Andreas Dombret: Deutsche Bundesbank's 2012 Financial Stability Review – the risks to the German financial system

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the presentation of the Deutsche Bundesbank's Financial Stability Review 2012 "The risks to the German financial system", Frankfurt am Main, 14 November 2012.

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1. Risks: an overview

The risks to the German financial system remain high. For a number of years now, we have seen the risk situation being shaped by the development of the financial and debt crisis. I do not expect these factors to decouple in the near future. That is why the European sovereign debt crisis remains the greatest threat to financial stability in Germany.

At the same time, the risk map will need to be redrawn, as monetary and fiscal policy measures on a massive scale were needed to stabilise the financial system. This has entailed an ever greater transfer of risk to the public sector and has caused the low-interest rate environment to become entrenched. The side-effects of short-term stabilisation measures can leave a difficult legacy for financial stability in the medium to long term.

That is why we need to make a distinction between acute risks and medium-term risks. Acute risks are like a rear-view mirror in which the financial and sovereign debt crisis is visible. Acute risks are located primarily in the legacy portfolios of asset-backed securities and sovereign risk in the context of the sovereign debt crisis.

Medium-term risks, meanwhile, require us to look ahead and consider what might be around the next corner. Preventive macroprudential oversight has to take medium-term risk factors very seriously. Its task is to promptly identify potentially unhealthy developments that might unfold and endanger financial stability in the future.

Today, we can see a growing number of the risk factors that played a role in the run-up to the financial crisis. The Financial Stability Review 2012 addresses three topics:

- First, the entrenched low-interest rate environment. This is spurring the search for yield.
- Second, real estate prices. These are showing accelerated growth in Germany's urban centres. The experiences of other countries show that precisely such an environment of low interest rates and high liquidity can encourage exaggerations on the real estate markets. And this can pose a considerable threat to financial stability.
- Lastly, the global shadow banking system still plays a major role and is closely linked to the German financial system.

I would now like to discuss each of these three topics in greater detail.

2. Low-interest rate environment shapes financial system

The low-interest rate environment undoubtedly forms the backdrop for the medium-term development of the financial system. Persistently low interest rates give rise to both incentives and the need to adjust. They encourage investors to search for yield while taking on greater risk.

It is now clear that yield-seeking investors today face conditions which are different to those prevailing before the financial crisis broke out. Back then, the "Goldilocks" economy – one in which neither economic growth nor inflation was likely to present any substantial problems – was a highly influential macrofinancial theory. Nowadays, these scenarios are much more sceptical.

Hence, investors searching for yield today are doing so in a different environment altogether. For one thing, banks are in a weaker position. Large parts of the corporate sector now have a better credit standing than the banking sector. Logically, enterprises are now increasingly funding their operations via bonds, bypassing the banks.

The Financial Stability Review identifies various signs for the current search for yield:

- Corporate bonds are highly valued, despite the gloomier outlook for the economy and for the enterprises' credit risk.
- Investments in hedge funds are rising strongly worldwide; over the past five years, they have risen by two-thirds in nominal terms to US$1.5 trillion.

3. Challenge for insurers

German life insurers have been noticeably affected by the persistently low interest rates. This low-interest rate environment is being reflected ever more strongly in the yield on their investments. The net return on investment dwindled to 4.1% in 2011 and the downward trend is expected to continue. A wide variety of measures are being taken to counter falling earnings:

- Insurers have reduced the profit participation share.
- The German Federal Ministry of Finance has once again lowered the maximum technical interest rate for new contracts, most recently from 2.25% to 1.75%.
- Furthermore, an "additional interest provision" was set up.

Yet it goes without saying that life insurers are also seeking a strategic response to the persistently low interest rates. There are signs that they are cautiously realigning their investment strategy. New business areas such as infrastructure and real estate financing or direct lending are being developed and extended. It is essential that they set up an appropriate risk management system that takes account of Solvency II. At the same time, the advance of insurers is intensifying competition in these markets, and this, too, is transforming the environment in which banks operate.

4. German real estate market gaining momentum

In a low-interest rate environment, developments on Germany's real estate markets warrant particular attention. The real estate loan is a heavyweight element of financial stability. Real estate loans make up over two-thirds of households' debt. Conversely, they account for 40% of total domestic lending; in the case of savings banks and credit cooperatives, this share is as high as around one half.

Residential property prices are rising at an accelerated pace in urban areas. The observed set usually comprises a group of seven large cities: Berlin, Cologne, Düsseldorf, Frankfurt am Main, Hamburg, Munich and Stuttgart. In 2011, prices rose by over 9% on average for new residential property in these cities and by 7% for pre-owned property.

