Claudia Buch: The Deutsche Bundesbank's 2016 Financial Stability Review

Speech by Prof Claudia Buch, Deputy President of the Deutsche Bundesbank, at the press conference to unveil the Deutsche Bundesbank's Financial Stability Review, Frankfurt am Main, 15 November 2016.

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Ladies and gentlemen

I would like to welcome you, on my behalf and on behalf of Andreas Dombret, to the unveiling of the 11th edition of the Deutsche Bundesbank's Financial Stability Review.

The stability of the financial system has been the topic of much discussion over the past year. Interest rates, which have remained low for years, are currently in the focus of the debate. These low interest rates reflect weak global economic growth. At the same time, they are encouraging increased risk-taking and an expansion of borrowing.

It is impossible to pinpoint exactly when interest rates will go back up again. Market players are capable of getting it wrong when it comes to assessing risks and future economic growth. To illustrate the point, let's compare this with election forecasts.

Most forecasts got the outcome of the US presidential election wrong: only 11 out of 96 forecasts predicted the election outcome correctly.[1] The election forecasts took into account average "standard" forecast errors from the past. However, these errors were exceeded by a considerable margin in the actual election. This is not actually anything to worry about if isolated errors (eg in individual US states) cancel each other out. However, if all the individual forecasts are systematically biased in the same direction, they won't cancel each other out. And if all observers rely on forecasts, this can lead to false certainties.

At this moment, if we look at the financial markets, we see a danger of market participants holding false certainties – and thus, expecting interest rates to stay low, and asset prices to stay high, over the long term, taking excessive risks. On the whole, risks could be systematically underestimated, and the value of collateral for lending operations could be overstated.

The surprise that sets in when the opposite occurs is all the greater. In the financial markets, surprise news leads to abrupt price corrections – as was shown by the markets' response to the Brexit vote. Market interest rates can jump up, leading to a significant need for adjustment with the potential for adverse consequences for the real economy.

Financial stability considerations therefore warrant the build-up of risk buffers so that losses from unforeseen events can also be cushioned. The larger the risk buffers in the financial system themselves, the lesser the contagion effects and self-reinforcing mechanisms that are set in motion whenever unexpected events occur. An adequate capital ratio thus will not weigh on financial institutions and the economy but is instead a precondition for enabling financial markets to perform their function for the real economy and to promote real economic growth. Better capitalised banks are more competitive and tend to grant more loans.

1. Key statements of the Financial Stability Review

Against this background, allow me to summarise the key statements of our report.

1. In the current macroeconomic setting, there is a danger of risks being underestimated. Low interest rates, low risk premiums and high valuation levels are affecting all sectors of the economy – firms, households and general government. The incentive is there to amass

more debt. This increases vulnerability to future changes in prices or interest rates.

2. The current macroeconomic setting can favour a credit-financed real-estate boom. Prices are rising in the German real-estate sector, and lending is on the rise. However, there are no acute signs of an easing of credit standards. Preventive measures can mitigate future risks, though.
3. Risks are accumulating in financial institutions' balance sheets. The amount of low-interest long-term loans is rising, while the share of low-yielding assets has increased. This is leading to increased liquidity and interest rate risks. Persistently low interest rates would hit precisely those financial institutions whose business models depend heavily on interest rates.

2. In the current macroeconomic setting, there is a danger of risks being underestimated.

Low interest rates are not a new phenomenon. A trend towards falling nominal and real interest rates has already been visible since the 1980s. This reflects weak aggregate productivity growth, the real economic fallout from the financial crisis and the attendant low inflation. A decisive factor in the stability of the financial markets is whether yields adequately reflect the underlying risks. There are signs that risk premiums are too low – thus providing an incentive to take excessive risks.

Firms' profits are a reflection of the weak global real economic growth. By comparison, equity market valuations in Europe are currently close to, and those in the United States above, their average over the past 10 years. Firms' weak profitability therefore does not seem to be feeding sufficiently into market valuations.

If we look at the risk premiums on corporate bonds, we come to a similar conclusion: these, too, currently do not seem to be sufficiently reflecting the actual risks – measured here in terms of default rates.

Developments in the German corporate sector are departing from these global trends to some extent. Gross domestic product (GDP) is forecast to grow by 1.7% in 2016, which is higher than the country's potential growth rate.[2] Insolvency ratios are at an all-time low. Credit risks from domestic business on German banks' balance sheets are commensurately low. At the same time, liquidity risk and interest rate risk are mounting. Mr Dombret will go into more detail on this shortly.

If assets are mispriced, there is a risk of an abrupt correction. The severity of the consequences of such a correction correlates with high debt. Debt trends and levels vary considerably between sectors and regions:

- across the globe, sovereign debt has risen since the crisis.
- corporate debt has risen dynamically over the same period, especially in the emerging economies. Household debt here has risen, too, albeit from a low initial level.
- whereas households in the United States have deleveraged, household debt in Europe has fallen only slightly. Germany has also been seeing a trend decline in household debt, which currently stands at 53% of GDP. The bulk of this debt – around 70% – is for loans for house purchase.

3. Low interest rates can fuel a credit-financed real-estate boom.

Loans for house purchase not only make up a major portion of household debt. They are also significant for banks, as they make up around 50% of lending to domestic households and firms. At the same time, international experience has shown that credit-driven real-estate market overvaluation – depending on the structural situations in those markets – has often triggered systemic financial crises.

It is for this reason that our macroprudential oversight pays particular attention to the German real-estate market. Our first step is to identify the target: to reduce the likelihood and extent of future crisis-like developments. The earlier we can detect distress, the earlier every individual player can take countermeasures – by adjusting contractual terms appropriately or by building up risk buffers.

