Claudia Buch: The Deutsche Bundesbank's Financial Stability Review 2015

Speech by Prof Claudia Buch, Deputy President of the Deutsche Bundesbank, at the press conference to unveil the Deutsche Bundesbank's Financial Stability Review, Frankfurt am Main, 25 November 2015.

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Ladies and gentlemen

I would like to warmly welcome you to the unveiling of the tenth Financial Stability Review of the Deutsche Bundesbank. It is almost ten years ago to the day that current governor of the Reserve Bank of India and then professor at the University of Chicago, Raghuram Rajan, asked the following question: has financial development made the world riskier? A cornerstone theory addressed in his speech delivered at the Federal Reserve Bank of Kansas City's annual Economic Policy Symposium in Jackson Hole was that low monetary policy interest rates incentivise excessive risk-taking.

The situation today is quite similar to 2005. Interest rates are low, which is squeezing banks' and insurers' earnings, and investors are on the hunt for higher returns. But fundamental framework conditions have shifted as well. Notably, better possibilities exist today for regulators to tackle systemic risk.

1. What factors influence financial stability?

For in recent years, microprudential supervision and regulation have been increasingly complemented by a macroprudential perspective so as to encompass the stability of the financial system as a whole. The extent to which individual institutions are high-risk and their compliance with regulatory capital buffer requirements form the foundation of microprudential supervision, which is designed to safeguard the stability of individual institutions. But safeguarding "financial stability" goes beyond this. It involves ensuring that the financial system is able to perform its key macroeconomic functions at all times – particularly in periods of crisis and upheaval.

The European financial system has overcome two such periods of stress in the past year: First, the heightened uncertainty over the summer surrounding Greece's future in the euro area and, second, concerns surrounding the deceleration of growth in China and in other emerging market economies. Despite a number of significant and sometimes abrupt price movements, it can be said that the financial markets have, to date, proved themselves resilient to such events, not least thanks to strengthened regulation.

At the same time, monitoring systemic risk is an ongoing task. We do this by focusing on two questions.

> First, can the failure of a market participant (or a group of market participants) compromise the functional viability of the entire financial system? Are individual market participants very large – that is to say, too big to fail – or too closely interlinked with other market actors, meaning they are too connected to fail.
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> Second, can many smaller market participants collectively engender systemic risk given that they are exposed to similar risks – are they too many to fail? For instance, a sharp hike in interest rates could weigh on multiple credit institutions at the same time.

The objective of macroprudential oversight and regulation is to identify and contain such risks and misguided incentives. This can only be achieved by ensuring sufficient resilience in the financial system as a whole.

2. Key statements of the Financial Stability Review 2015

Against this backdrop, allow me to summarise the current situation in the German financial sector by outlining the key statements made in our report.

1. Low interest rates pose risks to financial stability as they squeeze banks' and insurers' earnings. Institutions could then assume greater risks without having sufficient capital buffers to be able to cushion the impact of these risks.
2. Dangers are also associated with an abrupt sharp hike in interest rates. Banks that, for instance, had granted long-term, low-yielding loans would then have higher funding costs.
3. The business volume in Germany's shadow banking sector has grown. We see no evidence of heightened risks at this time, however.
4. Macroprudential instruments are gradually being put in place. These instruments are intended to curb scale effects and procyclical effects. Instruments that can be employed to mitigate risks arising from mortgage lending are under development.
5. The European capital markets union will be an important complement to the banking union. Better developed and integrated equity markets, in particular, could play a role in improving the way in which risks are shared.

3. Low interest rates and financial stability

The current low interest rates are a global phenomenon. They reflect the low real economic growth and expansionary monetary policy stance observed around the world. Consequently, attention is currently focused on monetary policy decisions and their impact on interest rates. However, an expansionary monetary policy can also cause significant risks to financial stability to build up. Empirical studies have shown that monetary policy has an impact on the price of shares, bonds and real estate. The longer interest rates stay low, the more incentive market participants have to take greater risks. However, it can end up being a problem if misguided incentives cause risk premiums to drop to an excessively low level.

