Andreas Dombret: Deutsche Bundesbank – Financial Stability Review 2010

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, Frankfurt am Main, 25 November 2010.

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I. The situation

The stability situation in the German financial system continued to be dominated by risks stemming from the international environment. The focus here is on two key topics which will continue to occupy us for the foreseeable future: first, the European sovereign debt crisis that has persisted since the early summer of this year and, second, the potential inherent risks of an extended period of low interest rates.

Against this backdrop, it is all the more important to note that the stability of the German banking system has shown a marked improvement since the publication of the last Financial Stability Review. Its resilience has increased thanks to more stable earnings and better capitalisation; the situation with regard to risk has eased slightly, especially in domestic lending. Nevertheless, the German banking system still has vulnerabilities and structural shortcomings.

Above all, the revised regulatory provisions for more capital and for a more appropriate liquidity reserve will bring about a longer-term gain in stability. One key challenge that still has to be resolved, however, is how to deal with systemically important financial institutions.

II. Risks of high sovereign debt and persistent low interest rates

The European debt crisis has been the crucial event of the past few months. Its onset in the early summer of this year placed European financial stability in acute danger. The response of governments and central banks was rapid and on a massive scale, thus preventing an escalation of the crisis. Our “heat map” shows the increasing risk in the European government bonds segment (Figure 1): since the previous year, the “traffic lights” have jumped from green to red. Yet, it is possible to identify positive developments, too. Tensions in the interbank market have eased, for example, not least because the banks are now hoarding significantly less liquidity.

The problem of high sovereign debt is still active, however, and will keep us busy for some time to come. It will also be important to tackle the longer-term challenges and ensure the long-term sustainability of public finances.

There are three key approaches to this. First, the fiscal rules have to be hardened. Second, macroeconomic developments in the member states have to be monitored more closely in future. Both of these points of approach are designed to prevent government debt crises. However, such crises cannot be ruled out entirely in the future either. Therefore, third, it will be necessary to establish a crisis management and resolution mechanism as a prudent and necessary supplement to the existing regulatory framework. Given strict compliance with the “no bail-out” principle, assistance to individual member states linked to strict conditionality and a very limited timeframe should be possible if stability of monetary union as a whole is at risk. In a well-regulated crisis mechanism of this kind, private debtors should not be allowed to escape their responsibility. It should be stated explicitly, however, that such a mechanism should be established only after the end of the crisis and not interfere with existing agreements and obligations.

In addition to the risks of the debt crisis, it is crucial not to lose sight of the risks inherent in an extended period of low interest rates. This includes, in particular, the possibility of new bubbles being formed in some markets for assets as part of a resurgent "search for yield". This is not a problem at present, but could become an issue in the medium term.

Persistently low interest rates incite, furthermore, the entering of liquidity risks and thus put banks at the whim of market sentiment. Expanding banks' short-term refinancing was more or less unavoidable in periods of strong mistrust; the correction of this expansion has not taken place so far. This means that the banks may be on a collision course with the large financing needs of general government, since large issuances of government bonds are to be expected over the next few months.

Finally, an abundant supply of liquidity may incite banks to defer a necessary clearing-up of their balance sheets. Major legacy problems in the loan portfolios may lead to banks holding back longer in granting new loans.

III. Aspects of the risk situation in the German banking system

Beyond the risks emanating from the global setting, the risk and stability situation in the German financial system looks more positive than it did a year ago. Banks' profitability has recovered since its slump in 2008 and their capital adequacy has improved. Between the first quarter of 2008 and the second quarter of 2010, large complex financial institutions increased their Tier 1 capital ratio, on average, by 2.4 percentage points to 10.4%. Finally, the German banking system has remained fully functional at all times and the credit crunch that was feared for a time did not materialise.

Our financial system is currently riding a tailwind from the pick-up in economic activity in Germany. There is a strong upturn with growth at over 3% this year, which is bolstering the creditworthiness of domestic borrowers. Moreover, confidence in the German banking system is also benefiting from the fact that government budgets in Germany are deemed to be comparatively sound.

Vulnerabilities and structural weaknesses in the German banking system nevertheless continue to exist. The differences in the performance of individual institutions or categories of institutions have, if anything, become greater. It will therefore also be a matter of reducing excess capacity and, where necessary, developing future-oriented ad sustainable business models. This is due to the fact that the tailwind generated by positive developments in the economy as a whole may one day subside.

In my following remarks, I shall enlarge on individual aspects of the overall picture of risks in the German banking system.

