Hans-Helmut Kotz: Deutsche Bundesbank Financial Stability Review 2009

Speech by Prof Hans-Helmut Kotz, Member of the Executive Board of the Deutsche Bundesbank, at the press conference of the presentation of the Deutsche Bundesbank Financial Stability Review 2009, Frankfurt am Main, 25 November 2009.

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I German financial system stabilised

In early autumn of 2008, the international financial system was on the verge of collapse. Activity in interbank money markets was severely impaired, with virtually no turnover at all in the longer maturities. Enormous uncertainty prevailed. Premiums for unsecured loans soared to 50 times above their pre-crisis levels. All indicators of risk – whether in the equity, bond, credit or derivatives markets – were standing at all-time highs. There was a danger that the international financial crisis, interacting with the severest slump in global growth in more than half a century, would lead to a more or less uncontrollable downward spiral.

A perceptible stabilisation has been under way since the spring of 2009, however, even though this predominantly reflects the unprecedented measures taken by fiscal, monetary and financial market policymakers. A worse outcome was averted only thanks to these non-standard policy measures, which were applied throughout the world. The international and German financial systems were only stabilised when the public sector – in Germany as elsewhere – assumed the role of "risk-taker of last resort". This is the backdrop against which we present this year's Bundesbank *Financial Stability Review*.

At the current juncture, domestic credit institutions are benefiting from a more benign global economic outlook. Prospects have improved markedly, and this applies especially to the strongly export-oriented German economy. This is having an immediate positive impact on the conditions in which the financial sector operates.

Nevertheless, the road before us is strewn with obstacles. Major challenges for the German banking system still lie ahead. The purpose of our *Financial Stability Review* is therefore to assess possible risks going forward as well as the German financial system's resilience in the light of potential, but not unrealistic adverse developments.

Recent upward revisions of growth forecasts should not blind us to the fact that the more benign global economic climate is mainly the outcome of the large-scale fiscal stimulus programmes. Concurrently, extraordinary monetary policy measures were deployed to underwrite the financial system's stability. The process of restructuring the financial sector, which was made possible by these unprecedented policy initiatives, remains vulnerable, however, to setbacks in the recovery of the real economy. The upturn is still far from being self-sustaining. The coming year will show how far fading public-sector stimuli can be replaced by endogenous private sector activity – in Germany's case, this is typically generated by the interplay between net exports, capital expenditure and household consumption. It is still open to doubt, however, whether such a stylised or typical upswing will actually materialise this time round. Hence, it would be premature to regard the financial crisis, and the economic crisis directly linked to it, as having already run their course.

Clearly, a protracted period of stagnation in the major economies would pose a substantial risk to financial stability. The detrimental, self-reinforcing feedback loop between an unprecedented and globally synchronous reduction in the level of real economic activity and an essentially dysfunctional financial system, which has been unravelling since the summer of this year, might then tighten again. It follows from this that exiting the broad-based stabilisation policies should be predicated on and calibrated to a sustained improvement in the underlying market conditions as well as in financial sector resilience.

At the same time, it is important to bear in mind the implications which the highly unorthodox measures taken to support and stimulate the economy inevitably entail. They inherently carry considerable risks over the medium and long term. A prime example of such risks is ballooning government debt in many industrial countries. In addition to already acknowledged, explicit public debt, the bank rescue packages obviously impose an additional, implicit potential burden on the public sector. Transparent and credible strategies are therefore crucial for unwinding and managing the fiscal – and, of course, monetary – policy support measures. Should the policy-making process lose its credibility, this would be reflected in rising risk premiums and interest rates. Higher interest rates, in turn, would tend to depress capital expenditure and, therefore, potential growth. In addition, they would further hamper the already onerous task of consolidating public finances, which is vital to ensure sustainable debt containment. It is therefore crucial to keep market participants' expectations of a stability-focused monetary policy as well as a sound fiscal policy firmly anchored.

