

## Financial Stability Review 2009

### German financial system stabilised – challenges remain

As a result of the international financial market crisis, the German financial system, too, has come under enormous and unprecedented pressure. Systemic collapse was prevented only with the aid of non-standard fiscal and monetary policy measures. The financial markets have now recovered significantly, and recently there has been a perceptible improvement in the outlook for growth. Nevertheless, further tests for German banks look likely. Speaking today at the presentation of this year's Deutsche Bundesbank Financial Stability Review, Professor Hans-Helmut Kotz, Member of the Executive Board, stressed that "the financial crisis and the economic crisis directly linked to it can by no means be regarded as having been overcome."

The Financial Stability Review describes the progress that has been made in restructuring the German financial system. German banks have made considerable headway in consolidating their balance sheets and improving their capital adequacy. Moreover, domestic non-financial corporations' and households' moderate levels of debt place Germany in a comparatively favourable starting position for weathering the financial crisis.

Nonetheless, the German financial system is still facing considerable challenges. Losses from securitisation instruments have probably already peaked. Even so, depending on future economic developments, substantial write-downs will still have to be made on loans. According to the Bundesbank's model-based estimates, these write-downs could be in the range of €50 billion to €75 billion. However, the expected write-downs do not, of course, automatically translate into outstanding capital requirements.

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Currently strong operating income and existing loan-loss provisions could initially be used to cover any losses. Professor Kotz said that the German banking system should use the currently favourable times to bolster risk provisions and build up capital buffers. This was indispensable, he explained, not least to counter a potential supply-side shortage of credit on a long-term basis.

To avert further crises, the Bundesbank advocates implementing the reforms being discussed in national and international bodies as soon as possible. Efforts should focus on setting microeconomic incentive structures in a manner compatible with stability. Vulnerabilities in the regulatory framework should be eliminated and market participants' resilience strengthened. "We must ensure that the capital and liquidity buffers needed to weather crises are adequate in future," Professor Kotz emphasised.

The Financial Stability Review also highlights that the traditional microprudential approach focusing on individual institutions has to be supplemented by macroprudential supervision which takes account of the systemic dimension. In order to safeguard financial stability, the fact that risks are endogenous must be taken into consideration. Policies aimed at ensuring stability must take note of system-wide interaction in connection, for instance, with procyclical capital rules or liquidity spirals. The Deutsche Bundesbank has responded to this challenge and, in May 2009, created a new Financial Stability Department to intensify its macroprudential analysis.