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

Opening statement by Ms Sabine Lautenschläger Deputy President of the Deutsche Bundesbank, at the press conference 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. Introduction

Ladies and gentlemen, dear journalists,

Dr Dombret and I cannot, unfortunately, give the all-clear in presenting this year's Financial Stability Review. Like last year, we still see substantial risks for the financial sector. The still-smouldering sovereign debt crisis continues to shape the risk situation, even though progress has been made at the national and EU level. For this reason, it remains important that governments put structural adjustments in place to fight for their competitiveness and achieve sustainable public finances – with a view to addressing the root causes of the crisis. But risks stem not only from the sovereign debt crisis. The global economic slowdown and market liquidity in search of yield may lead to additional risks in the financial sector. And we are also keeping a very close eye on the challenges that emanate for insurance companies and banks from the low-interest rate environment. Dr Dombret will come back to that question in greater detail later on.

Before my colleague and I assail you with selected prices, balance sheet data and indicators, I would like to draw attention to one aspect which is not to be underestimated, and which poses a threat to financial stability in the medium to long term. I am referring to the imminent danger of overtaxing monetary policy in the battle against the sovereign debt crisis.

2. Government debt crisis

Without a doubt, the sovereign debt crisis has revealed weaknesses at the national level and weaknesses at the European level. To remedy these weaknesses is a challenge for European policymakers and national governments alike. And to overcome this challenge, very difficult and unpopular decisions have to be made. Of late, the search for solutions has increasingly led to the central banks. I consider this to be a dangerous route to take. Monetary policy cannot eliminate the causes of the crisis; nor can it, therefore, lead to the desired objective. The monetary policy measures that are implemented can only buy time. There is a general consensus on this within the Eurosystem. Nor is this time for free – it comes at a price.

The central banks have already done a great deal to contain the crisis, and have assumed considerable risks: not just financial risks but risks to their credibility and independence. The Bundesbank has repeatedly emphasised what needs to be done. At the European level, it is necessary to strengthen and improve the framework of monetary union. A key premise here is that an adequate balance must be maintained between liability and control. Whoever ultimately assumes responsibility for risks, be they in government budgets or in banks' balance sheets, must also be able to control and exercise influence on the build-up of risks. Greater mutualisation must not go hand-in-hand with weak rights of intervention and controls. If that were to happen, the consequences of the political mistakes made by individual member states could easily be passed on to all the others. That would not result in a stable framework for monetary union, however. And where there is no stable framework, crises are pretty well inevitable.

At present I do not see a political majority for either of the two possible solutions – be it the path to a bona fide fiscal union or the way back to the Maastricht Treaties. Many member states are unwilling to renounce much more sovereignty, and the mutualisation of risks that has been put in place so far can only be reversed with great difficulty.

However, work on the institutional framework of monetary union has not come to a complete standstill.

3. Banking union

The establishment of a European banking union has been the subject of intense debate since the middle of this year. The term "banking union" refers to the creation of a single European system of banking supervision, a single resolution and restructuring mechanism and a single system of deposit protection. A banking union constitutes a step towards greater integration in Europe and – if it is correctly conceived and implemented – it can strengthen the institutional framework that is so important.

A single system of banking supervision makes sense given the substantial financial linkages between European institutions. And in tandem with a suitable resolution regime it could reduce the strain on national budgets caused by the restructuring of banks. Unlike a national authority, a European supervisory body has no incentive to act out of a false sense of consideration for "its" banks. What is more, it can help achieve a level playing field within the euro area and, at best – thanks to the extensive body of data at its disposal – it can better identify risks that threaten the banking system or risks that emanate from it.

But setting up an effective, strong European banking supervision structure is a highly complex task. This is demonstrated, not least, by the many questions that remain to be answered. For instance, clarification is needed on how monetary policy and banking supervision can best be separated organisationally under the umbrella of the ECB, what form the governance structures within the ECB should take, how at least 17 national supervisors are supposed to cooperate with the ECB within a single supervisory system, and finally who is to take what decisions on what legal basis and with what legal protection. And then, this system will have to develop a comprehensive supervisory approach to be able to generate the advantages of a European system of supervision. Seen in that light, the timetable announced at the EU's October summit, though it has been somewhat relaxed, still strikes me as being very ambitious.

Effective banking supervision is essential to stable monetary union. Thus, in my opinion it is a central, forward-looking project, and not so much a means of solving today's problems. And because of its importance for the future of monetary union, we must be careful in how we proceed. Certainly, Europe will gain nothing from hasty implementation that produces a label without content.

4. Situation of and challenges facing the German banking sector five years after the onset of the crisis

A) The German banking system: the position today

Where does the German banking system, which in future is to be supervised by the ECB, stand at present?

Five years on from the outbreak of the financial crisis we are still bogged down in an arduous process of recovery and stabilisation. Yet we have made some discernible progress. The German institutions are in a more robust condition than they were five years ago.

