DEUTSCHE BUNDESBANK
EUROSYSTEM

Consistency as a mandate

Speech at the ceremony to commemorate "250 years of the Pfandbrief"

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1 Introduction

Dr Hagen, Ms Lambrecht, ladies and gentlemen,

Many thanks for inviting me. It gives me great pleasure to be with you today.

Last week, a new exhibition opened at the German Historical Museum here, dedicated to Wilhelm and Alexander von Humboldt. Wilhelm, the older of the two brothers, is supposed to have said: "Only those who know the past have a future." It is therefore worthwhile to take a look back at the past.

We have already learned much today about the genesis of the Pfandbrief. Just over two weeks after Frederick the Great issued the cabinet order which paved the way for the Pfandbrief, Wilhelm's brother Alexander, whose thirst for adventure and knowledge holds us in thrall even today, was born.

Alexander von Humboldt was much more than a polymath and scientist. He was also a daredevil for whom no risk was too great. On the long boat trip along the Orinoco and Rio Negro rivers, his boat capsized twice in waters infested with crocodiles and piranhas. In the Andes, too, Humboldt narrowly escaped death when, next to him, a wall of snow suddenly broke off and plunged into an abyss. [1]

The other birthday celebrant has no such tales of derring-do to offer. The Pfandbrief is less about daredevil adventures and more about consistency and soundness. In this respect, it shares a similar fate to the Bundesbank: both are regarded as being rather dull.

Boredom is less desirable for a festive occasion such as this, but all the more so for Friedrich Nietzsche, to whom boredom was a precondition for original thought and productive action. [2]

Central bankers do not find boring to be all that bad, either. As former Bank of England governor Mervyn King used to put it, "boring is best". With a view to predictable monetary policy, he explained that "a successful central bank should be boring". [3]

As regards the Pfandbrief, a reputation for being boring is at once a compliment and a seal of confidence. Once money is put on the table, many lose their lust for adventure.

2 The Pfandbrief as a model of success

Let me begin with this question: what is the recipe for the success that the Pfandbrief has enjoyed over such a long life?

Its unique selling point is undoubtedly its high level of security: Pfandbrief holders enjoy two layers of protection against default. That is like circus acrobats who are protected by a net and a safety line – or someone who wears both a belt and suspenders.

Not only is the issuer liable, but the Pfandbrief is also covered by a pool of assets subject to statutory quality standards and conservative measures of value. If the issuer becomes insolvent, the Pfandbrief holders have the right to the cover pool, access to which is denied the other creditors.

This double layer of protection comes with a further advantage: as the cover assets remain on the issuer's balance sheet, it is in the issuer's own best interest to avoid a creditor default and to handle risk-relevant information carefully. Experts refer to this as having "skin in the game". [4] The expression illustrates that, in the event of a default, the issuer will not get away with his skin intact.

This mitigates the moral hazard of issuing loans without performing due diligence on clients and sufficiently monitoring them. This incentive problem is often seen as one of the factors leading to the onset of the sub-prime crisis in the United States. [5] Pfandbriefe can therefore make an important contribution to financial stability. On the other hand, it is also possible that, in extremis, the issuance of covered bonds can get out of hand.

What is good for the Pfandbrief holder can put the other creditors of a bank at a disadvantage: the more covered bonds an institution issues, the more collateral is set aside to cover them – and the smaller the quantity of unencumbered assets available to cover the rest of the bank's creditors. [6]

Such asset encumbrance must always be kept in mind. (mindestens) This is why transparency is decisive, and institutions are required to disclose their holdings of encumbered assets. However, the Bundesbank does not believe that regulatory intervention, such as by setting a cap on asset encumbrance, is necessary.

What the topic shows us is this: the security of the Pfandbrief is not necessarily identical to the security of the issuer. And, during the financial crisis, individual issuers did, in fact, encounter severe distress. This was due, not least, to attempts to use short-term funds to finance long-term business. However, not a single Pfandbrief defaulted. This is why Jean-Claude Juncker has found that "[c]overed bonds have proved themselves to be a reliable and stable form of financing, particularly during the financial crisis". [7]

3 Monetary policy

Ladies and gentlemen,

The Pfandbrief has taken on a greater role in monetary policy implementation in the euro area since the financial crisis. The Eurosystem has launched three purchase programmes for covered bonds over the past ten years.

