

Financial Stability Review 2013

Sabine Lautenschläger, Deputy President of the Deutsche Bundesbank

Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank

Frankfurt am Main, 14 November 2013

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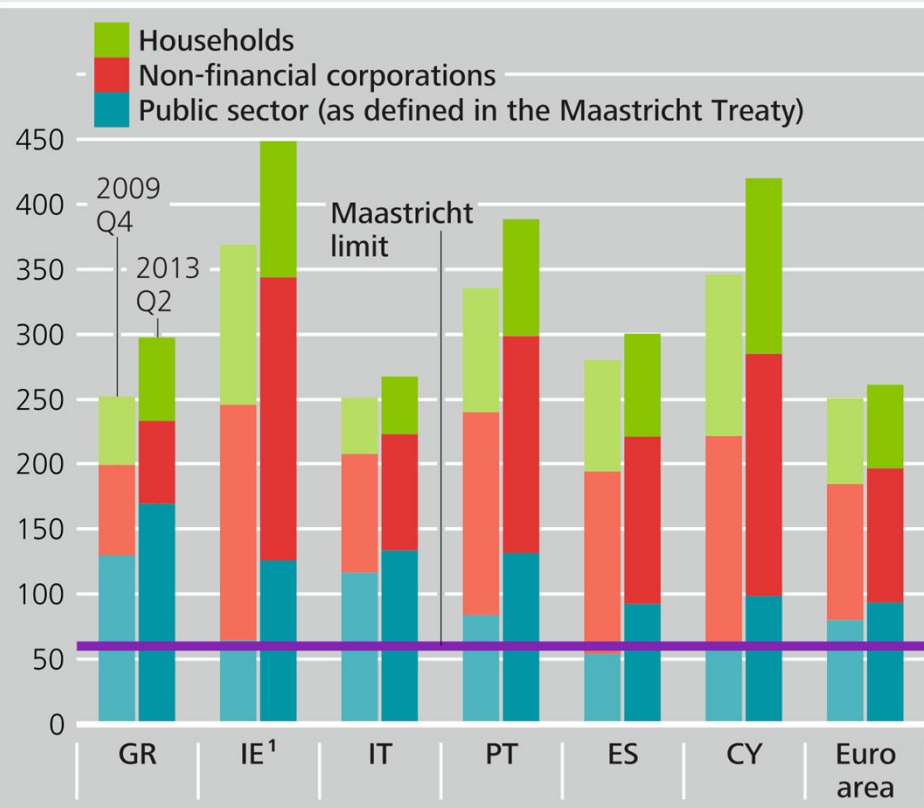
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European debt crisis not yet over

- Reforms are taking effect: rising exports and falling deficits
- Sovereign debt still main vulnerability:
 - Debt levels continuing to rise
 - Deficit of four programme countries as well as Spain and Italy still above 3% of GDP
- Debt problem also affecting private sector:
 - Non-financial private sector highly indebted in some cases
 - High volumes of non-performing loans in Greece, Cyprus and Ireland

Public and private sector debt

As a percentage of GDP



Sources: Eurostat and ECB. ¹ Data for non-financial corporations are largely determined by the funding activities of large international enterprises.

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Exposure to selected euro-area countries

Balance sheet exposure of German banks* to borrowers in selected euro-area countries

€ billion, as at 2013 Q2 and change compared with 2009 Q4

Country	Borrowers									
	Government sector		Banks and money market funds		Other financial sector		Households and (non-financial) corporations		Total	
		Change		Change		Change		Change		Change
Greece	0,0	- 20,1	0,2	- 1,2	0,1	- 0,9	9,0	- 1,8	9,3	- 24,0
Ireland	4,9	+ 2,7	1,3	- 15,8	15,8	- 24,7	5,3	- 0,7	27,3	- 38,5
Italy	36,6	- 30,9	40,1	- 18,4	5,1	- 3,8	14,6	- 1,7	96,3	- 54,8
Portugal	4,2	- 3,4	2,1	- 9,2	0,6	- 0,5	5,4	- 2,2	12,3	- 15,3
Spain	17,1	- 7,5	30,3	- 30,2	12,4	- 17,8	21,9	- 8,2	81,8	- 63,7
Cyprus	0,1	- 0,4	0,0	- 0,6	0,2	+ 0,0	6,7	- 0,3	7,1	- 1,3
Total	62,8	- 59,6	74,0	- 75,4	34,2	- 47,6	63,0	- 15,0	234,0	-197,6