II Ongoing challenges

The government and other public support measures have bought the financial system time to cope with losses and to prepare for potential financial strains lurking on the horizon. Moreover, public-sector intervention has had a decisively positive impact on the outlook for earnings. Short-term interest rates are at very low levels indeed. The yield curve, ie the spread between long-term and short-term rates, is exceptionally steep. This naturally allows substantial income to be generated from maturity transformation (see Chart 1). Income from commissions and fees has also soared recently, partly on the back of the large-scale issuance of government bonds which the public sector has been obliged to launch in response to the financial crisis. Income from commissions and fees is being further boosted by vigorous corporate issuance activity. This has also begun to boost equity and credit markets since the spring of 2009, thus improving banks' earnings form brokering and proprietary trading. Nonetheless, this development is fragile. It is being buoyed by the non-standard public sector support packages which – being extra-ordinary – have to be phased out at some point. Quite clearly, the current conjuncture does not represent a new post-crisis normality.

Yet this by no means implies that German banks have not recognised the seriousness of the situation. They have consolidated their balance sheets and also bolstered their capital buffers (see Chart 2). For instance, the average tier 1 capital ratio rose by 2.4 percentage points between mid-2007 and mid-2009. Another positive aspect is that, by international standards, Germany is in a comparatively favourable starting position for weathering the financial crisis. For one thing, domestic enterprises and households have relatively moderate levels of debt. Consequently, the percentage of non-performing loans is correspondingly low. For another, real estate prices in Germany have been flat for a long time, and have thus in no way decoupled from fundamentals. Obviously, this is limiting credit risk in property financing.

Nonetheless, even in case a lasting economic recovery is underway, German banks will have to tackle some sizeable problems. For instance, their balance sheets will have to accommodate substantial further value adjustments. Based on our empirical assessment, for the 17 banks mostly involved, with some €90 billion of impairments already recognised, the peak of write-downs on securitisations is behind them. Given current prospects, additional write-downs on structured products of some €10 billion to €15 billion are to be expected (see Charts 3 and 4). If, however, the price recovery in evidence since mid-2009 continues, losses in the overall portfolio will be lower.

The outlook for the evolution of assets in the loan book is, however, quite different. Here, the well-established stylised fact is that write-downs lag the real economy's cycle This also holds in the current situation. Loan losses will be a drag on banks' earnings going forward. Using the information from a time series as well as a cross-section dimension for the whole German banking system, we conclude that further write-downs of between €50 billion and

€75 billion are to be expected. It goes without saying that, particularly at this juncture, these estimates (see Charts 5 and 6) are subject to significant uncertainty. Statistical relations are likely to be less robust than they have typically been in the past. We should add that our assumption for economic growth is significantly less benign than the current consensus. Therefore, if the economic recovery accelerates, as assumed in recent forecasts, banks' re-valuation requirements would be correspondingly lower. Needless to add, the projected potential write-downs will not automatically translate into additional capital requirements. Current income as well as loan-loss provisions can obviously also be used to cover potential losses.

Nevertheless, banks would be well advised to steel themselves against possible negative developments. They have won time to tackle their accumulated problems and prepare for future contingencies. They should use the capacity to adjust that has been created, first and foremost, to bolster their risk provisioning, shore up their capital and enhance their cost efficiency. Currently, the low level of lending largely reflects German enterprises' weak demand for credit, hence access to credit is currently not impaired by capital scarcity. But looking ahead, fatter capital cushions would strengthen banks' capacity to cater to the rising corporate borrowing demand which typically accompanies an upswing. At the same time, the pricing of this credit supply should be commensurate with the underlying risks.

III Macroprudential approach – a new focus for supervisors and regulators

After having successfully stabilised the financial system, governments, central banks and prudential supervisory authorities around the world now face the challenge of drawing the appropriate conclusions to prevent a crisis of such a magnitude from recurring. By its nature, financial stability is a public good. It cannot therefore be ensured solely on a private basis. There is a significant difference between private and social rationality. Actions that are reasonable from an individual perspective may generate unintended externalities which produce adverse implications for systemic stability. Consequently, financial stability cannot be expected to arise spontaneously from the interactions of private players. At the same time, the absence of financial stability may well entail enormous costs to society – as we have just painfully experienced. Therefore, together with national and international institutions, we are working hard to draw the right lessons in order to contain potential vulnerabilities. As the reasons for the crisis are multifaceted and complex, there are no simple answers or quick fixes. What is needed, rather, is a set of specific changes and concrete amendments to the regulatory and supervisory framework. Thoroughness has to take priority over speed.

