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1 Introduction

Germany's economy has been expanding for eight consecutive years now.

- Enterprises and households alike can borrow cheaply, and they have accumulated comfortable capital buffers.
- Banks, meanwhile, have built up their equity capital in the years since the crisis.
- Default numbers are low; valuations in the financial markets are high.

Market participants, encouraged by the rosy macroeconomic prospects for Germany and Europe, are expecting interest rates to slowly increase again.

So there's no reason to fear for the stability of Germany's financial system, then?

Assuming the economy does indeed follow its expected path, then, yes, the risks to financial stability will be limited.

But what if the economy takes an unexpected turn for the worse? How will the markets respond to an unforeseen slowdown in real economic momentum and to rates staying low for even longer? Or to the emergence of political risk and a spike in risk premiums in financial markets?

A “stable” financial system needs to be in a position to weather unexpected, but by no means wholly unrealistic, scenarios such as the ones I have just mentioned.

These are the questions we have to consider, then, if we are to identify risk early on and thus play our part in safeguarding financial stability in Germany.

All in all, it would be premature to see the benign economic prospects as any reason to sound the all clear. During the extended spell of low interest rates, risk has been growing in the German financial system in three respects.

1. Low interest rates and strong growth might cause risks to be underestimated.
2. Second, risks can be mutually reinforcing in the financial system.
3. And third, the resilience of the financial system might be overstated.

2 Low interest rates and strong growth might cause risks to be underestimated.

Germany’s economy is in good shape at the moment, and it’s not alone – the global economy, too, is expanding at a brisk pace. International Monetary Fund (IMF) projections suggest that the world economy will expand by 3.6% this year, compared with last year’s 3.2%, and indicate that this trend will continue in the years ahead. Market participants, bolstered by the current growth forecasts, are expecting interest rates to slowly start picking up again. A gradual upturn in interest rates would generally boost the stability of the German financial system.

- Life insurers and pension institutions would be more likely to be able to generate their contractually agreed guaranteed returns.
- Banks, meanwhile, would probably see their interest margins recover.

But it is precisely this already very lengthy upbeat economic spell in Germany that harbours the risk of market participants turning a blind eye to scenarios involving heavy losses. The longer booms persist, the greater the inclination to extrapolate them

into the future. Gaze into the rear view mirror like this for too long and there is a risk of overlooking hazards on the road ahead.

That's because there are other scenarios which could hit Germany's financial system hard. The markets have become more vulnerable to unforeseen events.

One risk scenario is a faster-than-expected upturn in interest rates. For instance, risk premiums in international financial markets might shoot higher all of a sudden.

A rapid increase in interest rates would drive up funding costs and might hit banks where it hurts, seeing as the terms and interest rate lock-in periods of bank loans have been extended in recent years – indeed, 44% of loans for house purchase now have lock-in periods of more than ten years. An abrupt increase in interest rates would put pressure on banks – their funding costs would go up, and their interest income would rise at a slower pace initially.

An abrupt rise in interest rates would also send valuations down from their current high levels and thus cause losses.

That scenario of persistently low interest rates would amplify the search for yield, with banks and other market participants taking on greater risks in an effort to keep their profits steady. Life insurers and pension institutions would find it increasingly difficult to generate enough income to cover the guaranteed returns they have promised to pay.

If the real economy takes a worse path than expected, that would also drive up the number of insolvencies. Insolvency numbers have almost halved in the past years, dropping from just over 39,300 in 2003 to a little more than 21,500 last year. To put that into proportion, given that there are just over 11,000 municipalities in Germany, that's an average of less than two insolvencies per municipality. Judging by those numbers, it's no surprise that credit risk at banks is minimal.

Low default rates on loans are welcome news, all other things being equal – but let's not forget that they are a backward-looking indicator. Future developments are what counts for the stability of the financial system. Larger banks use risk models of their own to estimate those risks and quantify their capital requirements. There is the danger, then, that banks might underestimate the risks which might arise if economic activity were to take an

unexpected turn for the worse. They might, in turn, also underestimate how much capital they need to set aside.


3 Risks can be mutually reinforcing in the financial system

Every market participant needs to hedge against negative scenarios – by making sure that they put enough capital into any investment and basing expectations on the most realistic scenarios possible. But what happens when risk materialises which the individual cannot readily grasp, when risks become mutually reinforcing in the system?

Contagion effects can arise in the financial system whenever market participants are contractually highly interconnected or investment strategies are very similar. In that situation, a relatively minor shock can send tremors through the entire financial system.

Allow me to use **two examples** to illustrate what I mean.

- First, risks stemming from an interest rate hike, revaluations in the markets and increased credit losses could materialise simultaneously. Asset values might plunge; write-downs would erode equity. And, in particular, credit risk could increase if economic activity in Germany were to unexpectedly begin to splutter.
- Let's now turn to my second example. One of the German banking system's fortes – its large number of smaller credit institutions operating directly within the regions in which they are based – might undermine stability precisely when interest rates climb more briskly and more strongly than anticipated. The bulk of Germany's smaller credit institutions – its credit cooperatives and savings banks – are highly exposed to interest rate risk. Small though these institutions may be individually, together they account for a significant share – roughly 50% – of lending to domestic enterprises and households. If those institutions were to run into difficulties, then, the repercussions for the economy as a whole could be severe.



