Andreas Dombret: Deutsche Bundesbank's 2013 Financial Stability Review

Opening statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the press conference of the Deutsche Bundesbank's 2013 Financial Stability Review, Frankfurt am Main, 14 November 2013.

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An overview of risks

I am pleased once again to present, together with Ms Lautenschläger, this year's edition of our *Financial Stability Review*.

Compared with previous Reviews, this year's is brought out in a somewhat calmer environment. The tension on the international financial markets has eased. This is beneficial to financial stability in Germany, in line with the degree of calm prevailing internationally after a period of turbulence. The situation is also reflected in the stress indicator for the German financial system. The indicator is well down from the levels it reached after Lehman and at the height of the European sovereign debt crisis.

However, two major risk factors remain.

- First, the low-interest-rate environment. This is placing a growing strain on the German financial system. On the international financial markets, there is an increasing risk that the search for yield will result in excessive behaviour and will give further impetus to the shadow banking system. German banks face greater pressure on profitability. For life insurers, low interest rates are increasingly eating away at their financial buffers.
- Second, the European debt crisis is not yet over. The risk of contagion remains high. It is a matter for concern for us that the ties between governments and domestic banks have tightened again in several countries.

I would now like to discuss each of these issues in greater detail.

Low-interest-rate environment affecting the financial system

When considering the low-interest-rate environment, people may be tempted to say: one man's joy is another man's sorrow. It is good for house builders and buyers and for shareholders. For savers and endowments, it is not so good. Your personal view of the low-interest-rate environment may therefore depend on which group you fall into. You can decide for yourself whether low interest rates are a boon or an annoyance. But we are not talking here about personal finance. We are concerned with the longer-term dangers to financial stability, and they affect everyone.

Low interest rates have without doubt helped to stabilise the situation. But now the time must actually be used. By governments to consolidate their finances and to strengthen competitiveness. By banks to clean up their balance sheets, review their business models and reduce risky portfolios.

But the longer the low interest rates last, the larger the undesired side-effects and the risks to financial stability. Low interest rates might induce market participants to enter into heightened levels of risk in the search for yield. This increases the danger of mispricing. In this way, the seed is sown for sudden corrections in asset prices. Things become dangerous when market participants grow accustomed to finance on these favourable terms and take them as a given for the future.

Germany's banks have so far shown little sign of a distinct movement in search of yield. The kinds of investments typical of the search for yield – emerging market assets or corporate bonds – have thus far remained limited. German insurers, on the other hand, are investing to an increased extent in corporate bonds. This could be detrimental to them if there were increased defaults on these bonds because of a phase of economic weakness. However, insurers' investment policies overall remain conservative.

Banks, in particular, should arm themselves against potential losses in market value in the event of a turnaround in interest rates. In the case of investments via exchange-traded funds, liquidity risk must be monitored, particularly where less liquid underlyings are concerned. A striking example of the need for this monitoring was provided in the United States in June of this year.

The issue of low interest rates is certain to influence financial stability for some time to come, as can be judged from the latest interest rate reduction by the European Central Bank. What is clear is that monetary policy has to adhere to its mandate. Safeguarding price stability in the euro area is its primary objective.

It is all the more important to keep a watch on the impact of monetary policy measures on financial stability in the euro area or in individual countries. It was therefore right and important to create a macroprudential supervisory set-up in Germany and Europe in order to identify dangers to financial stability and propose countermeasures. At European level, the Frankfurt-based European Systemic Risk Board (ESRB) is responsible for this. In Germany, the Financial Stability Committee was established at the beginning of the year. The Federal Ministry of Finance, the Federal Financial Supervisory Authority and the Bundesbank are represented on the Committee. It is a good thing that new macroprudential tools are available which can also be used at national level in particular and can be targeted at specific problems. The basis for the practical application of these tools has only been partially elaborated and there is still work to do here in many cases. The Bundesbank is playing its part in this.

Low-interest-rate environment puts German insurers under pressure

Our *Financial Stability Review* highlights how the low-interest-rate environment is increasingly weighing on German life insurers.

The low interest rates mean that it is ever more difficult for them to generate the guaranteed returns. The maximum technical interest rate for life insurers' portfolios – which generally equals the guaranteed returns – is an average of 3.2%. By way of comparison: the average current yield on public sector bonds with an original maturity of more than four years was recently around 1.3%.

Insurers need to respond. Their capital buffers are shrinking. The coverage ratio, which is the ratio of regulatory capital to regulatory capital requirements, dropped from around 186% in 2009 to just under 169% at the end of 2012. Life insurers are therefore called upon to strengthen their capital resources and to review the level of distributions.

In addition, the low interest rates are leading to high valuation reserves. These amounted to almost €88 billion at the end of 2012. Policyholders are entitled to a half share of these, although the valuation gains on fixed-income assets are nothing but paper profits. In the interests of financial stability, a sound and sustainable regulatory framework should be created for policyholders' participation in valuation reserves in life insurance.

We have carried out a scenario analysis. It enables conclusions to be drawn about the change in capital resources under Solvency I for various interest-rate paths.

- A mild stress scenario simulates government bond returns like those in Japan. In this scenario, 12 life insurers with a combined market share of 14% would fail to meet the requirements of Solvency I by 2023.

- In the more severe stress scenario, the extremely low interest rates affect a wider range of asset classes. In this scenario, no fewer than 32 insurers fall short of the regulatory requirements by 2023. Their market share is 43%. Thus, in this scenario almost half of the market is affected.

There is therefore no doubt that a persistent low-interest-rate environment harbours a potential risk to the stability of German life insurers.

