Sabine Lautenschläger: Deutsche Bundesbank's 2013 Financial Stability Review

Speech by Ms Sabine Lautenschläger, Deputy President of the Deutsche Bundesbank, at the presentation of the Deutsche Bundesbank's 2013 Financial Stability Review, Frankfurt am Main, 14 November 2013.

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1. Introduction

Ladies and gentlemen

I am delighted to welcome you to the Bundesbank today. The presentation of the Bundesbank's Financial Stability Review has become a firm fixture in the calendar. And, looking around, I can see some familiar faces. And, today, I will also be raising issues with which you are familiar.

For example, although the tensions in the financial system have eased since mid-2012, the side effects of the crisis policy are now coming into focus. Long-term low interest rates and abundant liquidity have a knock-on impact and weigh, for instance, on banks' profitability.

Crisis policy has given us breathing space that now has to be used for adjusting bank balance sheets and for consolidating public finances. This is because the debt crisis is by no means over. And, for that reason, I will begin with this topic. The second main point of my remarks will be the situation of German banks and, third, I shall, of course, be going on to talk about the banking union, which is connected with the two preceding issues and currently the dominant topic in the world of the European supervisors.

After that, I shall be handing over to Dr Andreas Dombret. One of the things he will be talking about is how insurers are getting on in the current low-interest-rate setting and what implications the low interest-rate has for the property markets.

2. European sovereign debt crisis

Let us first take a look at the European sovereign debt crisis.

As I already mentioned earlier: since the middle of last year we have been seeing a certain easing in the markets for European government bonds. The crisis measures taken by European governments and the European Central Bank (ECB) have certainly played their part. Apart from that, though, some member states have been making progress with their reforms. As a result, in crisis countries we note a considerable decline in current account deficits, falling structural budget deficits and, for the most part, shrinking unit wage costs.

The calm that has set in is deceptive, however. Despite the consolidation measures, levels of public debt have been continuing to climb. We have to interpret the current development as a kind of advance expression of confidence which now has to be redeemed by means of further reform measures. This fragility revealed itself, for instance, when a government crisis in Portugal in the middle of 2013 led to a sudden rise in the yields on Portuguese government bonds.

The strains due to debt are not confined to the public sector. The liabilities of private enterprises and households, too, remain at a high level. The risks emanating from this should by no means be underestimated. After all, the US subprime crisis – in other words, private sector debt problems in the United States together with real estate bubbles – formed the nucleus from which the financial crisis grew. A high level of debt in the private sector is by no means solely a US phenomenon, but one that also affects Europe. Although the private sector has successfully reduced debt in some euro-area countries, the overall level of liabilities remains high.

The situation of the private sector is reflected in the high levels of banks' problem assets. For example, without exception the percentage of banks' non-performing loans to countries in crisis has risen over the past few years, in some cases dramatically.

3. The situation of German banks

But how are German banks getting on?

The critical situation of both public and private debtors in some crisis countries is still one of the key risks to the German banking sector.

German banks' exposure to debtors from the four programme countries as well as Spain and Italy has dropped from €432 billion to €234 billion since the end of 2009. Although the default and contagion risks have declined, they are still considerable.

Considerable risks of default exist not just with regard to individual countries. Some German banks still have notable exposure to sectors that are cyclically vulnerable and marked by overcapacity, such as shipping loans, securitisations and loans funding foreign commercial real estate. These business segments will play a key role in the upcoming balance sheet assessment by the ECB and the national supervisors.

In these business segments, the picture is mixed. While an end to the slump in the shipping markets is not in sight, the swings in the valuation of securitisation portfolios have eased somewhat. It is not possible to make a blanket assessment of the commercial real estate markets, either. While the markets in Germany and the United States are in a relatively non-critical situation or have recovered perceptibly, the situation in some European countries such as the United Kingdom, Spain, but also the Netherlands, remains difficult.

It would especially cause problems for some banks if failures were to occur simultaneously in more than one of these cyclically dependent sectors. It is encouraging, however, that banks have continued to strengthen their ability to absorb losses.

We note a steady improvement in German institutions' capital ratios over the past few years. As at June 2013, the 12 largest German banks showed an average tier 1 capital ratio of 15.3%. That represents a year-on-year increase of more than 2 percentage points. The leverage ratio, too, has fallen on average from 33 to 28.

That is a gratifying development on the whole. It shows that future regulatory requirements are being anticipated. For us, this creates a good starting point for the forthcoming balance sheet assessment, which I shall go into later.

However, this should not detract from the fact that some banks still have to undertake considerable efforts to meet the requirements of Basel III.

Quite a few banks will therefore continue to shrink their balance sheets. This is because the increase in the capital ratios of the major German institutions over the past few years has been achieved less through the retention of profits than by reducing holdings of risky assets. Thus, the capital increase between June 2012 and June 2013 was more than €3 billion in net terms; since December 2008 it has been almost €20 billion. By contrast, the large German banks have reduced their risk-weighted assets by more than € 150 billion since June 2012; over the past four and a half years, the figure is as high as nearly €600 billion. This means that these 12 banks have reduced their risk assets by more than one-third in this four-and-half year period. I nevertheless basically take a positive view of this deleveraging, since it principally affected the cutback portfolios that were not part of the banks' core business.

