Andreas Dombret: Financial stability – challenges from a European perspective

Luncheon speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the American Council on Germany in New York, New York, 13 April 2011.

* * *

1. Welcome address

Ladies and gentlemen

Leaving Frankfurt heading south on the Autobahn, on the right-hand side you suddenly come upon two old planes framing a rampant arch. Neither of the two planes is a beauty. Nevertheless, the monument is a major attraction. The aircrafts are a Douglas C-47 and a Douglas C-55, which were two of the airplanes deployed by the United States Air Force during the famous airlift of 1948 to 1949. The arch in the middle of the triptych symbolises that airlift. To this day, Germany remembers that crucial moment in time.

A living friendship needs the sound foundation of common values and it also needs institutions that cultivate an intellectual and cultural exchange. The American Council on Germany plays an important role in bringing together leaders from both our countries. I was therefore honored to receive an invitation from you, the American Council on Germany, to speak to you today.

2. Introduction

Let me start by stating four propositions. With reference to the title of my speech, these propositions should constitute a current European perspective on financial stability. It goes without saying that they are far from being exclusively European.

My ***first*** proposition is that we have been living with the crisis for four years now. It is too early to announce the advent of a post-crisis economy or a post-crisis financial system.

My ***second*** proposition is that sovereign risk should be considered the main overarching risk to financial stability in Germany and in Europe as a whole. Nevertheless, my ***third*** proposition is that the risk outlook for the German banking system has been improving.

My ***fourth*** and final proposition is that financial stability constitutes a long-term strategy for forestalling the build-up of cyclical and structural excesses in financial markets. Even when acute threats to financial stability may warrant extraordinary measures, policymakers have to keep in mind the longer-term costs of prolonged *ad hoc* measures if they distort incentives and undermine market discipline.

3. In the fourth year of the crisis

Let me expand on my first proposition. We have not left the crisis behind us, although the nature of the crisis has obviously changed over the past four years.

The crisis that erupted in 2007 had its origins in a set of problems that centered on the securitization of mortgage loans. The weaknesses which allowed the crisis to unfold were made up of very different ingredients. Among these were structural problems in the financial sector such as flawed incentives and an overreliance on credit ratings. Risk-taking was encouraged by a macroeconomic setting commonly referred to as the “Great Moderation”. This was characterized by imbalances in capital flows and an environment of persistently low interest rates. Shortcomings in regulation and supervision also played their part. In the end, the crisis appears to have been the outcome of the interplay of all of these factors, although

views may differ on the relevance of every factor and its contribution to the outbreak and ensuing virulence of the crisis.

As far as Germany is concerned, our main weakness lay in banks with inappropriate business models. In their search for profitability and in order to save capital, they established what are known as structured investment vehicles. It gives no comfort that many banks in other countries did the same. These SIVs were short-term funded. And they invested heavily in financial products which their management probably did not fully understand. In particular, they failed to capture the risk profile of their investments and underestimated their exposure to systemic events.

In the second stage of the crisis, we were faced with the threat of a renewed Great Depression. Authorities around the world responded to this in a determined and bold manner. Finally, they succeeded in warding off the risk of a prolonged slump.

So we haven't left the crisis behind us yet? With regard to Germany, in fact, it is possible to advance three arguments to support that view.

- First, in Germany, we can expect our economy's output to match its pre-crisis level again by the end of this year, which is a reflection of the strong ongoing recovery.
- Second, banks have been making progress in cleaning up their balance sheets and strengthening their capital buffers. German banks have access to funding and wholesale markets.
- Finally, we can see progress towards an exit from state aid. Banks are giving back the government guarantees they received at the peak of the banking crisis for issuing state-guaranteed bonds. Last week, Commerzbank even announced that it was raising new capital on the market, putting it in a position to substantially reduce the capital provided by the German government.

Despite all the progress that has been achieved, however, it does not provide sufficient reassurance to believe that the financial system has already overcome the crisis.

First of all, the major central banks are left with balance sheets that have ballooned. The amount and the structure in question differ in line with the diverging strategies pursued. Nevertheless, this applies to all major central banks, including the European Central Bank. We firmly believe that these inflated balance sheets should not belong to a state of new "normal". In the long run, the persistent burden of inflated balance sheets might jeopardise the credibility of monetary policy.

