2014 Financial Stability Review

Press conference

Frankfurt am Main, 25 November 2014

Professor Claudia M Buch, Deputy President of the Deutsche Bundesbank
Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank

What is financial stability?

– Financial stability is the financial system's ability to perform its **key macroeconomic functions** – and particularly so in periods of stress and upheaval.

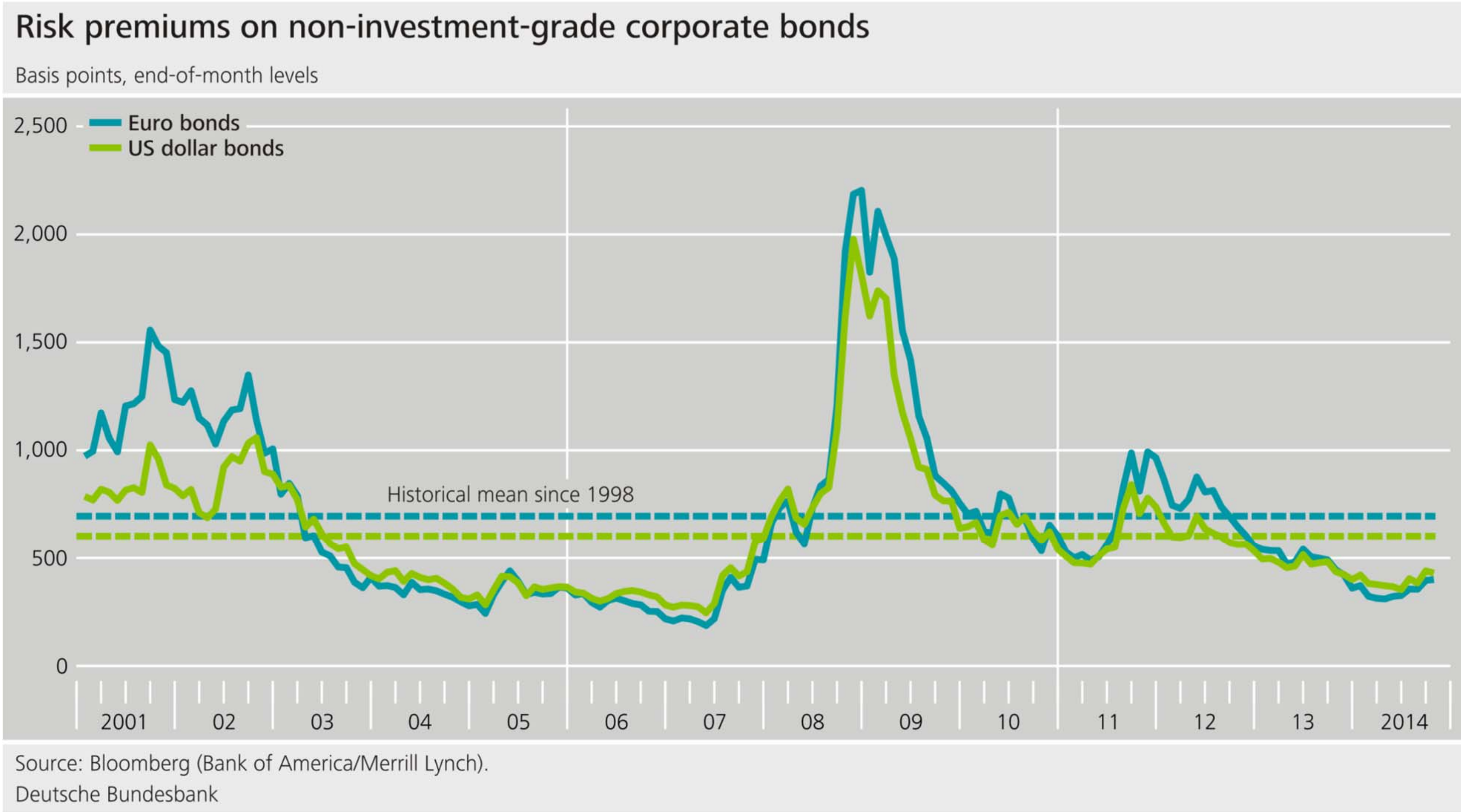
– **A financial system is all the more stable** …
  - … the **less pronounced the moral hazard** and
  - … the more ample the risk buffers and notably the **capital** in the system.

– **Macroprudential oversight** has the task of safeguarding systemic stability.
  - <u>In Germany:</u> Financial Stability Committee
  - <u>In Europe:</u> European Systemic Risk Board, ECB's Financial Stability Committee

Key statements of the 2014 Financial Stability Review

1. **There are incentives to engage in riskier behaviour in the current low-interest-rate environment.**
2. **German banks are better capitalised today, but profitability remains weak.**
3. **Mortgage lending is not a pro-cyclical phenomenon, but structural vulnerabilities exist.**
4. **The banking union helps to better identify risks and force the private sector to absorb a share of losses.**
5. **The preferential regulatory treatment afforded to sovereign exposures needs to be abolished over the medium term.**

