DEUTSCHE BUNDESBANK
EUROSYSTEM

Financial Stability Review 2014

Overview

Overview

The situation in the international financial markets in 2014 has been marked by low interest rates, accompanied by the provision of ample liquidity by central banks. In Europe, in particular, the expansionary monetary policy is a response to low inflation in what is overall a weak economic setting. Much of this weakness is due to structural problems. However, these cannot be solved through monetary policy measures but solely through appropriate reforms. While those European countries that have launched structural reforms are seeing clear signs of real economic recovery, some core euro-area countries are making only sluggish progress in implementing the necessary reforms. The need to consolidate public budgets in the light of high government debt levels has been repeatedly called into question. However, it is the core task of economic policy to enhance the conditions for real economic growth.

A major reform with respect to financial stability was the launch of the European banking union. Activities in 2014 have focused on creating the requisite institutional and organisational framework. One of the central pillars of the banking union is the Single Supervisory Mechanism (SSM), which commenced operations on 4 November 2014. This entailed the transfer of extensive microprudential and macroprudential powers to the European Central Bank (ECB).

Getting the banking union off to a credible start and creating sustainable structures in the European banking sector are key to winning financial markets' trust. While euro-area banks' total exposure to euro-area borrowers has dropped from 191% to 168% of gross domestic product (GDP) since the financial crisis erupted in 2008, adjustment has been uneven across countries. Hardly any adjustment has occurred in the euro area in the form of a market exit of (larger) banks.

Getting the banking union off to a credible start and creating sustainable structures in the European banking sector are key to winning trust.

A first step towards enhancing confidence in the banking sector was the comprehensive assessment carried out by the ECB and comprising an asset quality review of 130 euro-area banks and a stress test. A key objective was to create transparency prior to the launch of the SSM, to detect any legacy problems and capital shortfalls and to enable the necessary adjustments to be made. The ECB's comprehensive assessment confirmed that the balance sheets of the 25 participating German institutions are sound and that these banks are robust enough to withstand a simulated severe economic shock. Only one German bank had a capital shortfall as at 31 December 2013; however, this bank has significantly strengthened its capital base over the course of 2014, thus plugging the identified gap. Despite this positive outcome, German banks should nonetheless continue their efforts to improve both their capital cover and their profitability, not least in view of the fact that they are still lagging behind other European countries in terms of their leverage ratio.

Signs of riskier investor behaviour

The currently low interest rates, along with low volatility in the markets, are prompting an intensified search for yield. There is a danger that investors may be willing to take greater risks. Although searching for a higher yield represents normal investor behaviour, such behaviour can become problematical and jeopardise the functioning of the financial system if investors fail to maintain adequate risk buffers. Ensuring that banks have an adequate capital base makes a key contribution to the stability of the financial system. In addition, it must be assured that investment decisions are not distorted by regulations or by implicit government guarantees.

There are signs that the search for yield is leading to exaggerations in certain market segments. The first chapter of this Review, entitled "Low interest rates – risks to financial stability?", reveals that investors have increasingly been incurring risks during the current phase of low interest rates, which has persisted for some years now. This effect is clearly perceptible in the markets for corporate bonds and syndicated loans. The indications are less pronounced in other markets.

There are signs that the search for yield is leading to exaggerations in certain market segments.

Enterprises are increasingly tapping non-bank funding sources, which suggests that structural adjustments are occurring in the German financial system. For instance, firms are now obtaining funding by borrowing from non-banks and have recently stepped up their bond issuance. In addition, small and medium-sized enterprises (SMEs), in particular, have been increasingly retaining their earnings, thereby strengthening their capital base, in some cases significantly. For one thing, this improves the ability to finance innovation; for another, equity is a better buffer against shocks than debt as equity investors participate directly in an enterprise's profits and losses. The broader the investor base, the more potential losses are spread over a larger number of shoulders.

However, recourse by enterprises to new sources of debt finance concurrently carries the danger that risks might build up outside the banking sector and jeopardise systemic stability. In response to this, the supervisory and regulatory authorities are monitoring such developments, setting up additional reporting schemes and, where necessary, taking regulatory initiatives. Yet it is ultimately up to investors to hold sufficient capital as a buffer during possible periods of stress and to align their expected returns with real economic developments.

German banks and insurers have largely resisted the temptation to incur greater risk. In particular, they have not significantly increased their investment in lightly regulated vehicles such as hedge funds and credit funds. Banks have tended to de-risk, while insurers, on the whole, have pursued cautious investment strategies. During the financial crisis, it was particularly risks resulting from lending to non-residents which put a strain on German banks. As a result, German banks considerably reduced their exposure to foreign obligors. On the whole, however, the German financial system is still closely interconnected, particularly with other euro-area countries.