As these two examples show, the financial system needs to have sufficient buffers in the form of equity capital to be able to absorb even unexpected events, which can become mutually reinforcing in the system.

4 The resilience of the financial system could be overstated

German enterprises are better capitalised than they have been in a long time – the average capital ratio is 30%, and interest payments on loans stand at just over 5% of pre-tax profits. Household debt as measured against disposable income currently comes to around 90% and has remained virtually unchanged over the past few years, despite the low interest rates.

The situation is less positive at the global level. At 144% of GDP, private sector debt around the world is higher than its pre-crisis level (2007: 125%). This trend is explained, not least, by increased leverage in the corporate sector, particularly in emerging market economies.

However, low interest rates and a sound economic position mean that market participants could be taking an overly positive view of debt sustainability. Take, for example, the German housing market.

The real estate market in Germany is important to the economy as a whole. Lending for house purchase accounts for over two-thirds of household debt. More than half of all loans granted by German banks to non-banks are housing loans.

Experience in other countries has shown that if a real estate bubble accompanied by a strong build-up of household debt bursts, significant economic and social costs can come in its wake. We therefore keep a very close eye on risks to financial stability that can emanate from the housing market. What is particularly important here is the interplay between three indicators:

- changes in real estate **prices**;
- the **granting of loans** for house purchase; and

- **lending standards.**

Strong price rises alone are not evidence enough of a build-up of risks to financial stability.

The current situation in the housing markets paints a mixed picture.

- **House prices** are rising – and, at 6.1% in recent times, they are picking up much more strongly than prices across the board. A large part of this price increase can be explained by fundamental factors such as the healthy state of the economy or higher demand. That said, our models are unable to explain around 15-30% of the price rise in cities in 2016. In 2015, this unexplained portion came to 10-20%.
- Growth in **loans for house purchase** is moderate. Loan growth currently amounts to 3.9% and is thus lower than its long-term average since the early 1980s of 4.8%.
- We do not have sufficient official statistics on **lending standards** or the distribution of debt across the population. However, the available indicators give no suggestion that standards were loosened perceptibly or that household debt sustainability has deteriorated.

All in all, the risks stemming from housing loans are therefore still relatively low, and the information available does not indicate any direct risks to financial stability. There is thus no need to make use of the macroprudential instruments available from this year – these being minimum requirements for own funds (loan-to-value ratio) and for amortisation.

Nonetheless, there is a risk that lending activity in the real estate markets will prove unsustainable in future. This could be the case if interest rates rise or there is a turnaround in price dynamics. Loan collateral would then lose value.

What this means is that we will continue to closely monitor the residential real estate market. But to gain a better understanding of changes in lending standards, we need better official statistics. Furthermore, we cannot lose sight of the fact that our assessment of the situation may change in future.

5 What needs to be done?

Greater capital levels have been built up over the past few years, both in the German financial system and in the banks at its core. At the same time, though, the extended spell of low interest rates has left the system more vulnerable to unexpected developments. It is possible that the assessment of future economic developments and debt sustainability is overly positive, while contagion effects in the financial system could be understated.

There is thus no reason to sound the all clear. Sufficient resilience and sustainable loans are in the interest of each and every market participant. In this context, we have to look at the stability of the financial system as a whole.

Since the financial crisis, reforms have been initiated – the impact of which is now gradually making itself felt in the markets. More capital and the financial system's improved resilience to negative developments are a stated objective of these reforms. We can now begin evaluating the effects of the reforms. Have they achieved their objectives? Do the reforms bring with them unintended side-effects?

Under Germany's G20 presidency, which will come to an end in the next few days, we have made considerable progress. Together with our international partners, we have agreed on a framework for a structured evaluation of the reforms. Sound and reliable information and data are at the heart of each evaluation. This is why it's so important for us to close the gaps in the housing data in Germany.

A structured evaluation is the only way to gauge the costs and benefits of the reforms to society at large. Let me give you an example. The costs of failures in the financial system should be borne by those who cause them – the shareholders and potentially also the creditors of financial institutions – rather than by the taxpayer. The agreed rules for bank resolutions therefore have to be rigorously applied – and creditors have to bear losses in a resolution. There may be increased costs for the private sector, but society benefits when the costs of crises are shouldered by those who cause them.

A second example of the implementation and evaluation of reforms is capital add-ons for systemically important financial institutions. At present, the macroprudential add-ons imposed on the capital of institutions that are systemically important to the do-

mestic market are limited by European rules to a maximum of 2%. Yet the resulting capital buffers could be insufficient to actually cover systemic risk.

Evaluation therefore means making the costs and rewards of the reforms for society as a whole more transparent and disclosing any unintended side-effects. The evaluation of the reforms should not be used as a pretext to water them down or weaken the resilience of the financial system.

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