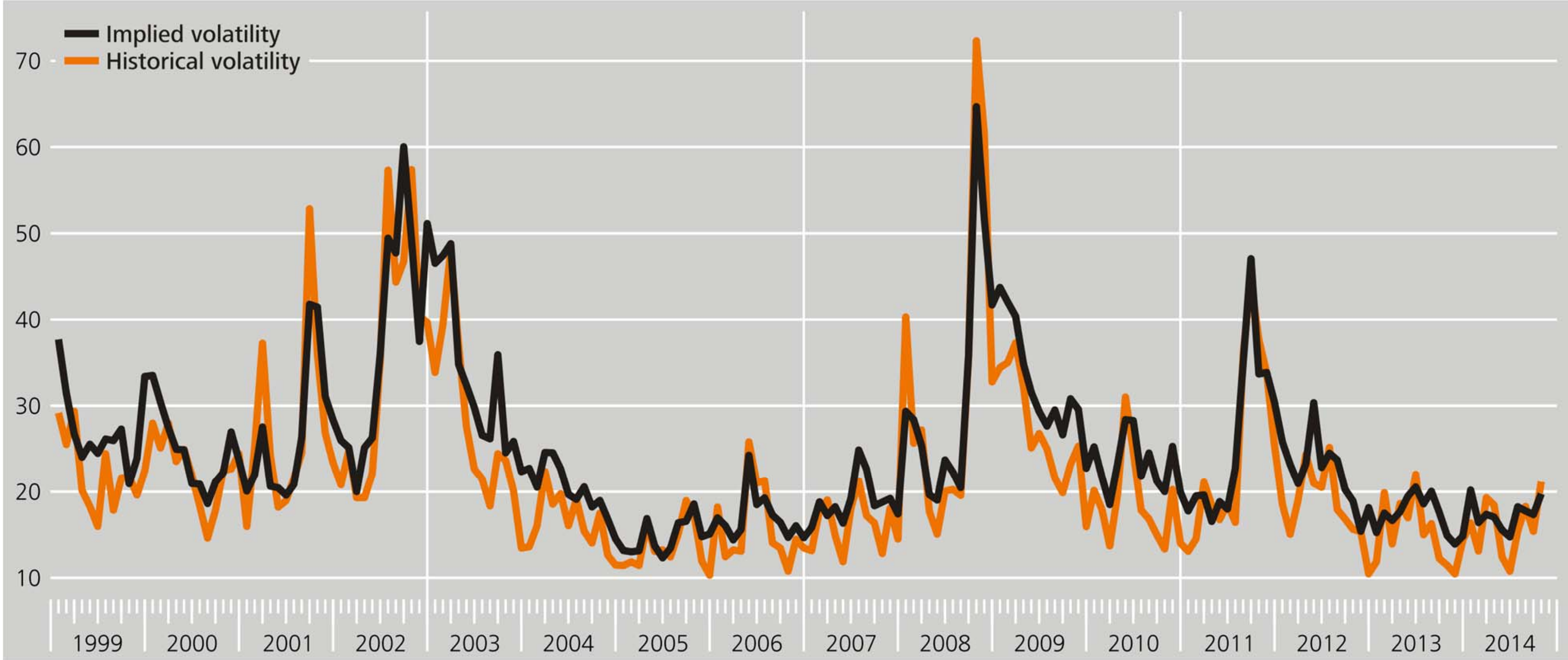
Risk premiums on corporate bonds currently as low as pre-crisis levels.



Low volatility might contribute to underestimation of risk.