The international trend towards shorter-term financing is also a fact of life in Germany. The share of outstanding domestic bank debt securities with a residual maturity of less than one year used to be fairly stable at 22%. At present, the figure is 30% and is at a persistently high level (Figure 2). Even so, the German banking system is well on the way to achieving a more stable composition of its wholesale funding sources. For example, the share of non-banks' deposits in total liabilities has gone up from 37% before the onset of the crisis to 40% at present. The deposits of non-banks are comparatively stable and thus reducing refinancing risks. The banks should maintain their efforts to make their refinancing structure more stable.

The market risks in the trading portfolios of German banks have fallen markedly since mid-2009, even though they have not fallen as sharply this year (Figure 3). In line with this, the capital requirements of institutions (with their own market risk models) went down by more than one-third between June 2009 and June 2010. Declining volatility played a part in this, but the reduction in formerly significant credit trading positions also made a contribution. The outbreak of the sovereign debt crisis in the early summer of this year nonetheless had systemic potential – something that can be surmised from the accelerating co-movement of the trading results. Evidently, in terms of their proprietary trading positions, the banks were exposed to the crisis in a very similar way.

German banks' exposures, especially to foreign institutions, still contain segments that are vulnerable. These include the financing of commercial real estate and legacy holdings of structured products.

The situation in the international commercial real estate markets has remained tense. Above all, market prices have fallen sharply, especially in the United States and the United Kingdom, but also in Spain and Ireland. In spring of this year, the Bundesbank surveyed 11 large German banks on the financing of commercial real estate. Their overall lending volume was roughly €325 billion, with the USA accounting for 15% and the UK just under 9%. Yet, 90% of the loans do not exceed the value of the property. In some 44% of cases, the loan-to-value ratio is 60% or lower. This means that the risks from commercial real estate are, on the whole, manageable.

Since the outbreak of the crisis, the spotlight has been on structured securities. Substantial amounts of these can still be found in German banks' portfolios. At mid-year in 2010, the book value of securitised real estate loans stood at €82 billion and the book value of CDOs was some €62 billion. Securitised student loans were just under €34 billion and CMBS around €22 billion. The overall volume was declining only slightly in the first half of the year. It should be noted, however, that exchange rate effects had a strong impact on these figures.

The risk situation in German banks' business with non-residents has diverged. There are still some difficult segments, for example, such as the construction sector in the countries where the real estate markets are under price pressure. But, overall, the credit standing of large, global enterprises has benefited from the upturn in the world economy. Elsewhere, the deleveraging via external assets, which could be observed in some cases last year, has come to a standstill. The share of foreign business, measured by loans granted to non-banks, has remained fairly constant this year at just under 21%.

Domestic credit risks have stabilised. This has been assisted by the pick-up in the economy as a whole and by the stability of the German real estate market, in which there were no detectable exaggerations. German banks' need for write-downs is likely to be already past its peak. In 2009, write-downs amounted to roughly €37 billion. For this year, we expect a clear decline to €23 billion (Figure 4). For the two-year period of 2009 and 2010, this means that, altogether, there were write-downs of some €60 billion. In the 2009 Financial Stability Review, we estimated a figure of between €50 billion and €75 billion. The actual write-downs are therefore in the lower half of the expected range.

The Stability Review also contains a stress test on the profitability of German banks in interest rate business and commission and fee business (Figure 5). The relevant risk scenario assumes a marked flattening of the yield curve (decline of 55 basis points in the spread between the three-month interest rate and the yield in ten-year Bunds) and a severe economic slump (4% decline in GDP). In the current economic situation, this is undoubtedly a very sceptical assumption. Operating income (excluding the trading result) shows a distinct fall in this scenario: Net interest income for the German banking system as a whole (measured by total assets) will go down by almost 8%; cyclically driven commission and fee income will fall by 10%. Added to this are large write-downs in the event the assumed recession materialises. According to our estimates, these would surge to around €35 billion again; in other words, they would be €9 billion higher than the average of the past five years.