We have to meet these challenges in order to avoid a medium-term trade-off between monetary policy and financial stability. Such a conflict would give rise to the danger that, given the build-up of risks to financial stability, monetary policymakers would put off the appropriate normalisation measures for far too long – the precise effect of which would be to cause further risks to accumulate.

4. Risks in the German financial system

To answer the question of where systemic risks can arise in the German financial system, it is useful to take a look at interconnections within the system. Within the German financial system, the most pronounced interlinkages are between banks. My fellow Executive Board member Andreas Dombret will therefore give you a more detailed account of the situation in the German banking sector shortly.

However, it is not only banks but also insurers that play a crucial role in households' investment. Banks and insurers perform different functions in the financial system. Insurers obtain the majority of their funding through long-term premium payments. Banks derive their funding from short-term deposits and the interbank market, in particular.

At present, low interest rates are squeezing banks' and insurers' earnings. Persistently low interest rates would jeopardise the resilience of many insurers. The Life Insurance Reform Act, which came into force in August 2014, helped bolster their resilience. Low interest rates lead to high valuation reserves, but these are only paid out to a limited extent to policyholders whose policies are now lapsing, meaning that the reserves are retained for the remaining policyholders.

Added to this, dividend payments by insurers to owners are restricted. This, too, strengthens their equity and resilience. Profit transfers on the basis of intragroup profit transfer agreements are not affected by this restriction, however. Some life insurers did not actually conclude a profit transfer agreement with their parent company until 2014 with an eye to being able to distribute profits in spite of this restriction. In individual cases, this undermines the original objective of the moratorium on dividend payments.

The chart shows how many insurers would hold insufficient own funds based on various assumptions regarding future interest rate movements. In the baseline scenario, it is assumed that excess returns on insurers' bonds revert to their historical mean and that yields on Federal bonds, or Bunds, increase in line with market participants' current expectations. Only one insurer would be at risk in such a scenario. However, many life insurers would have insufficient own funds if Bund yields persisted at their current levels or if their excess returns were to additionally fall back to their all-time low.

What the scenario analysis also tells us is that there is time for the enterprises to make the adjustments needed to cushion the negative interest effects and to implement countermeasures. Additionally, the introduction of the new Solvency II regime next year will improve the disclosure of risks. While there is a 16-year transition period prior to full implementation of Solvency II, firms should not waste any time in setting aside adequate own funds against their risks. However, Solvency II tends to make insurers' capital requirements more procyclical. The risks this can cause will need to be monitored closely, since a solvency balance sheet focusing largely on market values as per Solvency II can produce a more volatile picture of insurers' resilience. This can have repercussions for insurers' investment policy. If, say, insurers attempt to increase their solvency ratio during crises, such endeavours can lead to fire sales, which might further accelerate the fall in asset prices.

Even what currently appears to be a rather unlikely scenario – that of interest rates climbing sharply within a short space of time – can pose a real threat to the stability of life insurers. This is because the regulations in Germany leave them with no option but to offer fixed surrender values for products paying guaranteed returns. Since life insurers invest the bulk of their customers' premiums in fixed-income securities, the market value of their investment is sensitive to interest rates, while surrender values are not. Thus, if interest rates were to suddenly climb sharply higher, that might be a rational reason for customers to lapse their policies. In a worst-case scenario, that might spark an upsurge in policy lapses. Surrender values that move in line with the market value of insurers' assets might be one way of eliminating this risk caused by regulation. For new policies, that would be possible without interfering in property rights.

5. Significance of the shadow banking sector

Improvements in the regulation of banks and insurers might act as incentives for agents to switch to unregulated territory. That is why action has been taken in recent years to improve surveillance over what are known as shadow banks. But that term is a little misleading because there's nothing "shadowy" about shadow banking entities. Just like banks in the traditional sense, they are part of the financial system and provide important services – funding investment and helping investors to diversify risk more effectively. But just like the traditional banking system, shadow banks can also be a source of risk. Areas of the shadow banking sector which had contributed to the financial crisis are currently dwindling in importance – securitisation, to name but one. That holds true not only for Germany but worldwide, too.