This is all the more the case as the independence of central banks and their capacity to act appear to be crucial. Last week, the European Central Bank increased its key interest rates, ending the period of almost two years in which rates were at an all-time low level. The monetary policy stance remains accommodative. To preserve its contribution to growth and employment, it is essential that inflation expectations remain anchored in spite of recent price developments.

It goes without saying that we did not complain about the headline of the Financial Times' article on the rate hike. The article was entitled "ECB becomes Bundesbank".

Second, public indebtedness has reached critical levels in many countries, giving rise to doubts about sustainability. Public finances are already facing huge challenges posed by rigid structural deficits and demographic developments, and the strains have been further aggravated by the transformation of private debt to public debt in rescuing financial institutions and by high expenditures to avert recession. In Europe, we understand the current debt crisis as the third stage of the crisis.

Finally, large parts of the financial systems may seem, at a first glance, to be working well again. Nevertheless, moral hazard is still prevalent in the markets, fuelled by the implicit assumption in the markets that governments will rescue banks, if needs be, by spending

taxpayers' money. And by holding down interest rates and the cost of carry central banks may again be encouraging risk-taking that might sooner or later lead to a resurgence of high leverage and, with it, new excesses.

Acknowledging all the progress that have been made in the global banking system, especially in raising capital buffers and in sound liquidity management, there is still a long way to go in creating proper incentives in the financial sector. In one major respect, Germany has become a frontrunner.

At the beginning of this year, the German government introduced a new resolution scheme which facilitates the restructuring of distressed banks at the cost of their owners.

4. Sovereign risk

I now come to my second proposition. We have to consider sovereign risk as the main overarching risk in Germany and Europe as a whole − all the more so, since there is a strong link between sovereign risk and asset quality and the funding risk of the banking systems concerned.

Three weeks ago, the European Council agreed an important and comprehensive package of measures to tackle the current European debt crisis and obviate future strains. The package includes several elements.

The most prominent of these measures is the launch of a permanent Financial Stability Mechanism which will replace the temporary mechanism initiated last year. The permanent mechanism, known as the European Stability Mechanism, has major features that safeguard effectiveness and prudence.

- The ESM will have a lending capacity of €500 billion.
- Activating the financial assistance mechanism requires a unanimous vote by all participating member states.
- The granting of any financial assistance will be made subject to strict conditionality.
- A rigorous analysis of public debt sustainability will be conducted.
- When debt is considered to be unsustainable the private sector will be involved in restoring the public debt to a sustainable path.

It is important to realize that these facilities are bracing Europe even for the eventuality of further turmoil. At all events, protecting Portugal is not overstretching the available resources.

In addition, the euro-area heads of government agreed a so-called Euro-Plus Pact. Under the terms of this pact the countries concerned are committed to announce and implement a set of actions to improve their competitiveness. In particular, the countries should link the age of retirement to demographic change and the development of labor costs to the corresponding gains in productivity. Furthermore, a reform of the Stability and Growth Pact aims to enhance the surveillance of fiscal policies.

For observers outside Europe this variety of decisions and instruments may appear puzzling or, at least, complex and complicated. But that simply reflects the unique structure of the European Union, which is striving for comprehensive economic and monetary integration without transforming the political system into some kind of a United States of Europe. In fact, the determined and comprehensive decisions taken by the European Council confirm the Union's capacity to act. At the same time, they demonstrate the firm conviction that the Euro is contributing to our welfare and competitiveness and remains our common currency.

To put it in a nutshell: Europe has strengthened the governance of the monetary union and has launched a permanent support facility without transforming the character of the euro area:

- binding the member states by a common monetary policy,
- leaving the countries in charge of sound fiscal and economic policies,
- still retaining the possibility that a country may become insolvent,
- while, at the same time, providing a strict framework that exerts pressure towards discipline in order to ensure that every country acts in a way that is consistent with the interest of having a stable common currency.

In Germany, we have also strengthened our internal framework for sound fiscal policy. We have introduced a "debt brake" into our constitution. The federal budget is allowed to show only a slight structural deficit at all. The budgets of the remaining administrative levels must not post any structural deficit. In principle, deficits are allowed only to counteract fluctuations of the business cycle and must be balanced over the cycle.