The first two programmes were intended to help restore liquidity in a market segment important for bank funding. Both had a limited volume and duration and were terminated on schedule.

In that respect, they differ from the third purchase programme, which was launched in October 2014 with the intention of easing the monetary policy stance. In 2015 it became part of the broad asset purchase programme, or APP, under which the Eurosystem also buys corporate bonds, asset-backed securities and government bonds. The total volume now comes to more than €2.6 trillion. And the volume has been growing again since November, as the Governing Council of the ECB decided to recommence net purchases. Bond holdings are now being increased at a monthly pace of €20 billion.

The purchase programmes have helped prevent the crisis from escalating and have played a role in the euro area's economic recovery. They can, however, have undesirable side effects as well. [8]

While combating the crisis, monetary policy in a sense followed in the footsteps of discoverers and explorers such as Alexander von Humboldt. Central banks ventured into what was until then largely uncharted territory, armed with a raft of non-standard measures, and are still in the process of exploring this new monetary policy landscape.

It would be premature to make a conclusive judgement about the purchase programmes today. There has been too little research into the longer-term effects of non-standard monetary policy, in particular. Recently, my colleague on the Governing Council, Luis de Guindos, rightly called for a greater focus on the side effects in future. And for a long time now, I have untiringly pointed out this precise issue.

When it comes to the APP, my main criticism is of the purchase of government bonds in the euro area. The Eurosystem central banks have now become the countries' biggest creditors. This threatens to blur the line between monetary policy and fiscal policy.

Additionally, the risks to financial stability may increase as the period of ultra-loose monetary policy continues. The very low risk-free interest rates make riskier investments more attractive in relative terms. Many investors on the search for yield may probably be willing to take on more risk, and may rebalance their portfolios accordingly.

The impact of non-standard monetary policy measures relies to a certain extent on this portfolio rebalancing by market participants. It ensures that the expansionary stimulus provided by monetary policy is also transmitted to those areas of the financial system where the central bank is not directly active. [9] However, it may become a problem if market players take on more risk than they can bear.

4 Financial stability

Here in Germany, this issue is being discussed not least with a view to the property market. Since 2010, house prices have risen extremely steeply: by just under 60% nationwide and even by close to 80% in urban areas. Healthy economic growth and low interest rates are likely to have been key drivers of this. And both probably owe something to the accommodative monetary policy.

However, the price rise in German cities was much stronger than appears justified by longer-term economic and demographic factors. As Bundesbank estimates show, residential real estate in those areas was overvalued by between 15% and 30% last year. [10]

Now, elevated valuation levels do not represent a threat to financial stability per se – despite the potential for a setback. Risk can build up in the property market mainly if there is a sharp rise in loans alongside prices, and banks significantly ease their lending standards at the same time. There is no sign of such a spiral in Germany at present, however. [11]

But buildings and land also serve as collateral for the stock of loans. In Germany, roughly half of the bank loans granted to the private non-financial sector are collateralised with real estate. As a result, overvaluations in the property market could mean that banks overestimate the recoverability of their loan collateral.

What is more, the long economic upturn in Germany has meant that borrowers generally have better creditworthiness and fewer loans default. Consequently, banks have been able to scale back their provisioning for credit risk. Risk provisioning is at a historically low level today, and thus reflects the exceptionally favourable economic developments of the past. On the other hand, future credit risk could be underestimated.

All things considered, the German financial system has become more vulnerable to a scenario in which the economy experiences an unexpected downturn rather than simply treading water for a time, as is the case now. In such a scenario, more loans could default again while collateral loses value at the same time. And because of the low level of risk provisioning among banks, the ensuing losses would hit equity capital sooner.

In order to stabilise their tier 1 capital ratio, the affected banks might restrict lending. And if a large number of banks simultaneously respond in this way, financing terms would deteriorate further and the economic downturn would be exacerbated. So, we are dealing here with cyclical risks that are closely intertwined and could serve to reinforce each other.