Historical and implied volatilities on the German stock market*

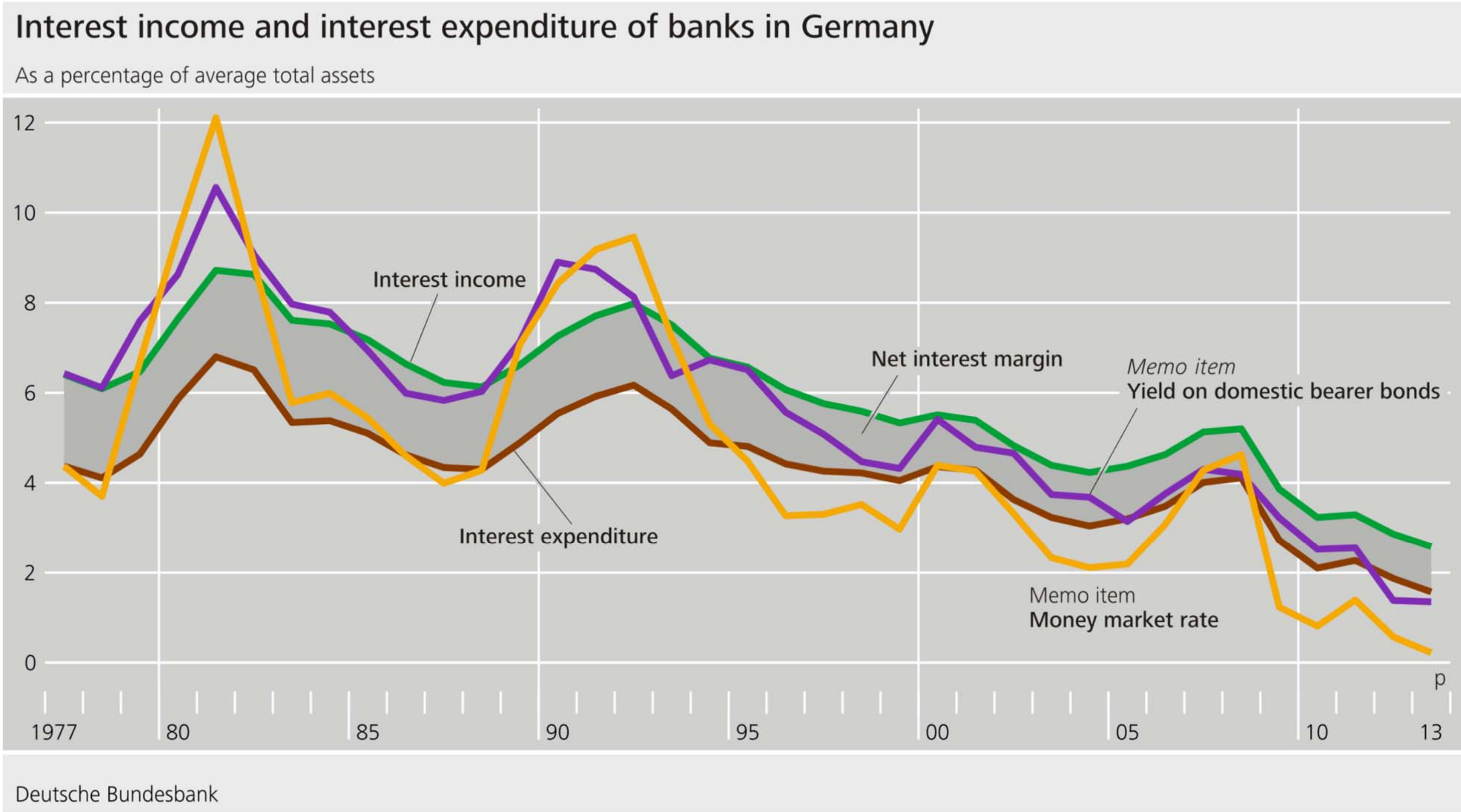
%, end-of-month levels



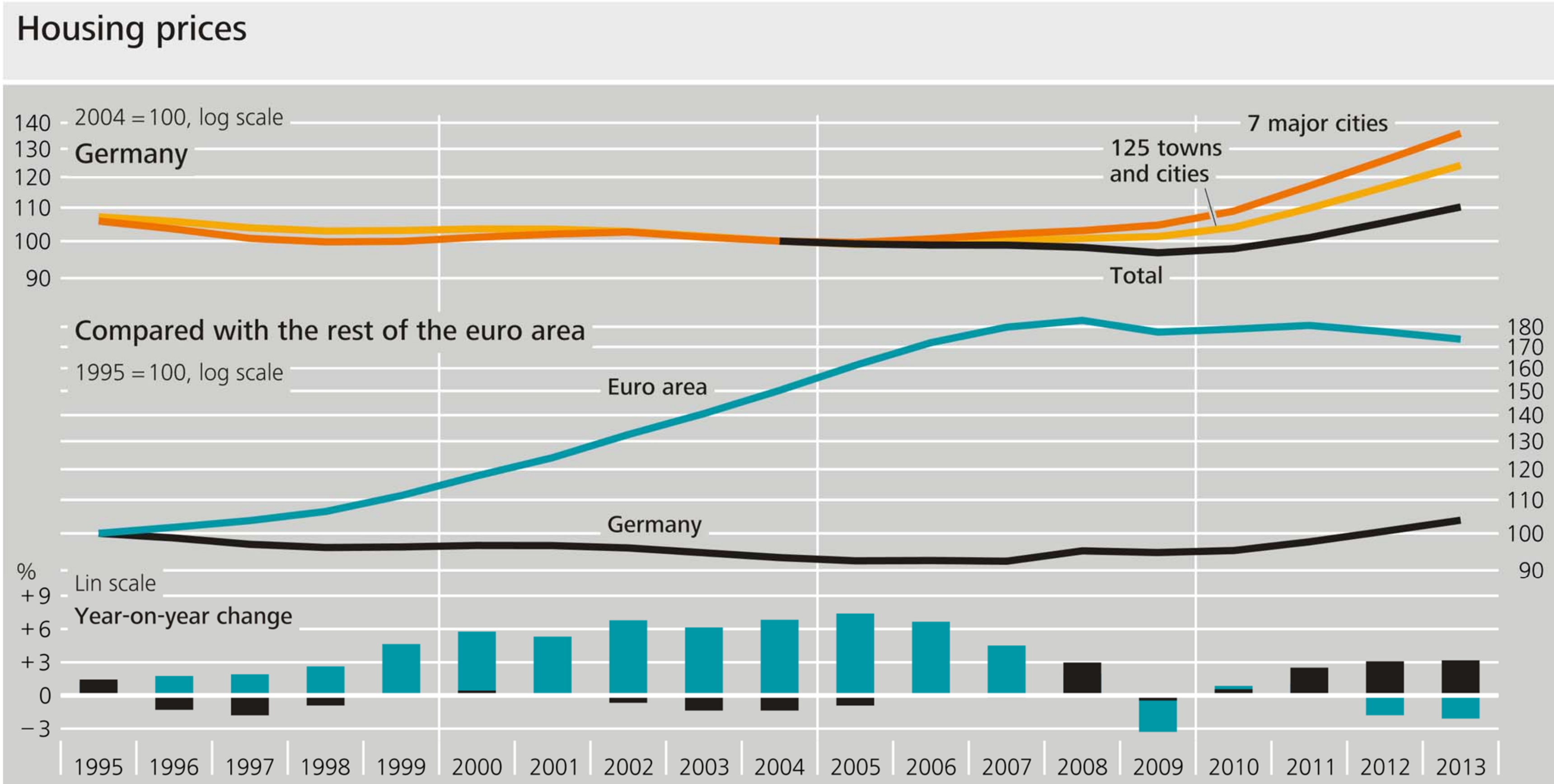
Sources: Bloomberg and Bundesbank calculations. * The historical volatility was calculated on an annualised basis from historical values of the DAX price index using a GARCH model. The implied volatility shows the fluctuations of the DAX in an annualised form, derived from market prices of options.

Deutsche Bundesbank

German banks are better capitalised, but their profitability remains weak.



Laxer lending standards are doing little to fuel housing market prices.