IV. Monitoring systemic risk

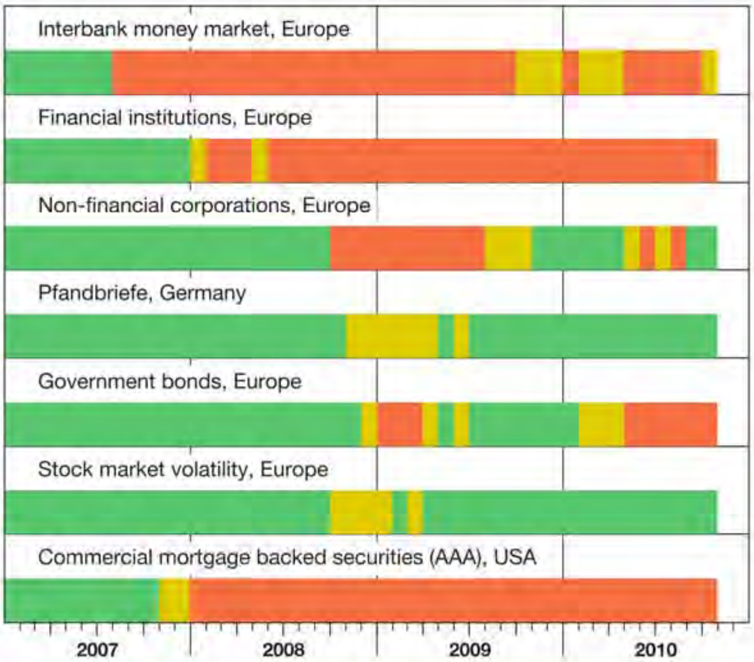
Central banks, including the Bundesbank, are facing new challenges. They have to identify systemic risks at an early stage, which places high demands on analytical skills. Any systemic risks that are identified have to be rigorously contained.

The refinements of the international regulatory framework that have already been put in place represent a gain for financial stability. The course has been set for an improvement in banks' capitalisation and liquidity. These measures will pay off in the long run and significantly enhance the stability of the financial system. I do not share the often-voiced fears in this connection about an excessive burden being placed on the banking sector.

Nevertheless, there remains much to be done. This mainly has to do with the treatment of systemically important financial institutions and the financial system's tendency towards (pro)cyclical behaviour. We, too, have to keep a closer eye on the limitations of the areas covered by regulation. After all, stricter regulation is of little use if activities are transferred to unregulated sectors and become concentrated there. For that reason, we have to throw a suitable amount of light on the shadow banking system and make it accessible to supervisory coverage, so that we can identify risks as soon as possible in the peripheral areas of the financial system, which are significant in terms of volume.

Figure 1

Stress indicators* for selected market segments

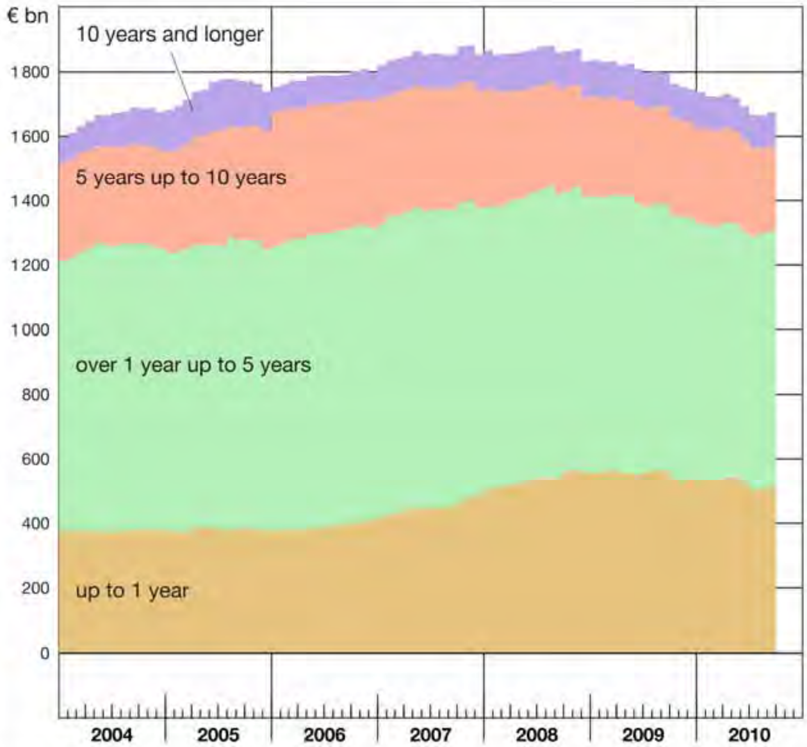


Sources: Bank of America Merrill Lynch, Bloomberg, Markit, Morgan Stanley and Bundesbank calculations. — * The stress indicator is the level of credit risk premiums or the implied volatility vis-à-vis the long-term average. Green indicates normal market conditions, yellow raised to exceptionally high stress levels and red extremely impaired markets.