Germany's 12 large complex financial institutions have made distinct improvements to their capital base in recent years. At the end of September 2012, these institutions had a tier 1 capital ratio of almost 13.6%, which represents a considerable increase over the 8.3%

tier 1 capital ratio they had in the first quarter of 2008. The institutions have improved the size and quality of their capital base, while at the same time steadily scaling down their risk assets over recent years. In this way, the banks concerned have also been able to reduce their leverage: since 2008, their leverage ratio has fallen from 43 to a value of 32.

The recapitalisation measures recommended by the European Banking Authority (EBA) have also helped make Germany's banks more resilient. The capital shortfall of almost €13 billion identified at five German institutions has been made good, and overall the 12 banks involved met the stringent requirement for a core tier 1 capital ratio of at least 9% on schedule – in fact, they exceeded the requirement by €15.5 billion.

In the past year, the institutions have reduced their claims on debtors in the euro-area periphery countries; their exposure to Greek debt is now negligible. However, German banks still have significant claims on the Spanish and Italian governments, amounting to €21 billion and €38 billion respectively. Their exposure to Spanish and Italian banks totals around €36 billion and €44 billion respectively. This means that susceptibility to an escalation in the European sovereign debt crisis remains a high risk for the German banking sector.

The German institutions have also rendered their balance sheets less vulnerable by scaling down known toxic assets. In the past two years, the 12 large German institutions have cut back their exposure to these asset-backed securities by 30% to around €116 billion. However, the securities still present a latent risk if their rating structure should deteriorate.

If the banks are to build further on the stabilisation they have already achieved, then an adequate earnings situation is of central importance. After the huge collapse in income suffered at the beginning of the crisis, the earnings situation of the 12 large complex financial institutions has recovered in more recent years and has now stabilised at a moderate level.

Earnings performance at the current end is somewhat modest. Earnings for the large complex financial institutions in the first half of this year – a strong half traditionally – were down on the first six months of last year. Interest income as well as fee and commission income – major contributors to profit – have so far been lacklustre. Volatile trading income in the first six months also came in below the previous year's level. In addition, risk provisioning, which was previously providing support for overall net income, has risen slightly of late. The figures we have so far for the third quarter of 2012 show a continuation of these trends; overall, however, the results are likely to be an improvement on those for the disappointing third quarter of 2011.

Thus, the German banking sector has gone a fair way towards recovering from the effects of the financial crisis. However, a glance at the reform agenda shows that over the coming years the pressure on institutions to adapt will not abate.

B) The German banking system: the challenges arising from regulation

The lessons learnt from the financial crisis have been worked through in a range of supervisory and regulatory reform packages. We have not only reformed supervisory structures and the way in which national supervisors work with one another, we have also formulated a number of new rules which will make certain lines of business more expensive and render banks more resilient. It is important now that we pay attention to consistency in further forthcoming regulatory measures, and that we very carefully analyse and take account of the incentives created and the cumulative effect of the numerous measures.

Basel III, with its more stringent requirements for the quality and amount of capital held, is without doubt the key challenge for German institutions over the coming years. This is very clear from the impact studies conducted on the new standards. German banks still have a fair way to go before they are able to cover the Basel III capital requirements in 2022, when full implementation will take effect.

Despite the need to meet these capital requirements, the risk that Basel III might curtail lending to the real economy and to small and medium-sized enterprises in particular appears to be low. First, the long transition periods will help institutions to position themselves accordingly. Second, small and medium-sized banks, which play an important role in supplying credit to small and medium-sized enterprises, are in a strong position to deal with the transition to Basel III, according to our analysis. And, finally, it is clear from all discussions with banking executives that domestic lending is the area of business in which all banks wish to expand.

What else needs to be attended to? There is no doubt we need to do further work on the too-big-to-fail problem. And, in my opinion, it is essential in this that supervisors at national and international level be equipped with a plentiful armoury of tools. These include a European recovery and resolution directive, recovery and resolution plans for the banks affected, and detailed consultation between supervisors worldwide on resolution procedures in the event of a crisis.

The Liikanen Group's proposals for a system of separated banking functions also represent an approach worth considering, in my view, because in principle they retain the universal banking model intact. To make a definitive judgement, we need to examine in detail to what extent the benefits expected from a separation of business areas are likely to be realised and what implications this has for banks, market structures and the real economy.

C) The German banking system: outlook

What do the challenges I have outlined mean for the future of German institutions?

The plethora of new developments occurring simultaneously will put a number of banks' business models under pressure. It is not just a matter of the costs that the more stringent regulation will bring with it, but also of the stiffer competitive conditions which will emerge. First, refinancing costs for institutions will rise, as competition for deposits will become considerably fiercer in Germany. And it is not only German institutions which will be wooing German depositors. Second, new competitors in lending business, the trend towards enterprises obtaining finance on the capital market, and the present low interest-rate environment are also likely to squeeze lending margins. Investment banking, in view of its volatile contribution to profit, will have to demonstrate whether it can generate reliable earnings over the long term. In addition, the increased capital requirements will make trading operations less attractive – if rightly so.

In sum, with higher costs and stiffer competition on the cards, the question arises for the German banking sector whether there will be sufficiently good business in Germany for every bank. Some banks will therefore need to work hard on their cost structure. As there are no indications whatsoever of a credit crunch, the option of consolidation in the German banking sector should also remain on the table.