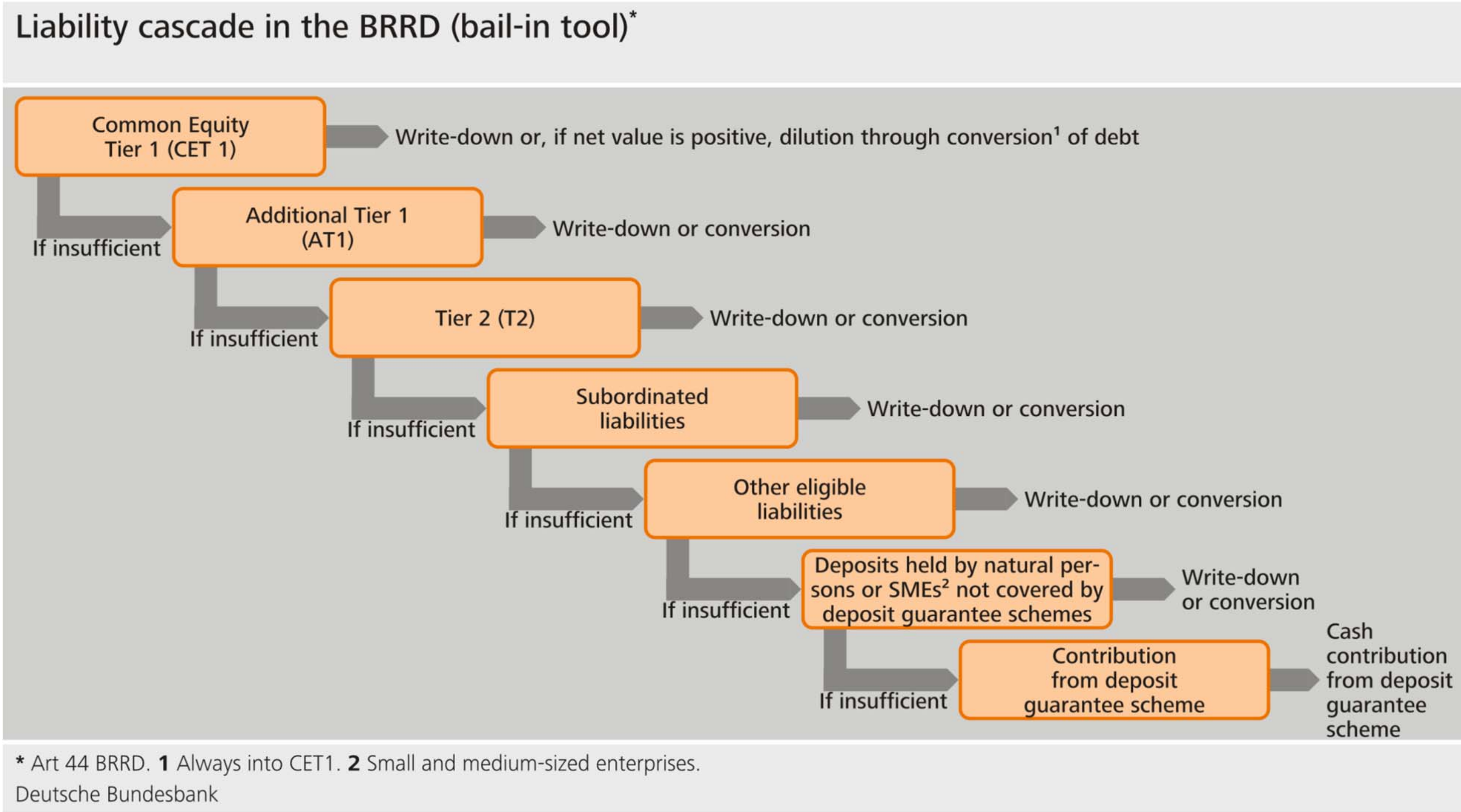


Sources: bulwiengesa AG, ECB, Association of German Pfandbrief Banks (vdp) and Bundesbank calculations.
Deutsche Bundesbank

What does the banking union mean for financial stability?

- **Single Supervisory Mechanism (SSM) means improved identification of risk**
  - Consistent standard of supervision
  - Early identification of risk through cross-border comparisons
  - Macroprudential powers conferred on ECB
- **Single Resolution Mechanism (SRM) means risk is handled better**
  - Superior toolkit for dealing with struggling banks
  - **Bail-in tool is crucial**: private sector shareholders and creditors will share losses
  - Public funds only as a last resort: keep discretionary scope at a minimum

Liability cascade in the Bank Recovery and Resolution Directive (bail-in instrument)



The preferential regulatory treatment of government bonds has to stop.

- **It is the declared aim of the banking union to sever the sovereign-bank nexus.**
  - Weak banks putting pressure on government budgets
  - Weak government finances placing a strain on banks' balance sheets
- **Banks' sovereign exposures rose during the crisis.**
- **One reason for this is the far-reaching preferential treatment which banking regulation affords to government bonds**
  - Exceptions to the large exposure limits
  - Zero weighting in the calculation of equity capital
  - Special treatment in the (planned) liquidity regulation

Financial Stability Review 2014

The situation of Germany’s banks

Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank,
responsible for banking and financial supervision

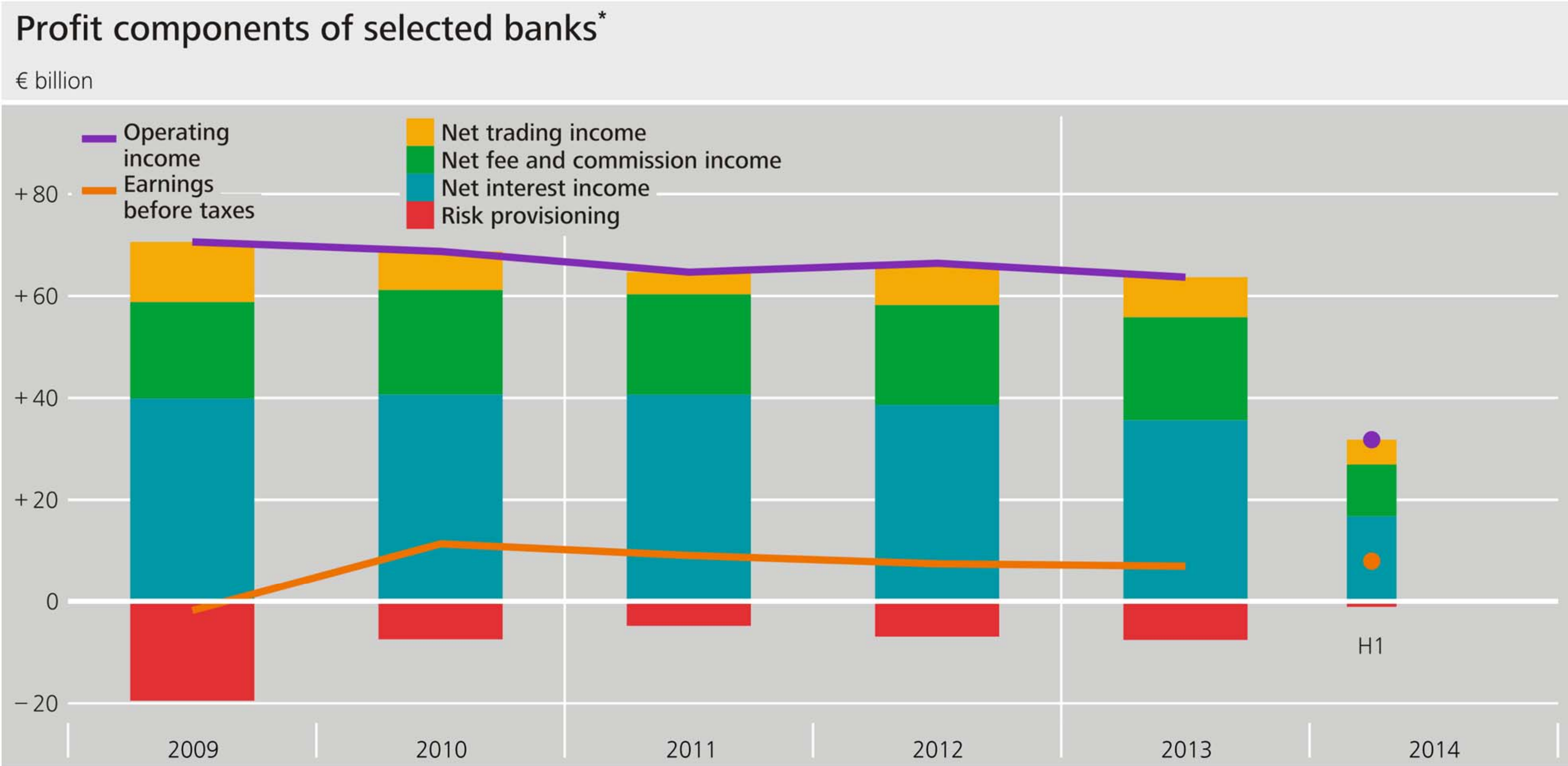
Comprehensive assessment confirms the resilience of German banks