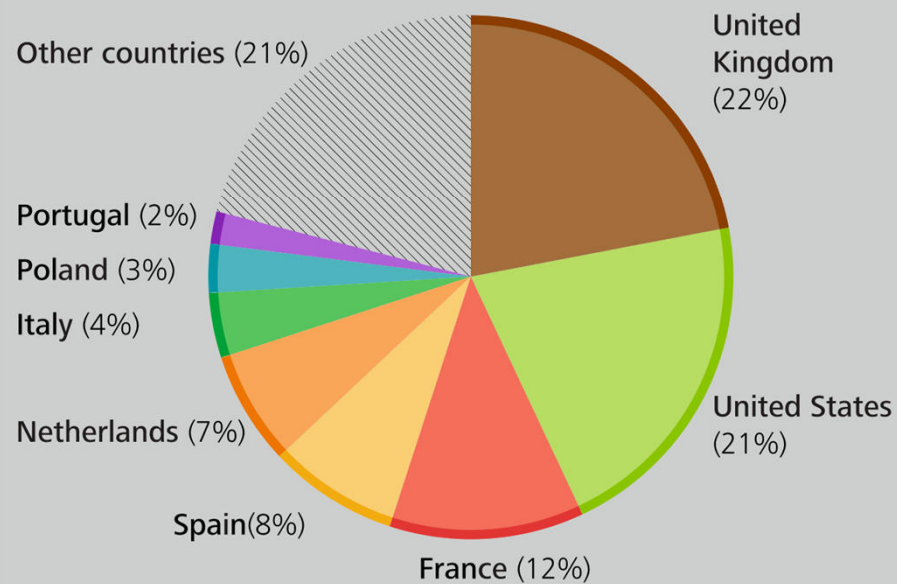
Source: the Bundesbank's credit register of loans of €1.5 million or more. * Consolidated banking groups whose headquarters are domiciled in Germany; figures for Greece exclude KfW loans guaranteed by the German central Deutsche Bundesbank

Exposure to critical sectors

- Individual banks still exposed to critical sectors
 - Eight major German banks have foreign commercial real estate exposures of €105 billion
 - Seven major German banks have shipping loan exposures of €86 billion
 - Book value of securitisations held by 12 major German banks: €94 billion

Regional breakdown of commercial real estate lending of selected German banks* abroad

As at end-March 2013, total: €105.3 billion
(Memo item Level of domestic financing: €149.8 billion)



