is still not in sight, for example. If anything, the incidence of defaults on variable-interest mortgage loans is likely to grow further. An extended period of adjustment has to be expected in the market for credit risk transfers, too.

An additional development consists essentially in the fact that other financial market segments are being affected by adverse factors. The government-sponsored Freddie Mac and Fannie Mae mortgage associations are but one example.

My third point, finally, is that the recent problems in the financial system were, over time, heading more and more in the direction of the banks. First, risk premiums rose and the securitisation markets faltered. Then, however, financial institutions found themselves in a situation where they were forced into an unplanned and unwanted expansion of their balance sheets because they were unable to resell loans as planned. Furthermore, they were drawn on through liquidity lines to special-purpose vehicles. In this way, risks were transferred back into the banking system. At the same time, the assets taken back on to the books have to be backed by capital. This means that, with the approach of the annual financial statements as well, the banks' capital base is coming somewhat more sharply into focus. Over the past few years, however, this capital base has improved visibly thanks to large profits and is therefore able to cushion the strains.

III International bodies working at full stretch

While we are still held in the grip of the current events in the financial markets and the associated major uncertainties, the international bodies are already working at full stretch on analysing the causes and implications of the distortions in the financial markets. At the centre of these activities stands the Financial Stability Forum. The FSF's function is mainly as a coordinator, whereas many of the specific tasks have to be performed by the member institutions, such as the Basel Committee on Banking Supervision and the Committee on the Global Financial System. On behalf of the G7, the FSF has set up a working group chaired by Mario Draghi. This working group will prepare a comprehensive report for the G7 meeting in spring.

This report will contain, above all, an analysis of the shortcomings in the international financial system. On this basis, any need for action can then be identified.

The working group's focal points are consistent with the insights which we at the Bundesbank have gained so far and have outlined in the Stability Review as an interim assessment of the financial market turbulence. This concerns four key areas: risk management, accounting, ratings and the regulatory framework – and, therefore, in large part, issues of adequate transparency in the financial system. Improving transparency is something in which all the parties involved in the "originate-to-distribute" model – originators, arrangers, investors and, not least, the rating agencies – must and, out of benign self-interest, will play a part.

Ratings of structured financial products, in particular, are subject to model risks and the risk that assumptions about, say, the development of macroeconomic data or default correlations turn out in retrospect to be unsustainable. The assumptions made should therefore be disclosed. In the necessary evolution of the rating methodology, thought also has to be given to examining how the rating results will respond to a variation of the assumptions in stress tests and scenario analyses, which should likewise be made transparent.

As the risk characteristics of structured financial products differ markedly from those of traditional bonds, it seems to me that, not least, the use of a separate rating scale for structured financial products would be a promising way to help create the necessary transparency.

At the same time, however, I would like to warn against exaggerated expectations. The more complex the financial products become, the more difficult it will be to create transparency. But this is where the financial institutions themselves also have a responsibility to make greater transparency possible. A tendency towards simpler financial products could also bring back more light into the financial system.

Last but not least, at the international level we shall certainly also have to take a good look at the experience of money market management during the financial turbulence. For the Bundesbank, I would like to emphasise how much the operational framework as well as the operational capability in the Eurosystem proved their effectiveness. In short, we have passed a crucial test but are still faced with challenges.