Claudia Buch: Presentation of the 2014 Financial Stability Review

Speech by Prof Claudia Buch, Deputy President of the Deutsche Bundesbank, at the unveiling of the Deutsche Bundesbank's Financial Stability Review, Frankfurt am Main, 25 November 2014.

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1. Introduction

Today is the ninth time the Deutsche Bundesbank is presenting its Financial Stability Review. For some of you here today, this is no doubt a routine event. But for me it's something of a first. So I am particularly delighted to welcome you all here today.

Even though the Bundesbank has published its Financial Stability Review on nine occasions now, the task of safeguarding financial stability is actually a new statutory mandate that has been given the Bundesbank. It was only last year that the German federal government established the Financial Stability Committee. The decisions made by this committee are based on analyses prepared by the Bundesbank. The bank is likewise a member of major committees at the European level which deal with financial stability matters.

The Bundesbank defines financial stability as the financial system's ability to perform its key macroeconomic functions, and particularly so in periods of stress and upheaval.

This is naturally a very broad definition that needs to be fleshed out in greater detail. We do this by focusing on two crucial questions:

Are investment decisions being distorted by moral hazard? This moral hazard can arise from implicit or explicit government guarantees, for instance. But equally, it can also emanate from low interest rates and an ample supply of liquidity by central banks. This spurs investors to search for higher yields – even if it means taking on the elevated risks associated with these superior yields.

This brings me straight to the second question: How well equipped is the financial system to fend off risks that materialise? Capital plays an absolutely vital role in this regard. After all, the more capital a bank has, the more stable is not just the individual bank, but also the entire financial system, and the better it is shielded against the risk of revaluations – meaning greater stability all round.

It is for this reason that the Financial Stability Review seeks to identify signs of potential systemic instability early on. We examine whether the financial system is sufficiently resilient to withstand a number of downside scenarios.

2. Main findings of the Financial Stability Review

So what are the main findings of the Financial Stability Review?

1. There are incentives for investors to engage in riskier behaviour in the current low-interest-rate environment. As things stand, this is particularly the case in the corporate bond and syndicated loan segment.
2. As for banks' ability to bear risks, the picture is less clear. German banks today are better capitalised than they were just a few years ago, but their profitability remains weak.
3. This is why the Financial Stability Review takes a particularly close look at the situation in the housing market – after all, this sector has often been the primary source of critical developments in the past. Mortgage lending in Germany is not a highly procyclical phenomenon. This is to be welcomed, since it dampens the risk of overvaluation from this side. Yet banks are structurally vulnerable to changes in

prices, so we will continue to keep a very close eye on developments in the real estate markets.

4. The banking union helps to better identify risks and to force the private sector to absorb a share of losses. A key component – from a financial stability angle – is the Single Resolution Mechanism. In future, private sector owners and creditors are to be forced to shoulder the cost of restructuring or resolving banks.

5. But the banking union alone will be unable to loosen the sovereign-bank nexus because sovereign exposures continue to enjoy privileged regulatory treatment. This preferential treatment therefore needs to be brought to an end over a medium to long-term horizon. The financial crisis swept away any lingering doubts that the close financial ties between banks and sovereigns can pose a threat to financial stability. This is another area, then, in which we should not create any misguided incentives to take on excessive risk.

I would like now to outline these findings in greater detail.

3. German equity and bond markets

Risk premiums on corporate bonds are currently very narrow. At times in 2014, risk premiums for non-investment grade paper in the euro area were no more than just under 300 basis points. So they came very close to the lowest levels seen in the pre-crisis era. We used these spreads to calculate implied default rates, which are lower than the historical norm. This suggests that risk is being underestimated – all the more so when one considers the frail state of the economy.

Broadly speaking, we see signs that enterprises are increasingly sourcing debt capital from outside the banking sector. This might be a sensible response to ongoing structural adjustments in the banking sector. But raising debt capital can pose a fresh set of risks because more capital makes enterprises more resilient. In this respect, firms are no different from banks. As a case in point, the capital ratio of German enterprises has climbed from just under 20% to just shy of 30% in the last ten years, which means that enterprises are more resilient to shocks.

The signs of significant overvaluation are less clear-cut in the equity markets than in the bond market. Volatility in these markets is relatively low, however. Investors might, then, feel inclined to extrapolate the current favourable setting into the future, presuming it to be the normal state of affairs – and turn a blind eye to a possible end to this quiet spell. Were this to occur, an abrupt and massive change in asset prices might disrupt the proper functioning of the entire financial system. As we have seen in the financial crisis, this might also cause liquidity to dry up.