One key insight gained from – or perhaps it is more accurate to say reaffirmed by – the crisis is that the traditional microprudential perspective, focusing largely on individual institutions only, is no longer appropriate. To address financial stability issues appropriately the microprudential approach has to be supplemented by macroprudential supervision. Naturally, microeconomic supervision remains indispensable. It is, however, far from adequate for the effective prevention of crises which are the upshot of systemic stress. A failure to take a holistic, system-wide view logically implies a danger of ignoring systemic risks that emanate from the interaction of the financial market players. Systemic risk is created endogenously rather than having exogenous origins beyond the remit of financial markets. It can arise, for example, in the form of herding behaviour. Systemic stress may also result from excessive homogeneity, which generally renders systems vulnerable. Liquidity risk is a special and important case in point. Here, feedback effects – between difficult funding conditions and problematic market liquidity – may bring about a systemic downward spiral. In particular, repo markets will be affected most severely. The systemic perspective therefore has a particular relevance for market-oriented financial systems (as opposed to those characterised by a higher degree of bank intermediation).

The design of macroprudential supervision and regulation hence raises a host of complex issues. Procyclical elements of regulation – whether they relate to capital requirements or

accounting principles – may, for instance, aggravate the inherent ups and downs of the financial system. If the impact of these regulations in an upturn is different from their impact in a downturn, this will have an immediate effect on the real economy. Such generators of procyclicality may, for example, favour a build-up of credit-financed imbalances in an upturn. In the same vein, these mechanisms might also potentially amplify feedback effects of negative market developments during a crisis. To contain these destabilising effects, greater importance should be attached in future to adequate and, in particular, counter-cyclical risk buffers.

A second challenge arises from the interconnectedness of the financial system. This is obviously a necessary feature of any modern financial system. But this interdependence entails consequences – macroeconomic costs which cannot be accounted for at the microeconomic level. These systemic externalities increase as institutions become larger and more interconnected. The macroprudential perspective therefore provides arguments for treating financial intermediaries differently according to their position in the system as a whole. This functional view also justifies regulating market participants outside the traditional banking system identically insofar as they fulfil similar functions or roles. The appropriate regulation and supervision of big or highly interconnected institutions poses a particular difficulty as their collapse would jeopardise the financial system as a whole ("too big or too interconnected to fail" problem). A logical corollary of this is the need for a greater intensity of supervision. Moreover, additional capital requirements make sound analytical sense. Yet it should be noted that the practical implementation of these theoretically advisable ideas involves some difficulties as does, incidentally, formulating anticyclical capital requirements. However, this must not lead to the issue being ignored, as the potential opportunity costs to society would be too grave.

It is clear from these brief comments that adding a macroprudential perspective to microprudential oversight poses major challenges for central banks and supervisory authorities. The Bundesbank is seeking to face these challenges by devoting particular attention to macroprudential analysis. Since May 2009, all work on these issues has been focused within our newly created Financial Stability Department. This department was also mandated to write this year's *Financial Stability Review*.

Getting macroprudential supervision right is indeed very much a work in progress. We are in the middle of a period of intense debate. Nevertheless, concrete progress has already been achieved in some areas. In this regard, the reform agenda which is being implemented through the G20 summit process, largely under the guidance of the Financial Stability Board (FSB), deserves special mention. Given significant mutual interdependence as well as substantial cross-border effects, there is good reason to establish rules at the international level. Inconsistencies encourage regulatory arbitrage and thus tend to heighten systemic vulnerability. Therefore, the Bundesbank is very much involved in the work of the FSB. I would like to restrict myself to highlighting just two aspects which enjoy a very broad consensus in the international debate.

First, there is consensus on one of the points mentioned earlier, namely the need to strengthen financial institutions' resilience; the capital and liquidity buffers for weathering crises have to be increased. More robust capital and liquidity requirements as well as an improved measurement of exposures to risks are also necessary so that risks arising from excessive leverage can be better controlled in the future. Due account should be taken when devising and implementing rules of the particularities and peculiarities of national financial systems. This is especially important with regard to the aspired improvement in the quality of banks' capital base. Here it is essential to focus on the targeted function – the ability to absorb losses – rather than on legal form. In view of the ongoing difficult economic environment, it is also evident that appropriate transition periods have to be granted. Overhasty implementation would pave the way for a likely capital-induced credit supply failure.