In a second step, the appropriate indicators have to be identified. Risks to financial stability can arise if a sharp rise in real-estate prices, a strong expansion of credit volume and an easing of credit standards all coincide. This kind of situation can occur particularly if many market participants have Pollyannaish expectations about the future development of debt sustainability and do not adequately take into account the possibility of prices falling and interest rates rising.

It is often very difficult for individuals to assess these macroeconomic risks, which can lead to a diminishing awareness of risk. Under these circumstances, it can be necessary to set minimum standards for real-estate lending. Before such a – third – step is taken, however, it is necessary to assess the risk situation as accurately as possible. To this end, the Bundesbank regularly publishes a set of indicators on its website.[3] Minimum debt sustainability standards should be imposed only once these indicators begin to show signs of a threat to the stability of the financial system. In order for such requirements to meet their target and to mitigate side effects, a careful assessment of the consequences will be necessary. Potential consequences must be assessed ex ante and, in a fourth step, the impact of these measures has to be analysed as precisely as possible ex post.

However, we're not quite there yet, which means that priority should be given to observing the risk situation.

Where is the real-estate sector in Germany headed? Residential property prices in Germany have risen sharply over the last few years, particularly in the big cities, climbing by just over 5%[4] in the first half of 2016 alone, and thus more strongly than the general price level, which was up by +0.3% during the same period (half-year value, measured in terms of the consumer price index). Inflation was regionally more broad based than in previous years. Since the beginning of the property market upswing, real-estate prices in the (large) cities have been rising faster than everywhere else. The disparity between urban and rural areas has been narrowing visibly since 2014, however.

At last report (September 2016), loans to households for house purchase grew by an annual rate of 3.7%, and thus less sharply than their average since the early 1980s, which is just under 5%. By comparison, households' income rose in 2015 by 3.1% – and by 2.3% on an annual average since 1991. The margin to the rise in households' income has thus narrowed.

With regard to the last indicator on the list – the development of credit standards for real-estate loans – the Eurosystem's quarterly Bank Lending Survey is showing a slight tightening since 2010. However, a growing percentage of German banks' loans for house purchase is long-term. Although this reduces the risks to households of possible changes in interest rates during the interest rate lock-in period, banks' interest rate risk increases inversely.

It is impossible to predict when the favourable lending conditions – which are not confined to the area of real-estate financing – will reverse themselves. A hike in interest rates would entail a decline in valuations and prices in the financial markets. Funding which, under the current conditions, seems adequate could prove no longer sustainable.

Each and every individual market participant can hedge against this scenario – through an adequate capital ratio and by structuring contractual terms in a forward-looking manner. Financial stability concerns also make it necessary, however, to identify risks which could affect the financial system as a whole. These risks are not always visible to individual banks or market participants. This is the case if, in cases of distress, individual market players are regarded as being either “too big to fail” or “too interconnected to fail". Another risk to financial stability, however, can arise if multiple financial institutions are exposed to similar macroeconomic risks (too-many-to-fail).

Capital adequacy is therefore the foundation of the financial system and a prerequisite for cushioning risks – akin to the ability of a bridge to bear a certain load provided it is built out of stable materials. At the same time, a bridge cannot be too stiff, and it must be supple enough to offset heavy loads. By the same token, financial stability considerations make it necessary to bolster resilience and at the same time maintain the ability to respond to change.

One type of change addressed in this report is the growing importance of fintechs, new technologies which, for instance, facilitate direct lending through platform-based brokerage or investment advice. New technologies can help make the financial system more stable by improving lending and risk dispersion. However, they can also encourage herding behaviour. This is why we are keeping a very close eye on these markets and developing regulatory criteria which strike a proper balance between competition policy, financial stability and technological neutrality.

Derivatives trading is another area in which the financial markets are witnessing change. In 2009, the G20 decided that standardised over-the-counter derivatives should henceforth be traded only via central counterparties (CCPs). They assume the role of contracting party between the buyer and seller in a financial transaction and take on the direct counterparty credit risk of their trading partners. By doing so, they can mitigate the potential for interbank contagion. The regulatory focus is on CCPs’ resilience and developing tailor-made recovery and resolution regimes. We therefore believe it is necessary to further enhance the macroprudential framework for CCPs and to take suitable measures to ensure sufficient protection against systemic risks.

Much like with bridge-building, it is impossible to calculate the exact level of strain at which the stability of the system is in danger. But, as early as the construction stage, the engineer will use a mathematical model and assumptions regarding certain environmental conditions to calculate plausible values before then factoring in a given safety buffer on either side of these values. The financial system likewise needs such a safety margin in order to ensure its resilience.

There is a huge incentive to create a stable financial system: the goal is to curtail systemic risk in order to make financial crises less probable and less severe. Stable financial markets are, above all, a precondition for improving monetary policymakers’ ability to pursue their mandate of ensuring price stability without conflicting agendas. And, by funding productive investment and diversifying risk, stable financial markets are particularly conducive to an efficient allocation of resources.

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[1] Based on the forecasts listed on the RealClearPolitics website since the beginning of September (www.realclearpolitics.com/).

[2] Deutsche Bundesbank (2016), Monthly Report, June 2016.

[3] See Deutsche Bundesbank, “System of indicators for the German housing market", available online at www.bundesbank.de/Navigation/EN/Statistics/Enterprises_and_households/System_of_indicators/system_of_in

[4] Based on information published by the Association of German Pfandbrief Banks; for more information, visit www.pfandbrief.de/cms/_internet.nsf/0/3E8C426DD5F01DE5C1258067004780AC/$FILE/vdp_Immobilienpreisinc vdp_Property_Price_Index_QI2003-QIII2016.xlsx