Recently, public finances have been developing more favorably than was anticipated at the height of the crisis. The figures for 2010 have been clearly driven up by the assistance provided to financial institutions. As a result of this effect, public debt at the end of 2010 posted an increase from 73% to 83% of GDP instead of a decline, as was published by the Bundesbank today. But this additional debt has to be seen in the context of the assets acquired. Assuming these assets can be realized over time, they will contribute to a future decline in public debt. For this year, we think the deficit ratio could potentially drop towards 2 % of GDP. This means, that public finances are on track to lower the debt level considerably over the medium term. Facing the future challenges to public finances, for instance those posed by demographic change, it is vital that the German government holds the current course of fiscal consolidation.

Ensuring the sustainability of sovereign debt is not a purely European issue. I am closely following the ongoing debate in your country on how to reduce fiscal deficits. Bearing in mind the recent painful experience of some European countries, I can only subscribe to the view that Janet Yellen, Vice Chair of the Board of Governors of the Federal Reserve, put so tellingly. She was talking about the United States, but her words should be read everywhere. She said:

> *"We should not defer starting a course for fiscal consolidation. (…) The sooner we start addressing the longer-term budget problems, the less wrenching the adjustment will have to be and the more control we – rather than market forces or international creditors – will have over the timing, size, and composition of the necessary adjustments."*[1]

5. Challenges for the German banking system

The ongoing crisis has been challenging for the banking system in Germany and Europe as a whole. Nevertheless – as stated in my third proposition – the risk outlook for the German banking system has been improving.

Generally, it has to be borne in mind that the German banking system is dominated by domestic business activity. The share of foreign business, measured by the volume of credit granted to non-banks, is just under 21%. In some major segments, however, the German banking system demonstrates a high degree of internationalisation. This is why the challenges for the international financial system are also relevant to us.

[1] Janet L. Yellen: Fiscal Responsibility and Global Rebalancing, Speech at the Committee for Economic Development 2010 International Counterparts Conference in New York at December 1, 2010.

One of the major national and international topics at the moment is refinancing. With regard to the composition of the refinancing basis the tendency is for the deposits of non-banks to increase. In the German banking system, the deposits of non-banks as a share of total liabilities have risen from 37% prior to the onset of the crisis to 42% today. In principle, this can be seen in a positive light as the deposits of non-banks are comparatively stable.

However, market-based refinancing – which is still important − continues to show a very short-term bias. This effect has also to be seen in the light of the “two-tier” banking system, in which a few banks in Europe still have only limited access to longer-term funding. Given the large refinancing needs, banks run the risk of coming into conflict with the high level of government borrowing needs. This poses a severe risk to earnings for some banking systems, although this is probably not so much the case for Germany as the banks that are active in the market do not generally conduct maturity transformation on a large scale.

A number of German credit institutions still have substantial holdings of problem assets in their books. The most vulnerable exposure segments include the financing of commercial real estate and the legacy holdings of structured products. To assess the situation in the German banking system, last year the Bundesbank surveyed 11 large German banks on their financing of commercial real estate. The total amount of credit they granted stood at around €325 billion, some 15% of which was accounted for by properties in the USA and just under 9% by real estate in the United Kingdom. However, 90% of these loans are not in negative equity and roughly 44% have a loan-to-value ratio of 60% or less.

Since the start of the crisis, the spotlight has been on structured securities. The overall volume of these instruments in the portfolios of German banks was contracting sharply. At the end of September 2010, the book value of residential mortgage-backed securities stood at €74 billion, and for collateralised debt obligations at around €58 billion. Securitised student loans accounted for just under €30 billion and collateralised mortgage-backed securities for around €22 billion.

From these figures on problem assets we can conclude that the associated risks are manageable in Germany on the whole. In general, the overall development of credit risk in the German banking system is still determined to a great extent by domestic conditions. Therefore, credit risk can benefit from our strong economic upturn as well as from the stability of the German property market, in which basically no exaggerations have occurred.