Deutsche Bundesbank F2IN0025B.Chart

Figure 2

Residual maturities of outstanding domestic bank securities



Deutsche Bundesbank F2IN0037.Chart

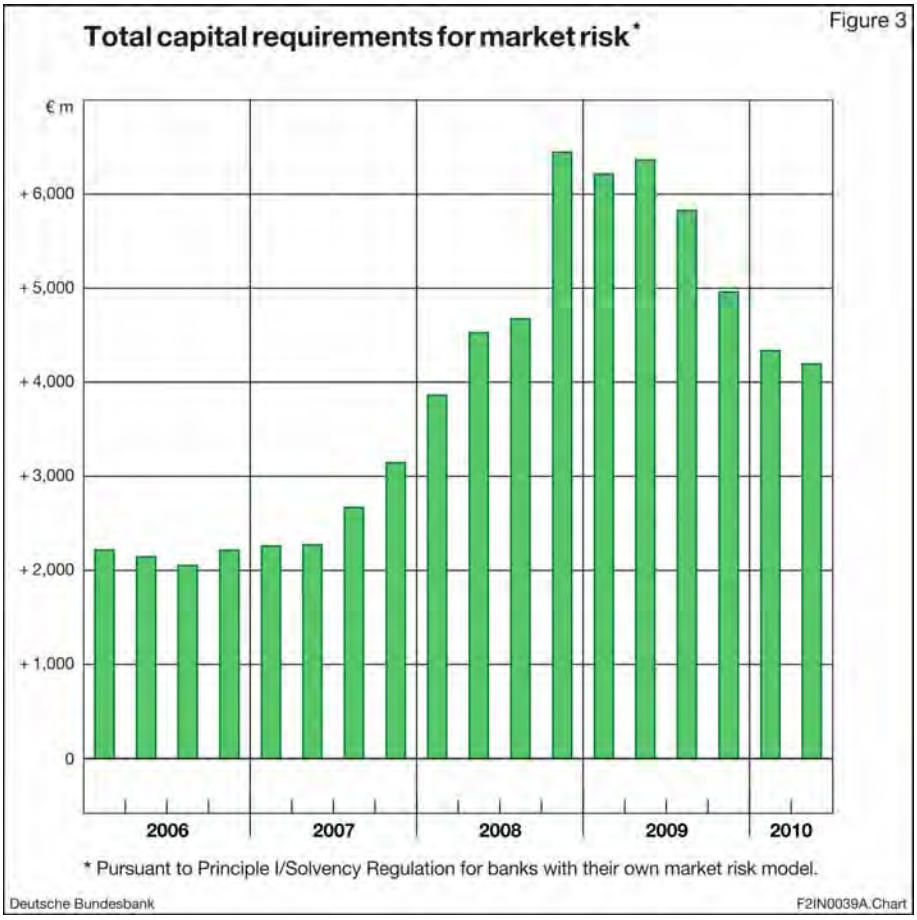


Figure 3
Total capital requirements for market risk*
€ m
+ 6,000
+ 5,000
+ 4,000
+ 3,000
+ 2,000
+ 1,000
0
2006
2007
2008
2009
2010
* Pursuant to Principle I/Solvency Regulation for banks with their own market risk model.
Deutsche Bundesbank
F2IN0039A.Chart