- The balance sheets of the major German banks are sound and capable of withstanding a simulated severe shock.
- Only one German bank was found to have a capital shortfall as at 31 December 2013, which it has remedied by raising capital this year.
- Further efforts still necessary as
  - several banks barely cleared the capital hurdle in the adverse scenario
  - five German banks would not have passed the stress test if implementation of the Basel III rules had been brought forward
  - German banks are still lagging behind the other European countries in terms of their leverage ratio. Several banks still do not meet the target ratio of 3%, for example.

Low-interest-rate environment and structural problems impacting on profitability of German banks

- German banking system characterised by falling profits in a persistent low-interest-rate environment.
- Operating income of 11 major German banks with an international focus was down by an annual rate of around 8% in the first six months of 2014.
- Main reasons: year-on-year decline in net interest income (-5%), which is a major source of income for German banks, as well as a decrease in the trading result (-30%)
- Sharp fall in risk provisioning (-63%) buoyed up the result for the first half of 2014.

Low-interest-rate environment and structural problems impacting on profitability of German banks



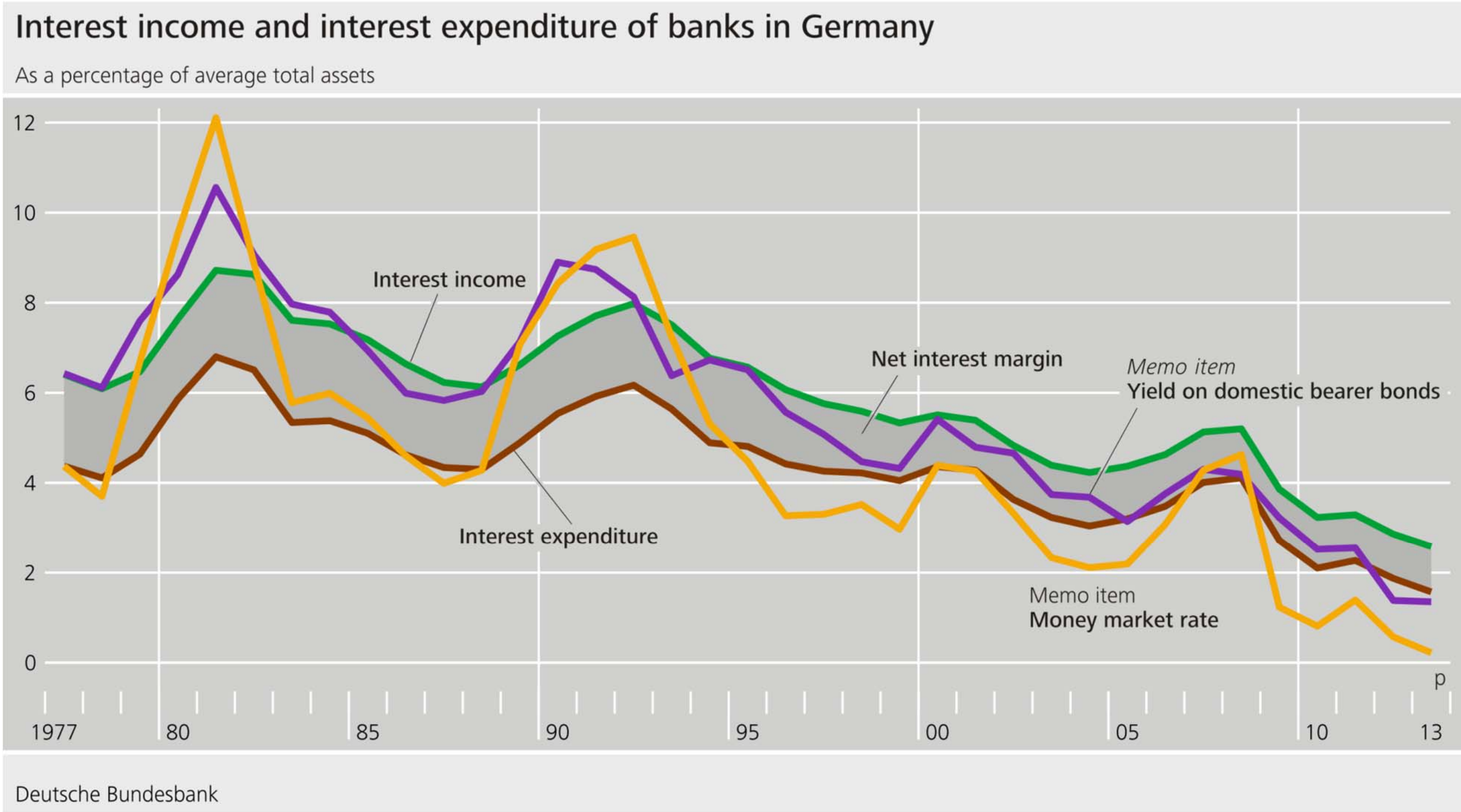
Sources: Corporate data and Bundesbank calculations. * Comprises IFRS data of 11 of the 12 major German banks with an international focus which did not transfer positions to resolution agencies in the observation period.