Nevertheless, sectoral weaknesses remain. In particular, within the Landesbank sector some banks are in the process of working out a resilient business model. This, in fact, is probably a reflection of ample capacities in some banking markets. However, the banks concerned have already de-risked and de-leveraged by significantly curtailing their balance sheets. Moreover, their owners have injected fresh capital. You may rest assured that banking supervision in Germany is closely and prudently monitoring these developments.

Notwithstanding that criticism, the Landesbanks deserve to be treated fairly by all the authorities. Of course, with respect to their capital endowment, all banks have to obey the current regulations, while, at the same time, having to decide on their own responsibility about their timetable for a timely adjustment to future regulation. As we see it, it is not the job of the authorities to enforce a kind of a fast-track adjustment towards the future rules in the current European stress testing.

Basel III introduces a definition of core tier 1 capital from the beginning of 2013 with an additional transitional period up to 2019. Under the upcoming definition, “silent participations” will no longer be eligible. Today, silent participations still play an important role in the capital endowment of some Landesbanks. This is consistent with current legislation. Since the timely transition from these silent participations to capital instruments that are commensurate

with the forthcoming core tier 1 definition is not at risk, the stress test in this category indicates a problem where none exists.

6. Financial stability as a long-term concept

I would now like to turn to my final proposition calling for a longer-term orientation in financial stability policy.

In general, financial stability embodies two fundamentally different disciplines. On the short-term we find some kind of crisis management, a discipline which occasionally comes to a spectacular climax in dramatic weekend meetings in a race to find *ad hoc* solutions. Such "emergency rescue operations" typically aim to buy time for necessary adjustments.

To some extent, the emergency rescue approach stands in contrast to the real sphere of activity in financial stability, which is essentially a strongly rule-based discipline. Implementing sound structures constitutes the long-term side of financial stability. Unfortunately, there is often a trade-off. Measure which seem necessary in the short run can do harm in the longer run. The political authorities and the central banks have to keep the inherent longer-term implications and costs in mind.

Macro-prudential policies apply regulatory and supervisory tools in order to curb systemic risk and to enhance financial stability. One innovation in the institutional setting in Europe is the recently established European Systemic Risk Board. The ESRB has a broad mandate that charges it with macro-prudential oversight in order to contribute to the prevention or the mitigation of systemic risk. The ESRB conducts a thorough analysis of the risks to financial stability in the European Union. The ESRB can issue warnings and make recommendations to both national authorities and authorities at the European level. While the ESRB does not have the power of direct enforcement its warnings initiate a "comply or explain" mechanism. Such communication tools which are addressed to single authorities – in contrast to a general advice – will exert heavy pressure.

7. Conclusion

So, what is the broad picture I would like to present from the current European perspective on financial stability? Ultimately, I would like to leave you with three key thoughts.

First, the Europeans continue to be concerned about the state of financial stability and, in particular, the state of public finances. Any complacency was wiped out by the outbreak of the debt crisis. Political leaders in Europe know that restoring confidence in public finance is crucial for the future of monetary and economic integration.

Second, we are witnessing Europeans' capacity to act with determined measures being taken on a variety of issues. Europe has adopted a firm course of consolidation.

Third, Germany is actively taking part in the important discussion on introducing effective macro-prudential surveillance. In many respects, global financial markets call for close political coordination on a global scale. Insofar as differences in our respective financial systems mean that the United States and Europe pursue different paths in regulation, it is nevertheless vital to monitor experiences abroad closely.

For example, we at the Bundesbank are monitoring with great interest the approach taken with the Dodd Frank Act and its ensuing implementation. I am very happy that the Bundesbank has maintained a representative office here in New York for nearly 25 years and also maintains an active trading desk here. There is certainly no risk of our representative running out of work in reporting on and informing us of the latest developments in your

country, while, at the same time, explaining and conveying German and European perspectives.

Fortunately, the rough winds of the Cold War that made the airlift necessary are gone. But, perhaps in a different way, we always need an airlift. In sculpture, the figure of the “Caller” can be found in many variations. In Bremen and in Berlin close to the Brandenburg Gate, there is one very impressive statue of this kind. In New York too, there are great monuments evoking this theme − at Battery Park, for example, where a mariner is calling in the storm. For a moment, let’s just imagine that both are calling out to each other.