German banks' capital ratios higher despite weak earnings

Against this backdrop, the chapter entitled "Risk situation in the German financial system" discusses the resilience of German banks and insurers. In the past few years German financial institutions have set up additional provisions for future risks. The aggregate tier 1 capital ratio of all German banks, measured in terms of their risk-weighted assets (RWA), rose from 8.9% in March 2008 to 15.3% in December 2013. Over the same period, German banks raised their capital ratio in relation to total assets from 4.8% to 5.8%, thus lowering their leverage. Tighter regulatory capital requirements and preparations for the ECB's comprehensive assessment programme played a major role in prompting banks to strengthen their capital base.

The Bundesbank has analysed the banking industry's resilience under various macroeconomic stress scenarios. These simulations show that, although losses arising from an abrupt rise in short-term interest rates as well as from an adverse housing market scenario would cause profits to drop considerably, the individual occurrence of such events would be manageable. However, experience has shown that macroeconomic risks generally do not occur singly. A cumulation of risks could pose problems for the German financial sector.

German banks' profitability remains structurally weak. They therefore remain vulnerable to financial market shocks and to a protracted phase of low interest rates. If interest rates remain depressed for the foreseeable future, banks' earnings could come under heightened pressure: higher-yielding loans will then have to be rolled over into lower-yielding loans, thus reducing net interest income. To make matters worse, banks would not be able to offset falling lending rates by further cutting deposit rates, which at many banks are already close to 0%.

German banks' profitability remains structurally weak.

Whereas business trends in the German insurance industry have been very positive on the whole, particularly life insurers are affected by low interest rates owing to their high guaranteed payments. For instance, while their own funds have remained constant, the regulatory own funds requirements have been raised. This results overall in a lower solvency ratio. Moreover, the German insurance industry is in the midst of adjusting to a new regulatory regime (Solvency II) which, irrespective of other things, is forcing them to reinforce their capital base.

Life insurers are affected by low interest rates owing to high guaranteed payments.

Mortgage loans under observation

Financial crises have often been triggered in the past by exaggerations on real estate markets. The chapter entitled "Mortgage loans under observation" examines to what extent there are signs in Germany of an overexpansion of residential mortgage lending and of an easing of credit standards. The Bundesbank's analyses show very few signs of procyclical behaviour by banks or of a destabilising nexus between mortgage lending and property prices. However, it is striking that, in the towns and cities under consideration with sharply rising housing prices, a large share of mortgages have a German sustainable loan-to-value ratio (*Beleihungsauslauf**) of over 100%. This points to structural vulnerabilities in the German banking system to urban real estate market risks.

It is striking that, in towns and cities with sharply rising housing prices, a large share of mortgages have a sustainable LTV ratio of over 100%.

It therefore remains necessary to monitor potential systemic weaknesses, to take any regulatory countermeasures that may be necessary and to chart the appropriate course for a sustainable development of the banking system in Germany. The establishment of a Financial Stability Committee (FSC) in Germany in 2013 created an institution which is intended to ensure the coordinated monitoring of threats to financial stability. The FSC regularly discusses financial stability risks in Germany and has focused to date on developments in the German housing market and the situation of German life insurers and credit institutions. The analyses for the FSC are prepared by the Bundesbank and *inter alia* cover the issue of whether any potential risks to financial stability can

* *Beleihungsauslauf* is the German term used to express the ratio of a loan to the mortgage lending value of a property. It is intended to reflect the sustainable value of a property and is generally calculated by means of a haircut on the market value.

be contained by using macroprudential instruments. Since the impact of these instruments is usually lagged, they must made available in a timely fashion and be capable of preventive deployment if need be. High-quality data are a precondition for analysing and assessing measures. The Bundesbank is therefore working on improving the availability of data for macroprudential analyses.

Enhancing confidence in the financial sector

Events in the autumn of 2014 showed how quickly an apparently tranquil situation in the financial markets can transmute into heightened market turbulence. Some markets began to display price volatility as a result of increased uncertainty about future market and economic developments. Doubts about the consolidation of government finances in faltering economies contributed to the volatility. Uncertainty is part of the normal market processes. However, one cause of uncertainty is that, although the legal basis has been created for many reforms, such as the new rules on national budgetary policy or banking union, it has not yet been tested in practice.

It is therefore a policy task to ensure that the new institutional rules are applied rigorously and that confidence in the European financial sector is further strengthened. The ECB's comprehensive assessment, which was designed to reduce uncertainty about the assessment of banks and detect any potential risks, was a key step towards that objective. It has emerged that disclosing risks on banks' balance sheets and driving forward the necessary structural change in the banking sector can foster growth in the real economy. In particular, it should be made possible for banks without a sustainable business model to exit the market.

Disclosing risks on banks' balance sheets and driving forward the necessary structural change in the banking sector can foster growth in the real economy.