“Everything is interaction.” Although that sentence could well have featured in our Financial Stability Review, which we presented last week, it was in fact written by Alexander von Humboldt back in 1803. [12] Humboldt always took a holistic view of the world, seeking to understand the interactions around him in order to see the big picture. This is rather like central bankers and supervisors analysing financial stability as a whole rather than individual institutions.

Action was needed from a macroprudential perspective, and Germany activated the countercyclical capital buffer for the first time in July. This ensures banks build up additional reserves when times are good and thus boosts their resilience to periods of stress. When times are bad, supervisors can lower the buffer again so that banks can then use this leeway to cover their losses. In other words, the countercyclical capital buffer has a stabilising effect and helps the banking sector to better absorb shocks.

5 Green finance

Ladies and gentlemen,

Risks, interactions and keeping sight of the big picture are critical factors when it comes to another topic, too: climate change. When Alexander von Humboldt witnessed the environmental damage caused by plantations on his travels in Venezuela, he was able to join the dots and warned of the human impact on the environment and its consequences for future generations. In particular, he noted the important role played by the forest in cooling the air, storing water and protecting against soil erosion. [13]

Climate change is a challenge that we all face. Christine Lagarde, President of the ECB, has said that all public and private institutions should act, within their mandates, to address it. [14]

The first “Grüner Pfandbrief” was issued back in 2015, even before the Paris Agreement was signed. Without wanting to flatter, it is now safe to say that this product innovation, which was designed to finance energy-efficient buildings, was a little ahead of its time.

The green bond market as a whole can make a substantial contribution to financing environmentally friendly projects. In Germany, sustainable investment has risen by over 70% in the past four years. What is more, strong market growth can be observed globally as well. [15] And yet the role played by green finance remains fairly small. Green bonds account for only just 2% of the international market as a whole. In other words, green finance probably still has considerable potential.

A key requirement here is a clear, generally accepted definition of what “green” and “sustainable” actually mean. This could also strengthen confidence in green finance, as it would counteract the effect of “greenwashing”. What this means is that a financial product is, for example, marketed as being green without actually being environmentally friendly.

A variety of standards and principles aimed at preventing such deceptive labelling and providing investors with clarity already exist. Expanding on this, the European Commission is currently working on its own classification system. This taxonomy will make it possible to classify sustainable financial products in a way that is uniform, clear and reliable. It is the centrepiece of the EU’s Sustainable Finance Action Plan and is intended to serve as a reference framework for investors so that Europe can reach the climate goals set as part of the Paris Agreement.

Central banks are also keeping these goals in mind. (mindestens) For us, this means accompanying the greening of the financial system, and it involves various areas of central bank activities.

We need to better understand the economic implications of climate change and factor these into our monetary policy analyses. For example, the growing frequency of extreme weather events could make inflation and growth rates more volatile or curb potential growth.

Furthermore, climate change or the transition to a low-carbon economy could cause risks in the financial system to emerge, as underlined by the Bundesbank in its latest Financial Stability Review. Macroprudential supervisors need to make sure that the financial system is also able to withstand these kinds of threats.

At the same time, banks need to take adequate account of climate-related financial risks in their risk management. If financing environmentally harmful projects were to become less attractive as a result, that would be a welcome side effect. In this context, central banks are needed in their roles as banking supervisors and are currently hard at work at the methodically challenging task of conceptualising possible climate stress tests.

But climate-related financial risks can also affect our monetary policy asset purchases. At longer maturities, in particular, climate factors could influence the default risk of corporate bonds. Insofar as they are quantifiable, these ramifications should be analysed and factored in.

It is, first and foremost, up to the rating agencies to continue expanding their analytical toolkits so as to also take adequate account of the climate-related determinants of default risk. The prerequisite here is transparency.

Our monetary policy asset purchases need to continue to be in line with the principle of market neutrality – this is derived from the EU treaties and our narrow monetary policy mandate.