4. The situation of German banks

This brings me to the banking sector. We believe that it's important for German banks and insurers to ready themselves for a possible end to the period of calm. For the most part, German banks are currently busy reducing risk and building up capital. Their resilience has improved. German insurers, meanwhile, continue to follow a relatively conservative investment strategy. However, they are affected by low interest rates owing to their high guaranteed payments.

Given that banks are now better capitalised, they presumably might be able to withstand isolated shocks relatively well. But German banks' profitability remains persistently weak. Ever since the 1990s, their interest margin has been diminishing – and with it, their ability to build up fresh capital by retaining earnings. The current low interest rates are amplifying this state of affairs because at the present time, banks are still reaping the benefits of the higher-yielding loans they granted in the past. But one by one, these loans are maturing.

5. The German real estate market

Because mortgage loans account for much of the credit supplied to the private sector, this was a market we scrutinised particularly closely. Price dynamics in Germany over the past 20 years have been much more modest than in the euro area as a whole. But saying that, property prices in big cities really have climbed quite sharply – by just over a third since 2008 in the big cities most affected by this trend: Berlin, Cologne, Düsseldorf, Frankfurt am Main, Munich and Stuttgart.

From a financial stability angle, two factors are crucial in this respect: developments over time, and the risk level.

Low interest rates might fuel demand for mortgage loans, which might give rise to a self-reinforcing interaction between lending and prices. However, the results of a Bundesbank survey of banks have indicated that the risks inherent in real estate business are hardly procyclical. All in all, mortgage loans grew at no more than a modest pace – at 2% per year, to be precise – while lending standards have hardly been loosened.

What we do see, though, are signs of structural vulnerability within the German banking system. The surveys found that 100% financing arrangements are certainly no longer out of the ordinary in the surveyed towns and cities. If a decline in urban real estate prices were to coincide with climbing default rates, this would have a considerable impact on banks' profits. A scenario like this might well be manageable, were it to occur in isolation. But experience has taught us that real estate crises normally go hand in hand with a downturn in the broader economy. If this occurred simultaneously, it could prove to be very trying indeed for banks.

Besides continuing to monitor developments in the real estate market, we currently see two areas in which action is needed. First, we are laying the groundwork for closing major data gaps. Second, we are evaluating what fundamental legislation is needed to even more effectively counter risk in the real estate market going forward.

6. Banking union and financial stability

We have taken a huge step forward at the European level this year. The European Single Supervisory Mechanism can apply a consistent and strict standard of supervision and compare banks across national borders, meaning that risks to financial stability can be identified earlier on. While it is true that it is primarily the nation states which decide on the use of macroprudential instruments, the European Central Bank, too, has been given macroprudential powers, and it can tighten national regulations. That makes sense and averts the danger of not addressing risks to financial system stability in good time.

But the banking union also provides answers to another key question: who is to bear risks that have materialised? In the pre-crisis era, there were no effective procedures for dealing with major banks that had run into difficulties. All too often, the cost of risks that materialised were passed on to the taxpayer, while private sector owners and creditors were hardly ever made liable.

Looking ahead, the Single Resolution Mechanism, the centrepiece of which is the bail-in instrument, will provide an improved toolkit for dealing with struggling banks, thus ensuring that private sector owners and creditors will be forced to share the cost of restructuring or resolving banks.

If banks sustain losses in the future, private funds will have to be used to absorb these losses in accordance with a clearly defined liability cascade. Only if these funds are insufficient will it be possible to take recourse to the European Single Resolution Fund (SRF), which is financed by the banks themselves. Public finances can only be used as a last resort.

The new regime also allows exceptions to be made from the bail-in rule if financial system stability is otherwise in jeopardy. The resolution authorities are exposed to a conflict of interest. On the one hand, strict implementation of creditor liability can produce contagion effects and, potentially, destabilise the system. On the other hand, every time an exception is made to the rule, it increases the likelihood that public money will need to be deployed, amplifying the moral hazard in the system. That is why discretionary scope needs to be used responsibly. Exceptions should be confined to rare, clearly defined instances. Otherwise, the seeds of growing risk in the future would be sown under the guise of protecting systemic stability.

7. Regulation of government bonds

One of the avowed aims of the banking union is to sever the sovereign-bank nexus. This mutual dependence became even more intense during the crisis. Government financial crises had an adverse impact on banks' credit quality; struggling banks placed a strain on public finances. The brunt of this was borne by enterprises which had less access to credit.

The banking union can help to make the private sector more liable for losses. It does not, however, do anything to change the regulatory setting. Government bonds are the subject of preferential capital requirements; there are exceptions to the large exposure limits; and government bonds will received privileged treatment in the liquidity regulation in future.

This preferential treatment needs to be brought to an end over a medium to long-term horizon. Only then will it be possible to separate the risks of banks and sovereigns, once and for all. That is not something which the banking union alone can achieve.