Banking union will strengthen liability of shareholders and creditors

The loss risks disclosed by the comprehensive assessment, should they materialise, will have to be borne at the national level. A decisive difference compared with earlier stages of the crisis is that, from 2015, harmonised European legal procedures for restructuring and, if necessary, resolving distressed banks will be introduced with the Bank Recovery and Resolution Directive (BRRD). This new institutional framework is discussed in the chapter entitled "Implications of the banking union for financial stability". A centrepiece of the new rules is the bail-in instrument, which as part of the BRRD has to be transposed into national law by 2016 at the latest. In a bail-in event, shareholders and creditors will in future have to bear part of a bank's recovery or resolution costs according to a clearly defined liability cascade.

Shareholders and creditors will in future have to bear part of the recovery or resolution costs.

The use of fiscal resources to resolve banks can only be a last resort and should be employed, if at all, solely as a stopgap measure. Government support must be in the public interest and be granted solely to avoid systemic crises. As a general rule, fiscal resources will come into play only after recourse has been taken to shareholders, creditors and the Single Resolution Fund (SRF), which is funded by contributions from European banks. In the medium term, the use of public resources should therefore no longer be necessary. Until the SRF is fully funded and operational, the provision of national fiscal backstops can contribute indirectly to giving sustainable credibility to an extensive bail-in of the private sector.

The bigger the bail-in of a bank's shareholders and creditors, the smaller any recourse to the national backstop will need to be.

Discretionary scope regarding bail-ins should be limited

There is no automatic guarantee that the new rules will achieve their desired effect through their adoption alone. Ultimately it will require the political will to apply them rigorously and to hold private creditors liable. The fact that the authorities have been given a certain amount of discretionary scope could prove problematical. A bail-in of creditors may be waived if it would jeopardise the stability of the financial system. The authorities responsible for bank recovery and resolution face a conflict of interest. On the one hand, rigorous implementation of creditor liability could threaten the stability of the financial system if contagion effects emerge at central nodes of the system. On the other hand, any exception to creditor liability increases the likelihood of recourse to the public purse. The discretion to waive the bail-in rule must be used responsibly; otherwise, there is a danger that the necessary process for resolving banks will not be introduced at all and that the task of tackling structural problems will be put off indefinitely.

The new bail-in rules have yet to be tested. It would be desirable to introduce them ahead of schedule in other countries, too, as is envisaged for Germany. This would help not least with any required recovery and resolution of internationally active banks prior to 2016.

Exceptions to the principle of creditor liability should be minimised, particularly to enhance confidence in the functioning of the new rules and to reduce uncertainty. Exceptions that are invoked to ostensibly protect the financial system but in effect merely serve to protect individual creditors or groups of creditors will create moral hazard. Although, in principle, there are rules governing who is to pick up the bill if exceptions to creditor liability are granted, it is uncertain whether the rules will be able to be applied as envisaged under time pressure in an actual resolution event. For this reason, too, the bar for exceptions should be set high. Otherwise, growing stability risks could arise in the future under the guise of protecting systemic stability.

Exceptions to the principle of creditor liability should be minimised.

Rigorous application of the new rules for dealing with distressed banks could take pressure off other policy areas. In order to be effective, monetary policy needs a healthy financial sector. At the same time, the task of resolving structural problems in the financial sector exceeds both the mandate and means of monetary policy. Since, following the launch of the banking union, the ECB is now responsible for both monetary policy and banking supervision in the framework of the SSM, it must be ensured that monetary policy mandates and instruments are clearly segregated from microprudential supervision and macroprudential oversight. It is important for monetary policy to remain independent of prudential supervisory considerations. This is especially crucial given that, under the existing legal framework, the banking union has complex decision-making structures, making it difficult to establish a clear separation of institutional responsibilities for individual tasks.

Rigorous application of the new rules for dealing with distressed banks could take pressure off other policy areas.

Preferential regulatory treatment of sovereign exposures should be ended

One of the avowed aims of the banking union was to sever the close ties between banks and sovereigns. However, it will only partially achieve this objective. Introducing a loss bail-in for banks' shareholders or creditors will lessen the likelihood of public funds being needed. This will not eradicate moral hazard created by banking regulation. This is the point of departure for the chapter entitled "The sovereign-bank nexus". As the European sovereign debt crisis showed, an intensive risk nexus between the financial system and sovereigns represents a systemic risk. Bank distress can create financial burdens which are too big for a sovereign to bear. Conversely, doubts about the sustainability of a country's public finances can weigh on national banks' credit rating.

However, the sovereign-bank nexus is attributable in no small part to the preferential treatment of sovereign exposures by financial sector regulators. This preferential treatment should be abolished in the medium to long term. Sovereign exposures should be backed by adequate own funds, and limits on large exposures should be applied to all of a credit institution's exposure classes. In addition, the liquidity regulations should classify government bonds according to their actual market liquidity.

The preferential treatment of sovereign exposures by regulators should be ended in the medium to long term.