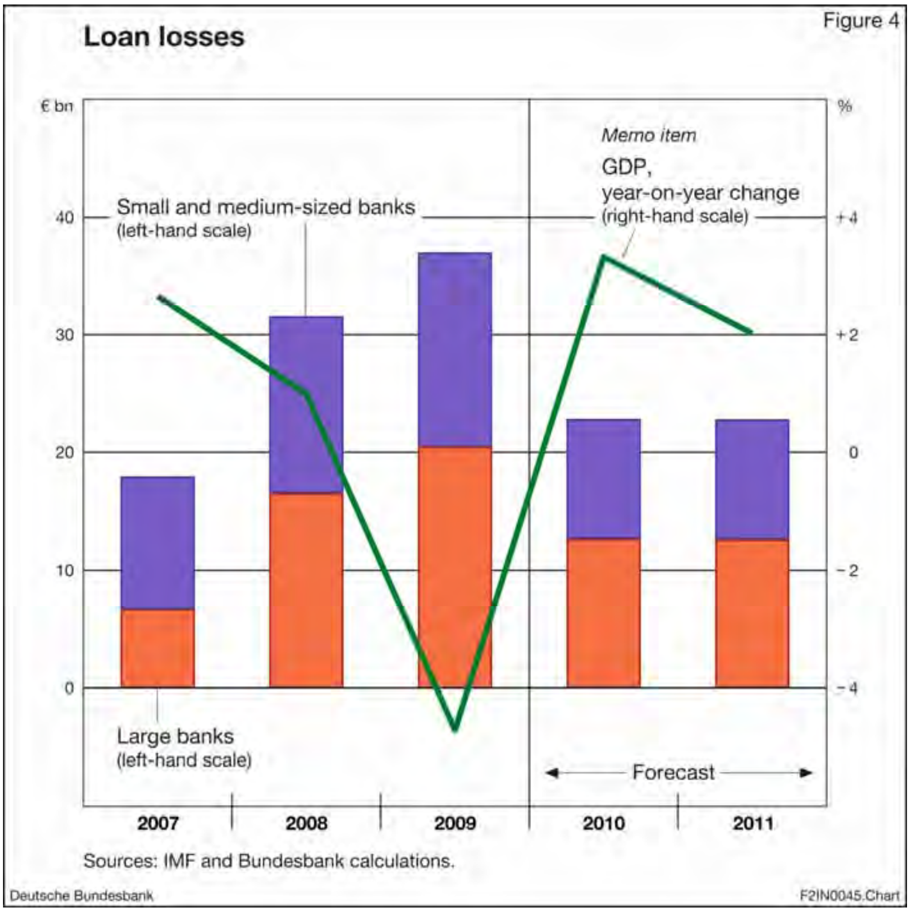


Figure 4
Loan losses
€ bn
%
Memo item
GDP,
year-on-year change
(right-hand scale)
Small and medium-sized banks
(left-hand scale)
40
30
20
10
0
+ 4
+ 2
0
− 2
− 4
Large banks
(left-hand scale)
Forecast
2007
2008
2009
2010
2011
Sources: IMF and Bundesbank calculations.
Deutsche Bundesbank
F2IN0045.Chart

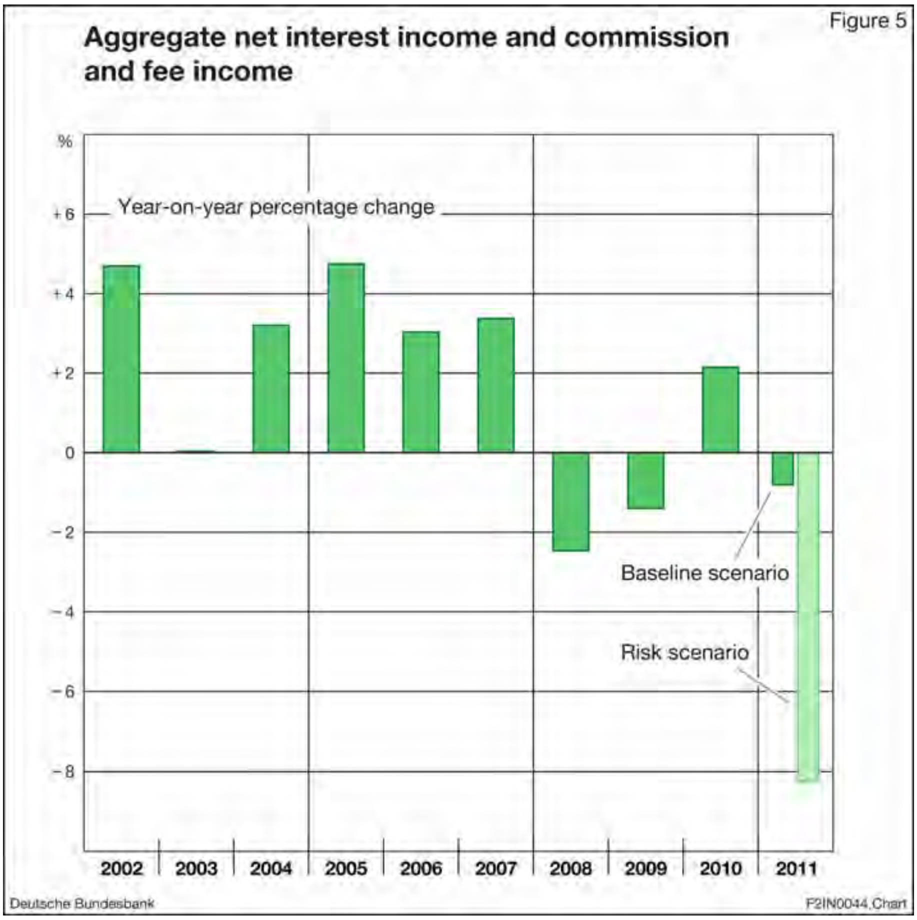


Figure 5
Aggregate net interest income and commission and fee income
%
Year-on-year percentage change
+6
+4
+2
0
−2
−4
−6
−8
Baseline scenario
Risk scenario
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Deutsche Bundesbank
F2IN0044.Chart