At the current end, the profitability of the large banks has stabilised. Recently, this has been underpinned mainly by the trading result and low risk provisioning – two income components which tend to be rather volatile and cyclically dependent. The most important source of earnings, especially for the German universal banking system – net interest income – is

declining, however. That is also due to the current low-interest-rate setting, which is exerting extra pressure on the interest margin.

What specific impact does the low-interest-rate environment have on banks?

The low-interest-rate setting lastingly reduces banks' profitability since net interest income shrinks. Net interest income falls if, for instance, asset-side high-interest-income legacy business runs out or, on the liability side, the interest contributions for savings and time deposits are reduced. At the same time, there is uncertainty as to whether a potential interest rate shock could impact on institutions' profitability and balance sheets. We are looking at this development closely. In the interests of a preventive supervision, we are analysing what medium- and long-term impact stems from sudden interest rate changes as well as the income effects of a persistently low interest rate level.

A closer look reveals that German banks have structural profitability problems.

The interest margin has been decreasing almost continuously over the past three decades. You can see quite clearly from the chart that the interest margin was around 2% up to the mid-1990s. It has fallen by 100 basis points since then to just under 1%. There are many reasons for this. The provision of banking services in Germany is above average compared with other European countries; there are signs of overcapacity in the German banking sector. In addition, there have also been technological developments such as the internet, which have facilitated market access for banks without a network of branches. Many banks are nonetheless competing for the same groups of customers in Germany – the *Mittelstand* and retail customers alike. Banks are also facing growing competition from non-banks. They not only offer loans, but are also successfully attracting investment capital.

For German banks, lack of profitability means two things in particular in the medium term. One, owners and investors have to prepare for lower returns in the long run. Given a lack of profitability, cost structures have to be come under scrutiny and business models have to be adapted. And if there are no earnings, there is no basis for staying in business. Market exits should therefore not be a taboo subject.

4. The European banking union

Ladies and gentlemen, the situation in the financial markets has unquestionably calmed down compared to 2012. However, we must not let this divert our attention from the structural problems besetting the banking sector. On the contrary – the recovery phase has to be used to implement the needed adjustments and reforms. After all, the challenges that lie ahead are enormous. And that goes not just for the financial markets but also for us supervisors and regulators. This brings us to a topic that has been making more and more headlines in the past few months: the European banking union. Let us look ahead to the next 12 months. What is on the agenda?

The legal basis for the new European Single Supervisory Mechanism, or SSM for short, has just been created. It is now time for its implementation. We will regulate cooperation between the ECB and the national competent authorities within a set framework and press ahead with our work on the new joint supervisory approach. We will also assemble teams of supervisors from the ECB and the national supervisory authorities and prepare them to take on supervisory functions.

The greatest challenge in the coming months will be the comprehensive assessment. The first step of the comprehensive assessment has already been launched. Supervisors have begun selecting the particularly critical balance sheet items of the 128 banks affected. The assets contained in the items will then be subjected to closer scrutiny. For instance, the recoverable value of the posted collateral and the valuation of illiquid assets will be assessed. The ECB will conduct a quality assurance check together with the national competent authorities at all stages of the assessment in order to ensure the comparability and robustness of the results. This appraisal of the present situation will be augmented by a

joint ECB and European Banking Authority (EBA) stress test which is designed to expose potential future risk as well.

The Balance Sheet Assessment will be a true "acid test" – for the banks as well as for the ECB and the national competent authorities alike. The comprehensive assessment is likely to cause some unease since the ECB will hardly be able to meet the market's sometimes unrealistic expectations. For example, it will not be possible to assign a specific euro amount to capital needs until the entire process – that is, BSA and stress test – has been completed.

The comprehensive assessment also represents a major opportunity, however. A thorough balance sheet cleansing can free banks of legacy problems and enhance the functional viability and stability of the European banking sector. What is important is that, at the national level, provisions should be made to cover potential capital needs. The ECB will additionally benefit from having a precise insight into the risk situations of those banks which will be under its supervision in future.

I see the BSA as an opportunity – for supervisors and banks alike.

The Single Supervisory Mechanism (SSM) is the furthest-advanced element of the banking union. By contrast, the single resolution mechanism (SRM) is still in its infancy. Time is short. The banking union requires not only an SSM but also a European SRM in order to strike the proper balance between liability and control. It makes little sense to shift supervision of European banks to the European level only to then, in the matter of resolution, to give responsibility back to a national body. And we supervisors need an instrument for resolving banks smoothly without impairing the markets, one which bails in owners and investors, in order to put the bite back into our demands for consolidation and balance sheet cleansing.

A proposal from the European Commission is on the table. In my view, however, there are both conceptual and legal problems in this regard. A true European resolution authority needs a watertight foundation; bank resolution will invariably involve a wave of lawsuits by third parties – in this case, bank investors. Primary law needs to be amended in order to create such a watertight foundation. Until that happens, we have to settle for a network of national authorities and funds, supported at best by cross-border burden-sharing agreements.

I am also critical of the idea of the European Commission having a strong position in resolution, since the Commission is also responsible for state aid procedures, which would create a conflict of interest that would be impossible to resolve cleanly.