But at the same time, there are other areas of the shadow banking sector which are coming to the fore. Mutual funds are just one example. This shows that shadow banks are not operating in a "regulatory vacuum" because mutual funds are subject to the Capital Investment Code (Kapitalanlagegesetzbuch). Valuation effects are one of the key factors driving up the volume of assets managed by these funds. Inflows of capital prompted by changes in the regulatory setting in other areas and portfolio reallocations tend to be less significant.

Just like any other intermediaries, shadow banking entities can be systemically important on account of their size, interconnectedness or a co-movement of risks. The key metrics do not currently indicate an increase in risk. First, maturity and liquidity transformation in the mutual fund sector are stable for the most part. Second, leverage through the use of debt tends to be on the low side. Fund investments by insurers and pension funds are geared more to the long term, bringing a degree of stability to the mutual fund sector. Third, concentration levels within the sector are mounting, however. This means that the size of some individual mutual funds could make them systemically important. It is not least for that reason that we will continue to keep a close eye on the shadow banking sector and potential risks in the future.

6. Macroprudential instruments

Financial sector regulation has been improved since the financial crisis. One of the main thrusts of these new regulatory packages was to introduce instruments that curb the risk caused by the size and concentration of institutions – that is to say, instruments which tackle the too-big-to-fail problem head on.

- The Recovery and Resolution Act for banks came into force in Germany at the beginning of this year.
- Starting in January 2016, systemically important banks will need to build up additional capital buffers.
- As from 2019, global systemically important banks will have to maintain sufficient total loss-absorbing capacity, or TLAC, in the form of debt and equity capital, which can be tapped in a resolution or recovery event.

All these measures are designed to reduce the likelihood of larger institutions running into difficulties and to facilitate the recovery or resolution of a failing institution without the need for taxpayer support.

But smaller institutions, too, can be a source of risk if they are too interconnected and exposed to similar risks. The countercyclical capital buffer (CCB) will be added to the macroprudential toolkit in January 2016 in an effort to combat procyclical risk. Banks will be forced to step up their provisioning in times of excessive credit growth, thus bringing capital adequacy levels across the entire banking system into line with economic activity. In the current situation, however, there is no need to ask institutions to set aside more capital because there are no signs of excessively rapid lending growth.

Financial crises are often triggered by excesses in real estate markets. Up to now, Germany has not had any macroprudential instruments which directly address the lending relationship between the creditor and the borrower. This deficit prompted the German Financial Stability Committee, in June 2015, to recommend the Federal Government to create legal foundations for a set of new macroprudential instruments regulating housing loans. These instruments include a cap on the credit volume relative to the property value (loan-to-value, or LTV, ratio) and a cap on the borrower's debt servicing capacity relative to their income (debt-service-to-income, or DSTI, ratio). Our work on these instruments does not necessarily mean that they will be activated in the near future. We do, however, need to be capable of nipping any unwelcome developments in the bud.

7. The European capital markets union

Before I bring my remarks to a close, I would like to take a look beyond the realm of banking regulation. The banking union was without doubt a huge step forward in curbing risk and making it more manageable. But in a monetary union, financial stability hinges on other factors as well – the functioning of the European capital markets and the way in which they facilitate the distribution of risk.

At the current juncture, cross-border capital flows in Europe are largely made up of debt capital – bank loans, mostly. This is a source of risk. Debt capital flows are more prone to a sudden reversal than other capital movements. What is more, debt capital does not cushion enterprises against risk – except when they become insolvent. Equity capital, by contrast, absorbs losses and can make businesses more resilient, ultimately strengthening financial stability.

The planned capital markets union can help to dismantle barriers that are currently distorting businesses' funding structures and the capital flows in the European Union. It can improve the conditions for a more efficient distribution of capital and risk alike. Stronger growth and deeper integration across the markets for equity capital could be the key to sharing risk more efficiently and, in turn, bolstering the resilience of the financial system. That "double dividend" – more growth, and a more stable financial system – is something the capital markets union promises to deliver.