The upward trend appears to have continued in the first half of 2012. This is shown in a narrower definition which comprises only owner-occupied dwellings. Prices in this segment are expected to rise by an average of around 11% this year, and thus even somewhat more sharply than last year, when they went up by just over 8%.

Special factors are also at play here. Savers are increasingly channelling their funds into forms of investment which they view as a hedge against monetary and exchange rate instability. Price exaggerations therefore cannot be ruled out in individual regional market segments.

All the same, there are no signs yet of a rapid build-up of risks to financial stability in Germany. The guideposts are:

- First, households' robust debt sustainability; their debt in relation to disposable income has been on the decline for years.
- Second, the moderate growth in loans; housing loans rose by only 1.2% last year.
- Third, the conservative terms of housing lending in Germany with longer interest fixation periods and limited debt financing shares.

However, the mortgage lending of regional credit institutions is showing a tendency towards local concentration.

5. Shadow banking system: small in Germany, but globally active

The search for additional risk factors which contributed to the financial crisis inevitably leads us to the shadow banking system, which, as we know, played a major role in the spill-over of the subprime exaggerations from the USA to Germany and Europe.

The Financial Stability Review first explains the structures in Germany, distinguishing between shadow banking entities and shadow banking activities.

The largest entities by far in the German shadow banking system are open-end mutual funds. Three-quarters of the total is attributable to specialised funds for institutional investors. By contrast, money market funds and hedge funds play only a minor role. Shadow banking entities in Germany manage net assets of around €1.3 trillion. This corresponds to approximately 15% of the total assets of the regular banking system. However, the very term "shadow bank" itself, and thus its definition, are fraught with some ambiguity. Still, it may be said that Germany's shadow banking system is thus relatively small.

Some of the particularly important activities of the German shadow banking system are repos and securities lending transactions. The increasing re-use of collateral is one of the primary sources of the risk of contagion in the financial system.

Moreover, the German financial system remains closely linked with the global shadow banking system. Foreign shadow banking entities provide funding to German banks, especially in US dollars. German credit institutions are also continuing to operate shadow banking entities abroad which have been given guarantees and liquidity lines by their domestic parents. Lastly, shadow banks such as hedge funds impact on market liquidity.

Problems in the global shadow banking system could still rapidly spill over to the German financial system. We do not live on an island. The global shadow banking system should be monitored very closely and be subject to internationally consistent regulation. Only a global approach will truly help to contain contagion effects – including those on German banks and insurers.

6. Summary of the medium-term risk situation

To sum up with regard to identifying medium-term risks: we are aware that pressure on banks and insurers is rising. The persistently low interest rates are the primary challenge facing insurers. At the same time, a wide variety of measures are being taken to counter falling earnings. Banks are confronted with a difficult environment; one that encompasses rising funding costs, fierce competition in domestic markets and growing disintermediation which bypasses banks. We cannot rule out exaggerations in real estate markets in urban areas. However, the risks to financial stability are limited at present. We note that the German financial system is closely linked with the global shadow banking system. Germany's shadow banking system itself, however, is small.

7. Necessary measures: what needs to be done?

Our Financial Stability Review, however, seeks not just to identify risks, but also points out the measures that need to be taken to safeguard the stability of the financial system over the medium to long term.

German credit institutions can contribute greatly to protecting themselves, and the financial system, against the build-up of risk via the real estate market. It is essential that they maintain the conservative terms of real estate loans. The report also refers to the foreseeable medium to long-term challenges to banks and their earnings. Above all, they should not attempt to take advantage of the low-interest rate environment in order to delay the clean-up of bank balance sheets.

In the low-interest rate environment, German insurers naturally need to continue to make provisions in order to sustain guaranteed returns in future as well.

Policymakers, too, have to contribute to financial stability.

The major policy decisions – where push comes to shove, so to speak – have to be the right ones; therefore,

- monetary policy should not be overburdened,
- the reform course should be continued in Europe
- and the ability of the banking union to function should be ensured – before the transfer of competencies to the European level.

In addition, financial market reform needs to be given an additional boost.

- The shadow banking system must be broadly identified.
- Attention should be paid to the coherence and cumulative impact of financial market regulation.
- International implementation of derivatives market regulation must be expedited.
- And – very importantly – credible resolution regimes need to be introduced in order to bring the "too big to fail" problem under control once and for all.