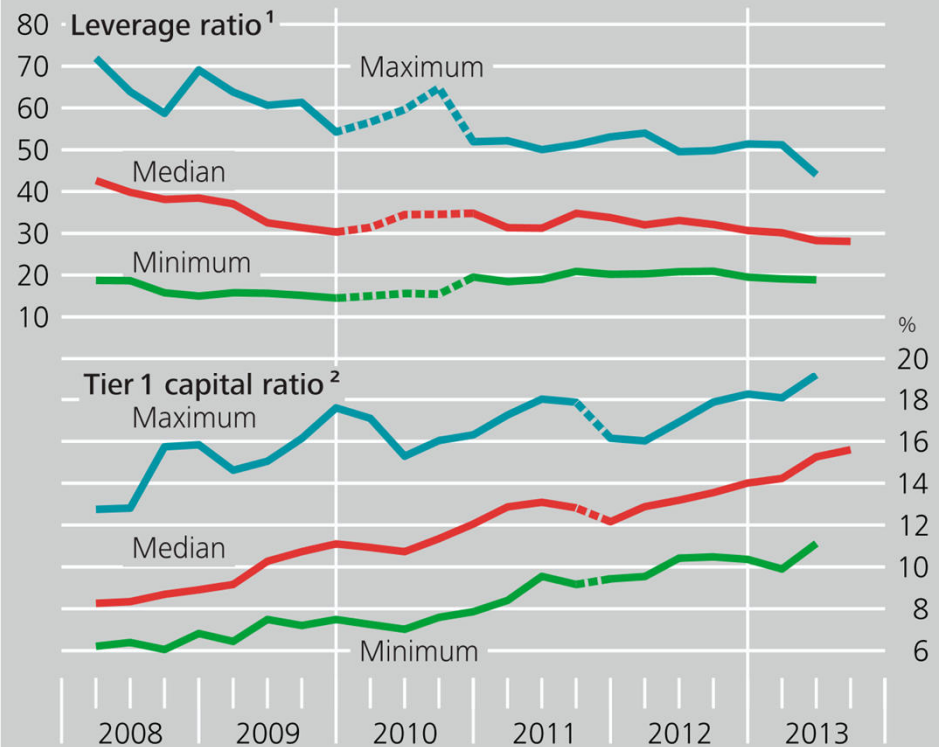
Sources: Commercial real estate lending survey. * Eight major German banks with an international focus.

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Rising tier 1 capital ratios, falling debt

- Banks anticipating future regulatory requirements but substantial efforts still needed in some cases
- On average, tier 1 capital ratios of the 12 major German banks up by 2.1 pp to 15.3%
- Leverage ratio (the ratio of total assets to tier 1 capital) down to 28
- Capital ratios being increased also by reducing risk-weighted assets

Leverage ratio and tier 1 capital ratio of selected banks*



* Of 12 major German banks with an international focus. **1** 2010: transition period pursuant to the Accounting Law Modernisation Act. **2** From end-2011, revised valuation owing to CRD III.

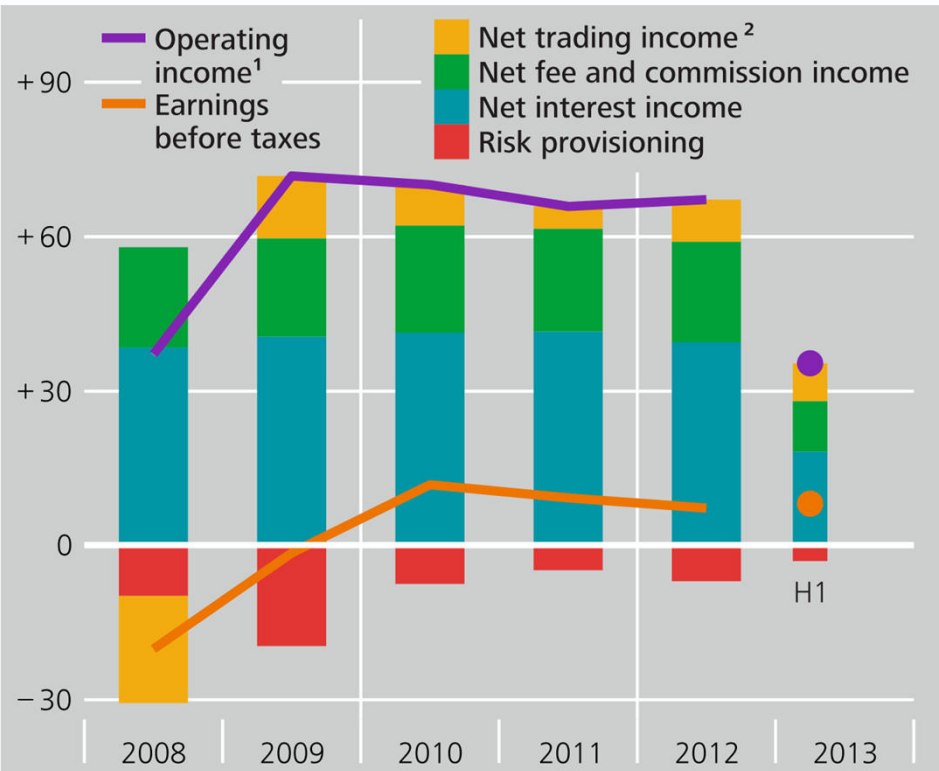
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Profitability stabilising at current end