Deutsche Bundesbank

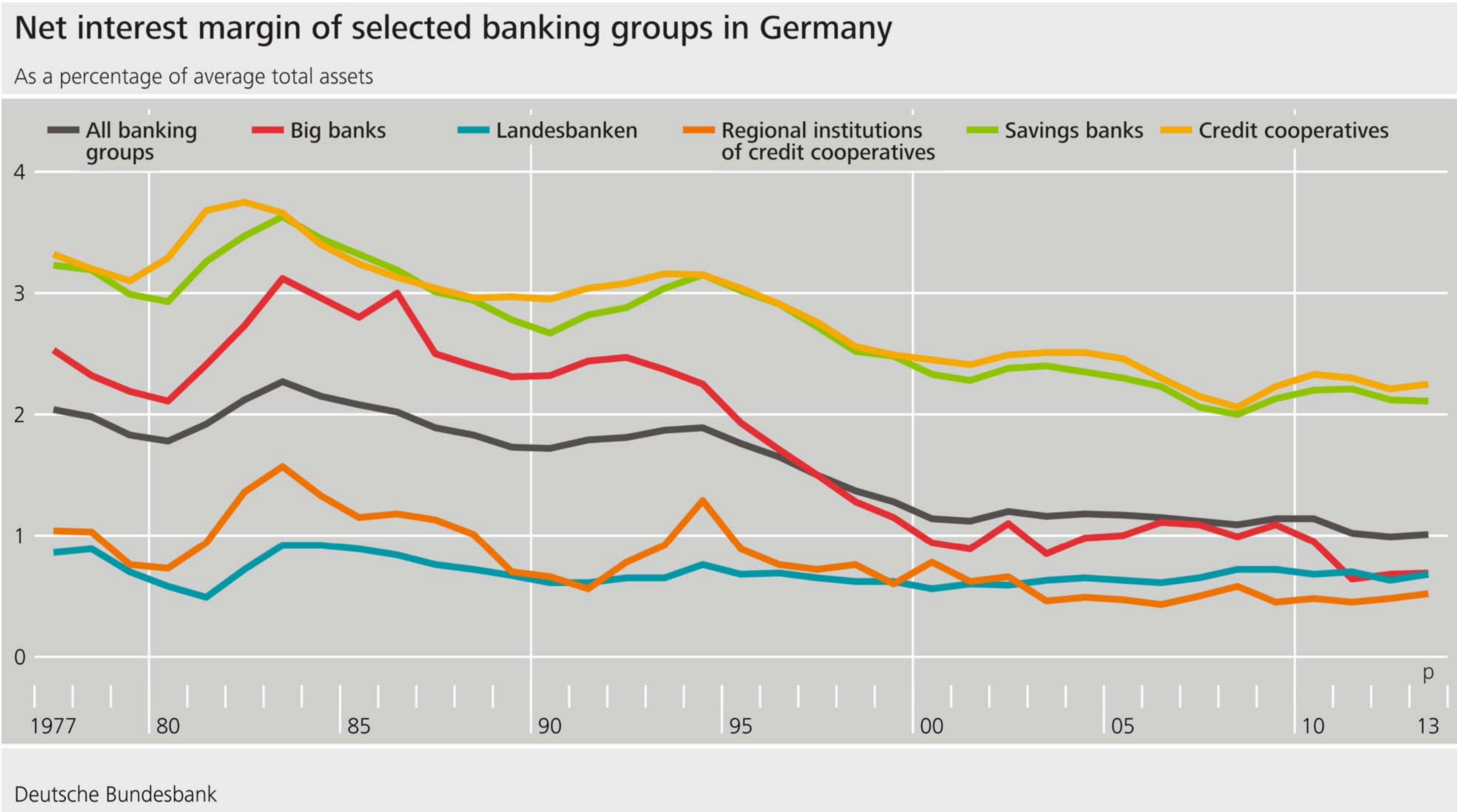
Shrinking interest margins could increase risk appetite of German banks

- Long-term developments show a structural decline in the interest margin.
- A protracted period of low interest rates could spark a greater risk appetite − particularly among low-earning institutions.
- The high co-movement of interest rate risk seen over a cross-section of banks could be a potential problem for financial stability.