A monetary policy which pursues explicitly environmental policy objectives runs the risk of overextending itself. With that in mind, Chair of the Federal Reserve Board Jerome Powell recently told Congress: “Climate change is an important issue but not principally for the Fed. […] That is for elected officials, not us.” [16] Democratically legitimate politicians need to decide on the tools to be used by our society to combat climate change – and it is also their responsibility.

The Bundesbank can support policymakers in this endeavour, as we manage the assets of various public authorities. We actively assist the public sector in “greening” its portfolios. Several of those public authorities have already explicitly incorporated sustainability clauses into their investment strategies. Our financial market experts have provided them with conceptual support and are in charge of putting these strategies into practice.

Only recently, the Network for Greening the Financial System, or NGFS for short, published the Sustainable and Responsible Investment Guide for Central Banks’ Portfolio Management. The NGFS now consists of more than 50 central banks and supervisory authorities spread across five continents who discuss how the financial system’s contribution to the objectives of the Paris Agreement may be strengthened. The Bundesbank is one of the founding members of the NGFS. International cooperation, such as this, is imperative for climate action.

6 Capital markets union

The value of cross-border cooperation became evident even during Alexander von Humboldt’s first expedition. His five-year-long trip of America was a research undertaking which succeeded only due to the involvement of the French doctor and botanist Aimé Bonpland. And upon his return from Russia, Humboldt founded an association – an international network, if you will – to study the Earth’s magnetic field. [17]

In the case of the Pfandbrief, at least, the European perspective is absolutely essential. This year, for instance, a legislative framework for covered bonds in the EU was adopted, ensuring a minimum level of harmonisation based on two building blocks. Not only does this piece of legislation introduce the “European covered bond” seal of approval, it also flags a premium segment to which the Pfandbrief of course belongs.

The harmonised definition aims to promote the stronger use of covered bonds as long-term sources of funding across Europe, enabling investors to reap the benefits of these debt securities on a larger scale. Because the markets for covered bonds are not all as well developed as they are here. All this may well provide the German Pfandbrief with a further impulse of internationalisation, following the initial surge when the Jumbo Pfandbrief was introduced in 1995.

At this point, I would like to add the following remark: The fact that the Pfandbrief became – in Dr Hagen's words – an "export hit" is not solely attributable to the product itself. It is also a great achievement of the Association of German Pfandbrief Banks, or vdp, and its sustained efforts at the national and international level.

The EU framework for covered bonds and the aforementioned taxonomy for sustainability are two steps towards a real capital markets union. However, it appears that Europe still has obstacles to overcome on its way to better access to funding and a wider dispersion of risk in the private sector.

In my view, the area of insolvency proceedings could be key to a deeper integration of the European capital market. This area still lacks a harmonised approach – not least because it is often closely intertwined with other aspects of national law.

A complete harmonisation of insolvency proceedings is therefore rather unrealistic. However, maybe that is not necessarily what is called for. Much the same as the covered bond framework, minimum requirements across Europe would be a pragmatic first step.

A clear and sound legal basis for securities, in particular, is important if we want to protect issuers and investors. This has also stood the Pfandbrief in good stead.

Time and again, the Pfandbrief has been able to adapt to new circumstances and overcome challenges over the years. But amidst all the change, it was essential that the Pfandbrief stayed true to its core brand concept, which was to provide the necessary security for long-term funding and investment. Going forward, this consistency will continue to be crucial.

7 Conclusion

Ladies and gentlemen,

Do you remember the saying? "Only those who know the past have a future." I would therefore like to end my speech where it all began, in 1769.

When Frederick the Great issued his forward-looking cabinet order, the world had already been looking skyward for some days: The night sky revealed something so remarkable that copper engravings were made to capture the event. What people saw was a large comet with an impressive tail that caused a sensation even beyond Europe. China's royal astronomers as well as explorer James Cook, who was sailing the South Pacific at the time, reported sightings.

The data compiled from all the different observations allowed scientists to calculate the orbit of the comet. It is travelling on a very long elliptical path around the sun. In 1769, it came particularly close to the sun, which meant that it was easily visible from Earth. We will probably have to wait a millennium and a half to witness the next one.

I hope the Pfandbrief shows just as much perseverance and wish its makers every success!

Thank you for your attention.

Footnotes:

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