- Operating income of 12 major German banks slightly up on year, at €35 billion
- Mainly due to rise of €2.3 billion in volatile net trading income
- Risk provisioning up slightly but still low
- Net interest income – banks' most important source of earnings – on the decline, however
- Low-interest-rate environment placing additional pressure on banks' net interest income

Profit components of selected banks*

€ billion



Sources: Corporate data and Bundesbank calculations. * 12 major German banks with an international focus. ¹ Sum of net interest income, net fee and commission income and net trading income. ² Including income from financial assets carried at fair value.

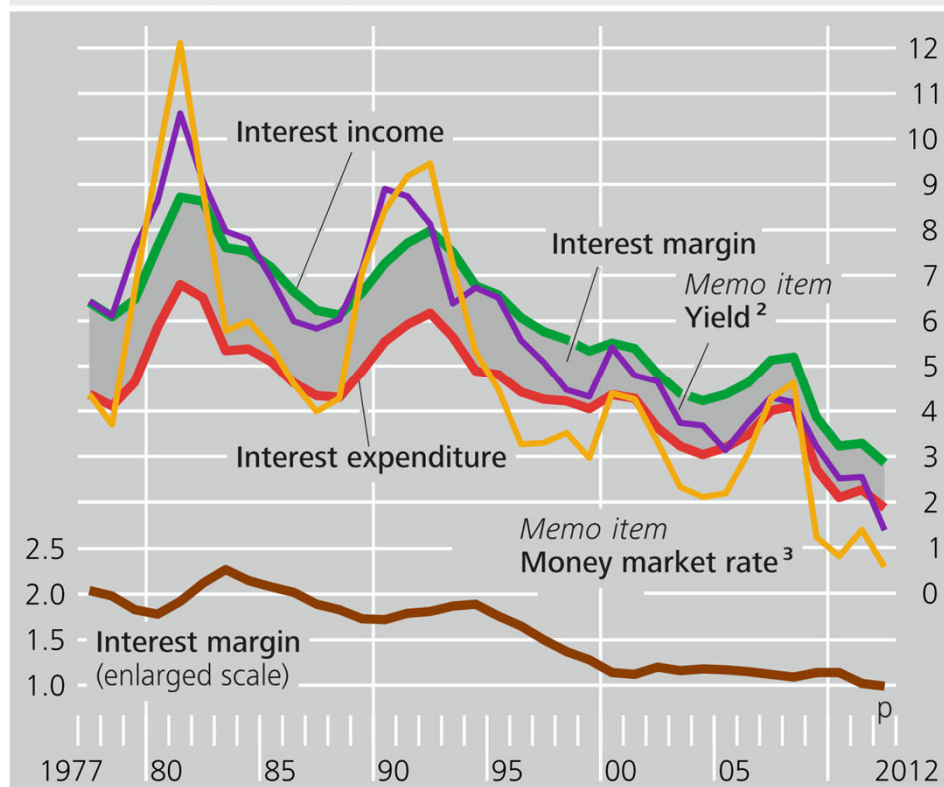
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Low profitability is structural

- German banks' most important source of earnings has been on the decline for long time
- Steady fall in interest margin because of intense competition:
 - Technological advances
 - Overcapacity in banking sector
 - Competition from non-banks
- Consequences for banks:
 - Lower profits in long term
 - Pressure on business models