Shrinking interest margins could increase risk appetite of German banks



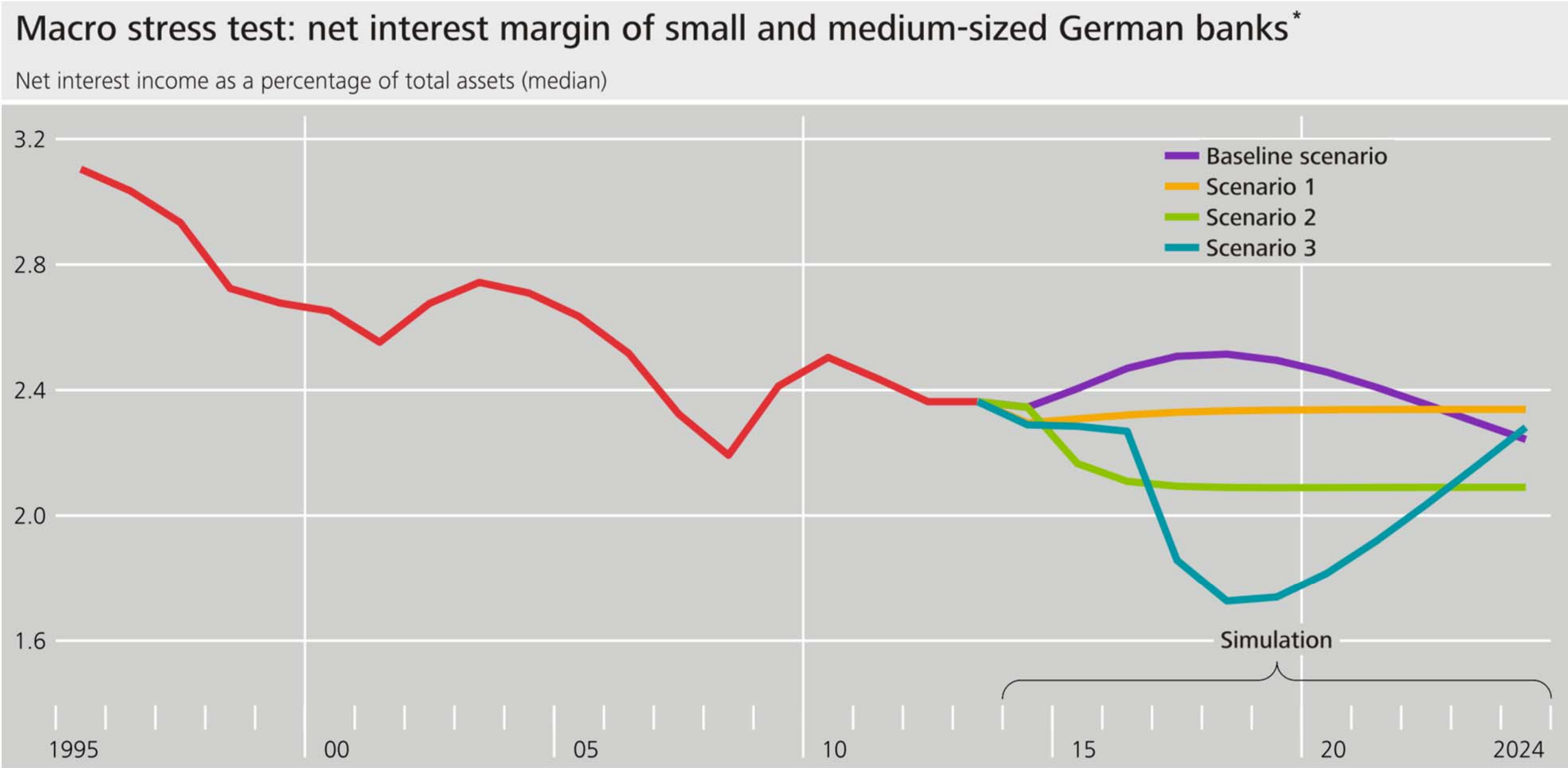
Shrinking interest margins could increase risk appetite of German banks



Macro stress test: interest rate shock has significant impact on profit and loss account

- Bundesbank macro stress test simulated various interest rate scenarios.
- Effects on profitability greatest in the case of abrupt interest rate hike (scenario 3) and a flattening of the yield curve (scenario 2).
- Parallel occurrence of risks could pose problems to the German financial sector.
- Adequate capital buffers therefore extremely important to cushion shocks.

Macro stress test: interest rate shock has significant impact on profit and loss account



* Savings banks, credit cooperatives and commercial banks (excluding big banks). Baseline scenario: market-based forecast of interest rate developments. Scenario 1: freezing of the yield curve. Scenario 2: flattening of the yield curve. Scenario 3: abrupt rise in interest rates.