It also needs to be borne in mind that our simulation is based on the requirements of Solvency I. Fair-value accounting under Solvency II would probably lead to even worse results. It is therefore important to configure the transition to Solvency II in a way which is compatible with stability.

Banks under pressure

When it comes to Germany's banks, part of the job of this year's *Financial Stability Review* is to look at the credit risks which confront us at the present time. To an extent, these risks reflect back on credit policies pursued in the past, such as in ship finance and securitisations. We also direct our attention to the future. For example, a constant watch needs to be kept on the business cycle, since a recession, for instance, would obviously have an impact on banks. It is particularly important to us that loans for German residential property do not turn into a new source of conflagration.

A model calculation reveals risks in the event of another severe recession in Germany comparable to the one in 2009. The calculation covered the years 2013 to 2015. It is mainly the 12 major German banks with an international focus which would be affected by this simulated economic downturn. They would be faced in particular with value adjustments and write-downs. Compared with the baseline scenario, operating earnings would drop by almost €15 billion for 2014 and by over €5 billion for 2015. By way of comparison: in 2012, the banks in question recorded combined operating income of €11 billion. Thus, this recession scenario would bring the threat of losses, at least if the banks did not succeed in reducing their costs accordingly. To be clear: this is a model calculation. It is not a stress test aimed at establishing recapitalization requirements, and has nothing to do with the forthcoming EBA and ECB stress test.

I can only recommend to Germany's banks that they review their options for reducing risk and for building up capital resources and put these options into practice where necessary – and the sooner the better.

Default risks for banks could arise in the medium term from mortgage lending. However, there appears to me to be a distinct public awareness in Germany that a spiral of rising property prices, lax lending standards and continued strong lending would undeniably lead to problems. I believe the Bundesbank has played its part in creating this awareness, for instance through articles in last year's *Financial Stability Review* and in the current October *Monthly Report*.

We have also taken a look at the German housing market this year. In seven major cities – Berlin, Cologne, Düsseldorf, Frankfurt am Main, Hamburg, Munich and Stuttgart – residential property prices climbed by almost a quarter overall between 2009 and 2012 – compared with a rise of just under 5% between 2005 and 2008. For 2013 we are expecting a further price rise of around 9%. The Bundesbank is currently assuming that housing is overvalued in the major cities by up to 20%. Low interest rates have without doubt created incentives for property investments which would not have been undertaken under normal interest rates.

In Germany as a whole, the upward trend is continuing, though at a significantly lower level. Housing prices across Germany actually fell by 1% between 2005 and 2008. Between 2009 and 2012 they then rose by more than 8% overall, and by 3% to 4% in the first half of 2013.

From the point of view of financial stability, however, it is not just the change in the price of residential property which matters. The interplay with lending is crucial. In view of households' sound levels of debt sustainability and a moderate rate of growth in property lending, currently 2.2%, rising property prices do not at present harbour any excessive risks to financial stability. However, the possibility that property buyers, particularly in major cities, could experience wealth losses due to potential price corrections cannot be ruled out.

We will therefore continue to monitor the situation on the German housing market closely. Surveys are currently being conducted at banks aimed at providing us with a more in-depth insight into the financing of residential property. Germany's banks should ensure that they apply conservative standards when issuing property loans.

Central counterparties gaining in importance

Close and opaque ties in the over-the-counter derivatives markets are a potential source of danger to the stability of the financial system. The regulation of OTC derivatives markets sets great store by central counterparties. They bear the default risks. If a major market participant defaults, the use of central counterparties is intended to lessen the shock waves, thus acting as a kind of breakwater.

It is therefore a positive development that ever greater use is being made of central counterparties for clearing. In the case of new index credit default swaps arranged between major derivatives traders, more than half are now being cleared through central counterparties.

However, it should not be forgotten that the central counterparties have been assigned a systemically important role. This requires safety barriers. Attention should be given to ensuring strict requirements globally for risk management at central counterparties. Suitable recovery and resolution regimes for central counterparties need to be established. We must not allow new systemic risks to build up at central counterparties and make us vulnerable.

What needs to be done?

In conclusion, let us look at the most important tasks facing us in terms of safeguarding financial stability.

One major risk factor is the European debt crisis and the risks of contagion it entails.

The debt crisis is far from being over. How could it be otherwise? The underlying imbalances built up over a long period of time, and correcting them will therefore also be a long process. It is important that economic policy-makers in the euro area continue with the consolidation and reform process they have embarked on. Monetary policy can only buy time. It is our firm conviction that monetary policy needs to be returned to its core task: the safeguarding of price stability.

The ties between governments and the domestic banking sector have actually tightened in some countries this year. The preferential regulatory treatment of government bonds on banks' balance sheets must therefore be phased out in the medium term.

The other major risk factor is the low-interest-rate environment.

Everyone should be factoring into their risk assessments the normalisation of the level of interest rates and the potential for rising volatility on the financial markets.

As I have explained, risks to financial stability as a result of low interest rates often emanate from the property market. Experience in other countries has shown that a prolonged period of low interest rates can result in price bubbles.

The low interest rates are eating away at insurers' financial buffers. They need to build up their capital resources and review their level of distributions. Efforts should be made to create

a sound and sustainable regulatory framework for policyholders' participation in the valuation reserves.

Finally, the new macroprudential tools need to be prepared for practical application. That is because the longer the period of low interest rates lasts, the more likely it is that macroprudential instruments will be employed. One thing is certain: as soon as we see a risk to financial stability, we will act.