Second, we must ensure that the incentive structures of participants in the financial system are aligned with the objective of fostering a sustainable development. This will be facilitated by enhanced transparency, which strengthens market discipline, even though it is obviously not sufficient on its own. This applies especially to the securitisation process. Significantly improved standards of quality and integrity are a key precondition for reviving the securitisation market. Originators should have a direct interest in ensuring that all risks (including those of correlated defaults) are captured adequately – for instance by retaining a vertical slice of securitisations. Provided the instruments are designed in a way which makes microeconomic risk-taking compatible with sound macroeconomic outcomes, they can play an effective role as a source of funding for the banking sector. They will thereby also contribute to reliable and properly priced lending to enterprises – which is the most important aspect from an economic perspective.

In a nutshell, the internationally coordinated reforms should substantially increase the stability of the financial system. On balance, they will probably imply more moderate earnings prospects in the financial sector. However, earnings are also likely to be less volatile and therefore more robust. Given the considerable negative externalities that may arise if financial institutions run into distress, that seems a price worth paying to safeguard financial stability. After all, in the long run banks themselves will also benefit from a more stable financial system.

Chart 1

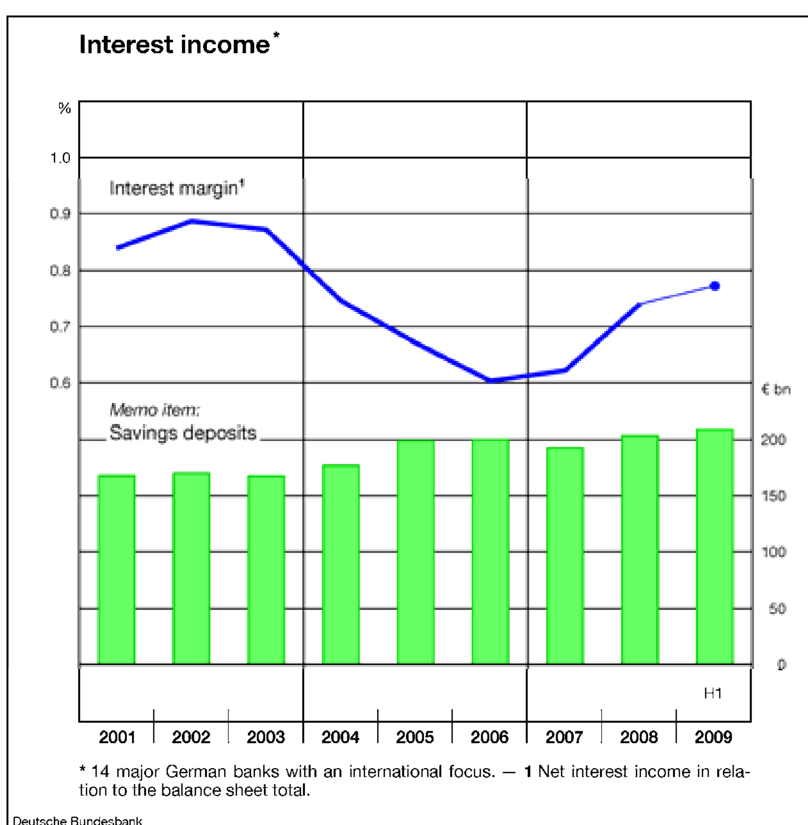

Chart 2

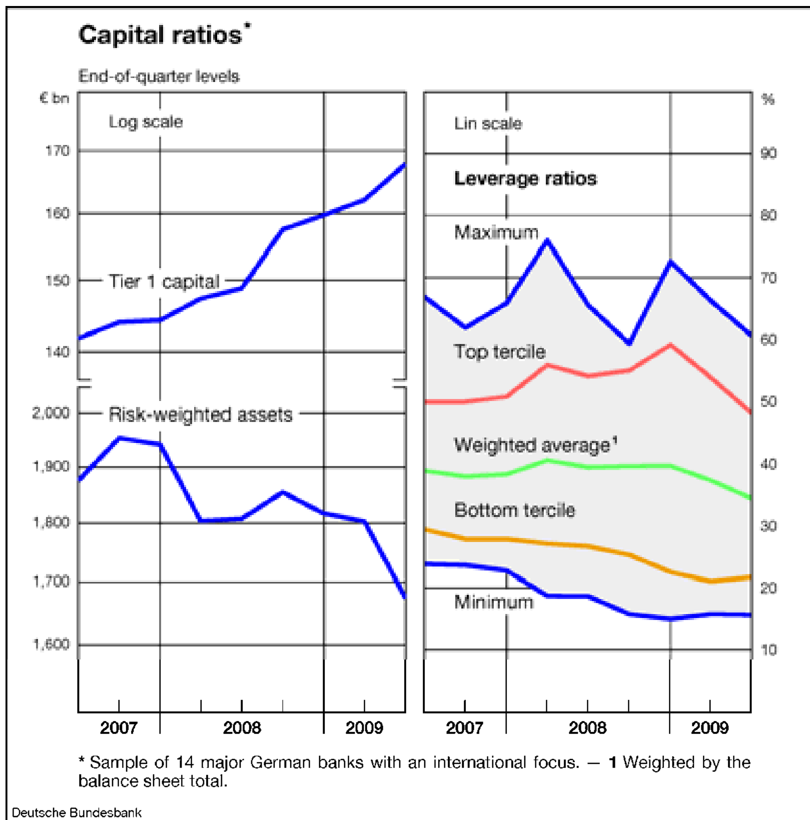

Chart 3

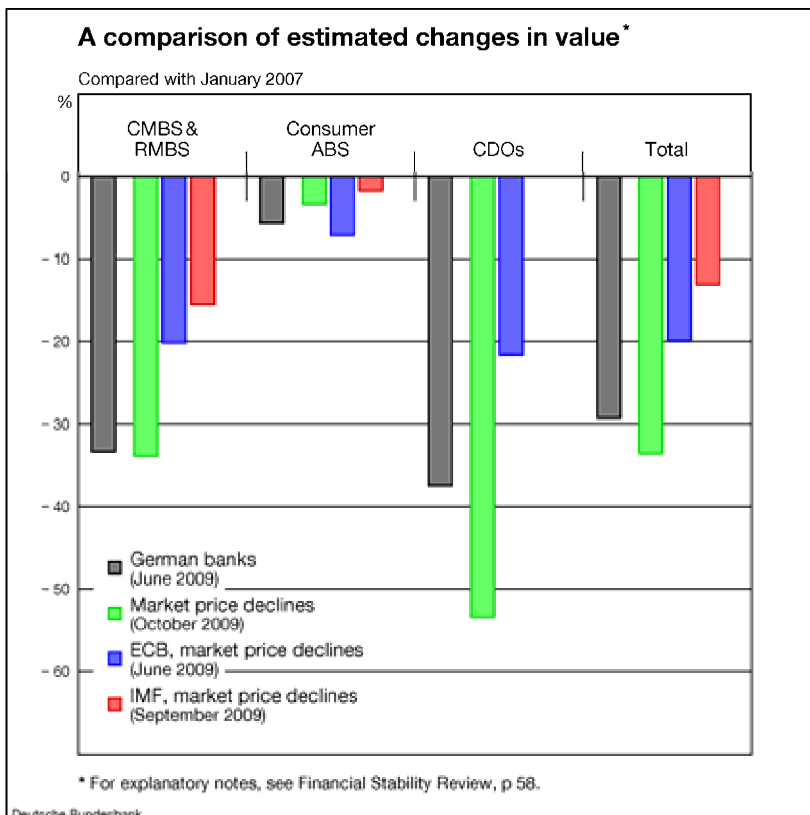

Chart 4

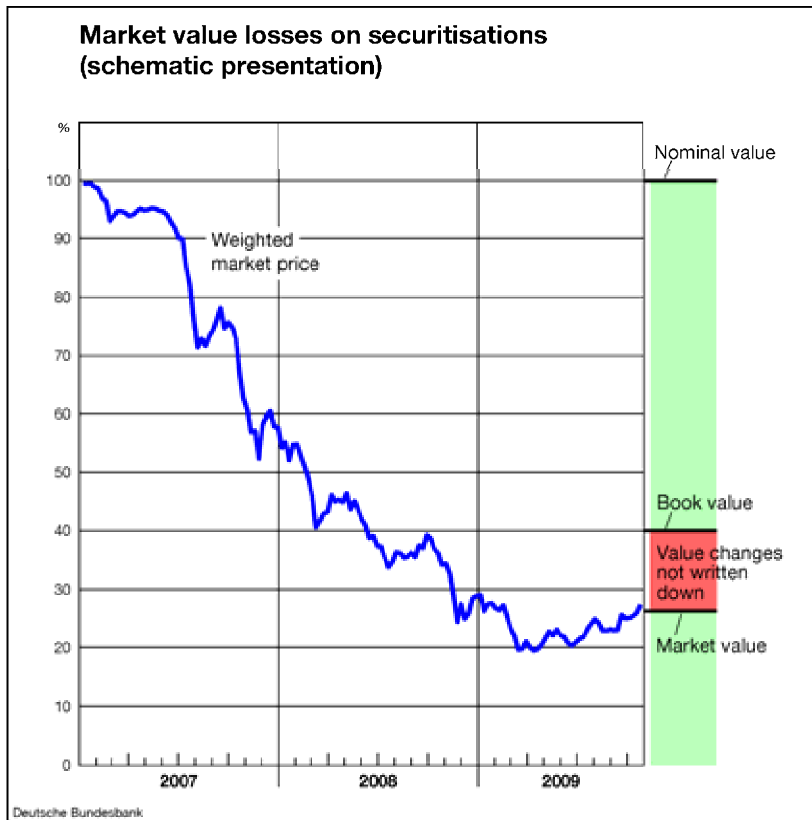

Chart 5

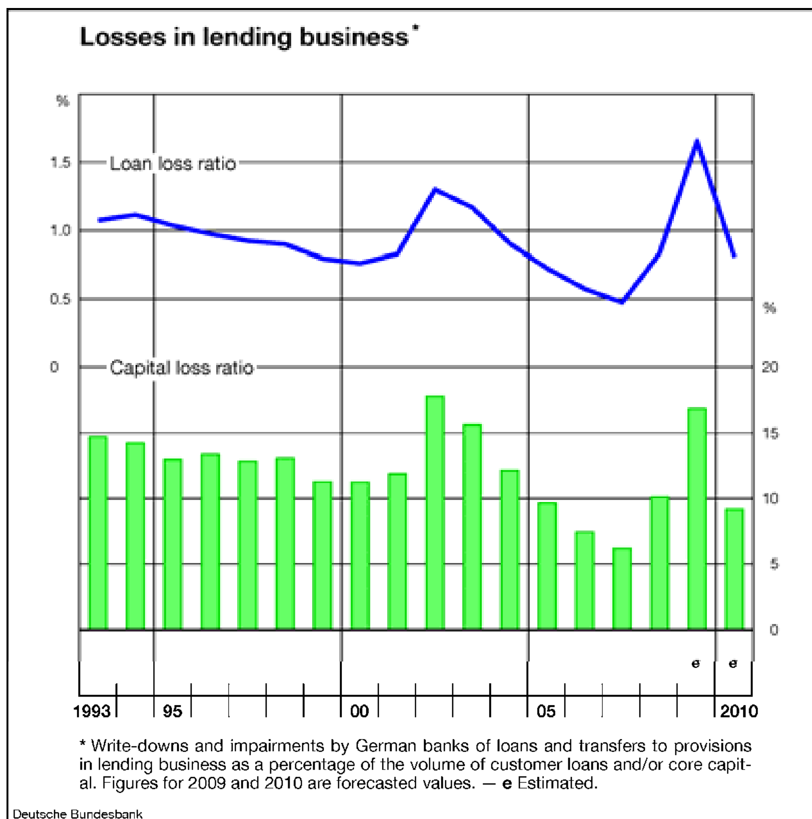

Chart 6