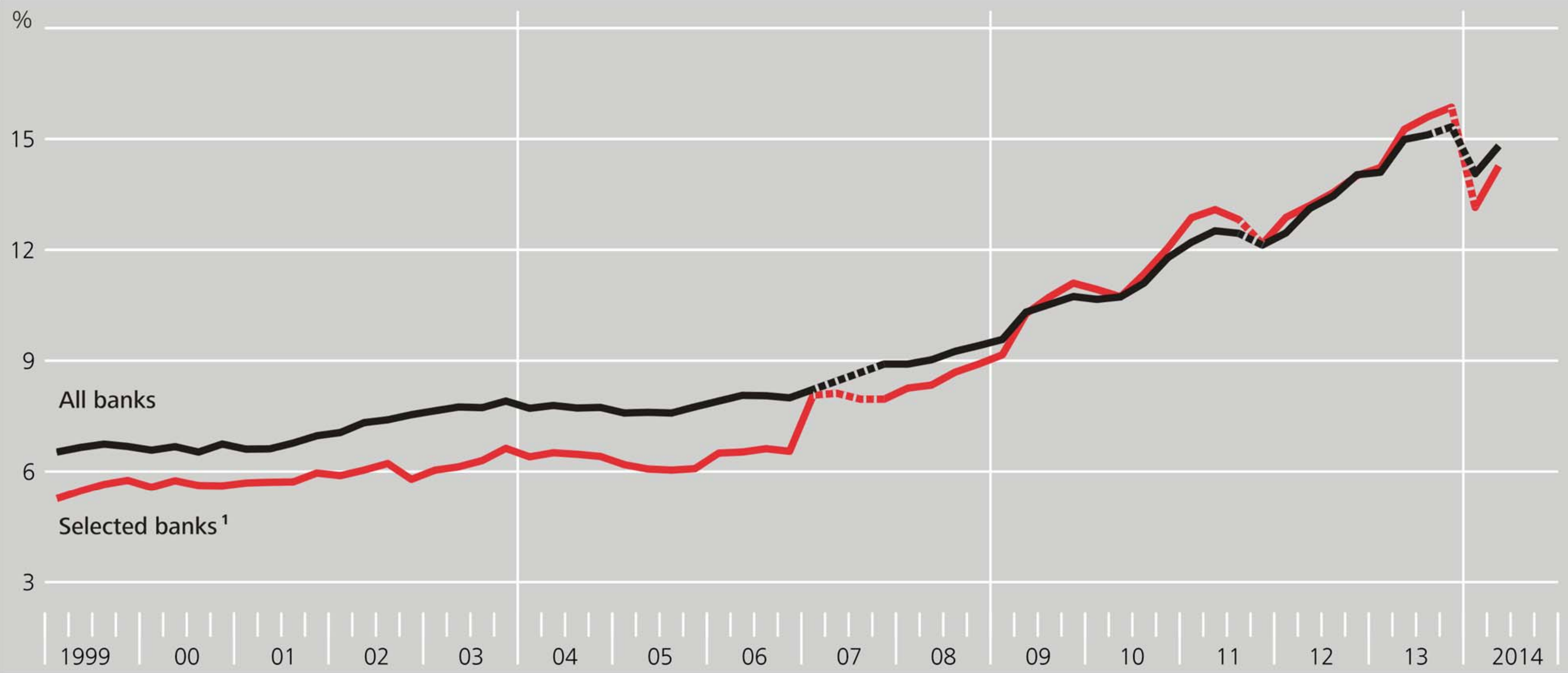
Deutsche Bundesbank

German banks' resilience improved

- Positive developments at the major German banks with an international focus
  - Capital base strengthened by raising capital (+€11.5 billion compared with previous year)
  - Profit retention and changes in revaluation reserves (+€2.5 billion combined)
  - Reduction in risk-weighted assets (€87.5)
- Decline in regulatory capital ratios in 2014 owing to
  - stricter qualitative standards for tier 1 capital
  - increase in risk-weighted assets under the new supervisory framework despite de-risking

German banks' resilience improved

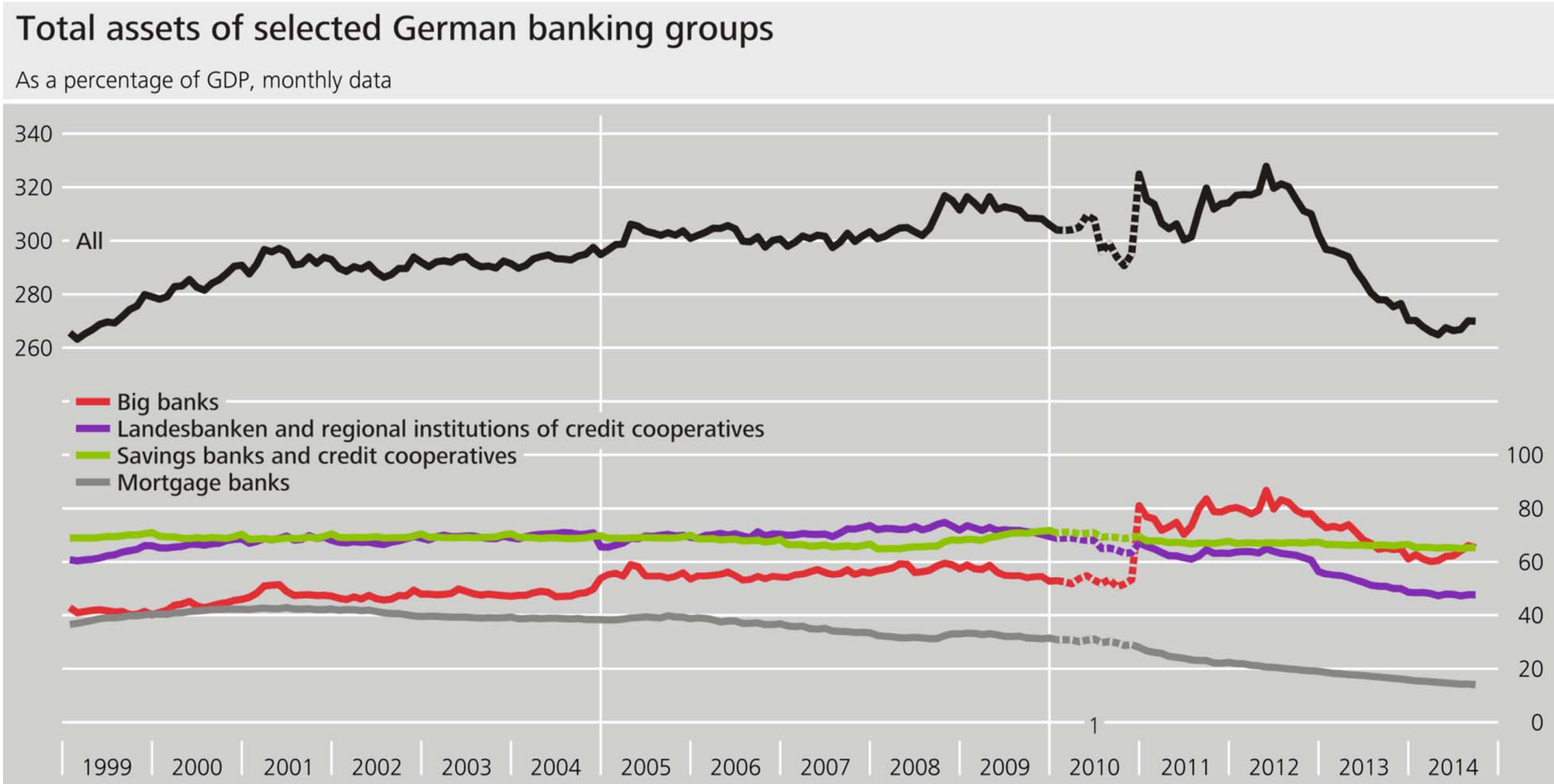
Tier 1 capital ratio of banks in Germany *



* Revised valuation of tier 1 capital and risk-weighted assets as of 2007, 2011 and 2014. **1** 12 major German banks with an international focus that did not transfer positions to resolution agencies in the observation period.

Deutsche Bundesbank

German banks have shrunk their balance sheets



1 Transitional period pursuant to the German Accounting Law Modernisation Act (Bilanzrechtsmodernisierungsgesetz).
Deutsche Bundesbank

Further measures which are necessary to ensure that German banks remain competitive in the long run.

- Further improvement in resilience required, eg through
  - adequate risk provisioning adjusted to the prevailing economic environment
  - increase in capital levels, eg by retaining profit
- Ongoing review and, where necessary, adjustment of business models
- Profitability must be increased, eg through
  - greater diversification of sources of income to reduce the heavy reliance on interest income
  - realisation of profit synergies and identification of cost reduction potential