Interest income and interest expenditure of banks in Germany

As a percentage of average total assets¹



1 Up to 1998, as a percentage of average business volume. **2** Average yield on domestic bearer bonds. **3** Three-month EURIBOR.
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Overview of comprehensive assessment

Risk assessment exercise (RAS)

- Comprehensive supervisory judgements on
 - risk factors
 - capital adequacy
 - business model
 - risk management

Balance sheet assessment (BSA)

- Risk-based review of assets on banks' balance sheets
 - Focus on credit and market exposures
 - Assessment of value adjustments, collateral valuation, classifications

Stress test (ST)

- While the BSA encompasses current risks under accounting rules (point in time), stress test also includes potential risks (forward-looking)

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Risks to financial stability in Germany

- **Undesired side-effects of persistently low interest rates are increasing**
 - Search for yield can lead to overvaluation of assets; shadow banking system gaining momentum
 - Banks' profitability under additional pressure
 - Life insurers' own funds buffers are being eroded
- **European debt crisis not yet over**
 - Contagion risks still high
 - In some countries the “doom loop” between sovereigns and domestic banks has even tightened

Calmer situation on global financial markets improving financial stability

- Stress indicator for German financial system signals easing of situation

→ Use time:

Governments

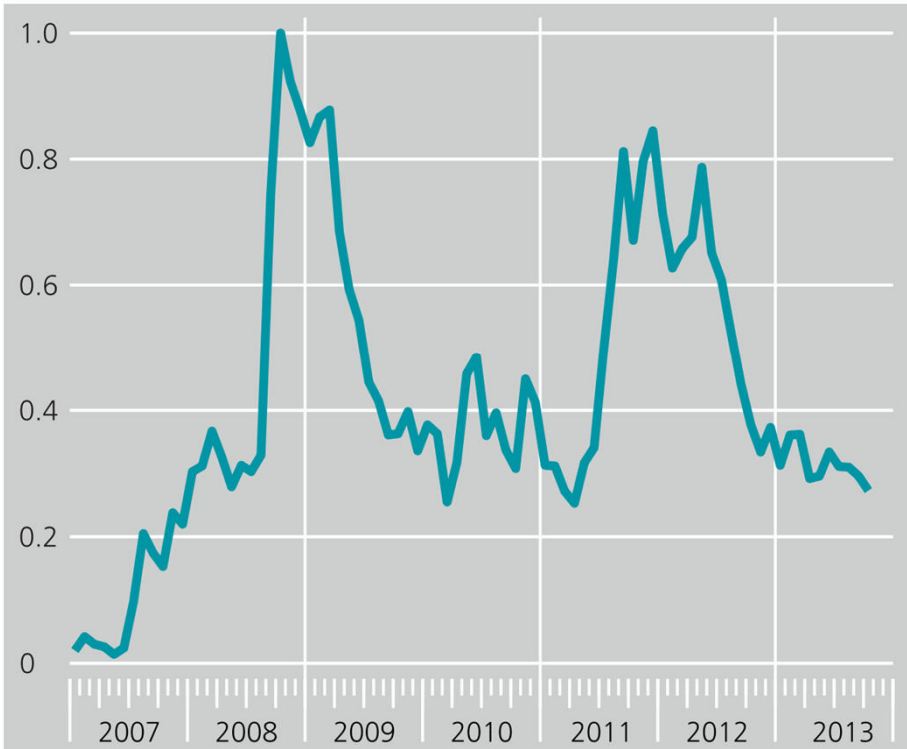
- Consolidate public finances
- Improve competitiveness

Banks

- Clean up balance sheets
- Review business models
- Reduce high-risk portfolios

Stress indicator for the German financial system

Data scaled based on historical low (0) and high (1)



Sources: Bloomberg, Ifo Institute, Markit, Thomson Reuters Datastream, Centre for European Economic Research and Bundesbank calculations. Deutsche Bundesbank

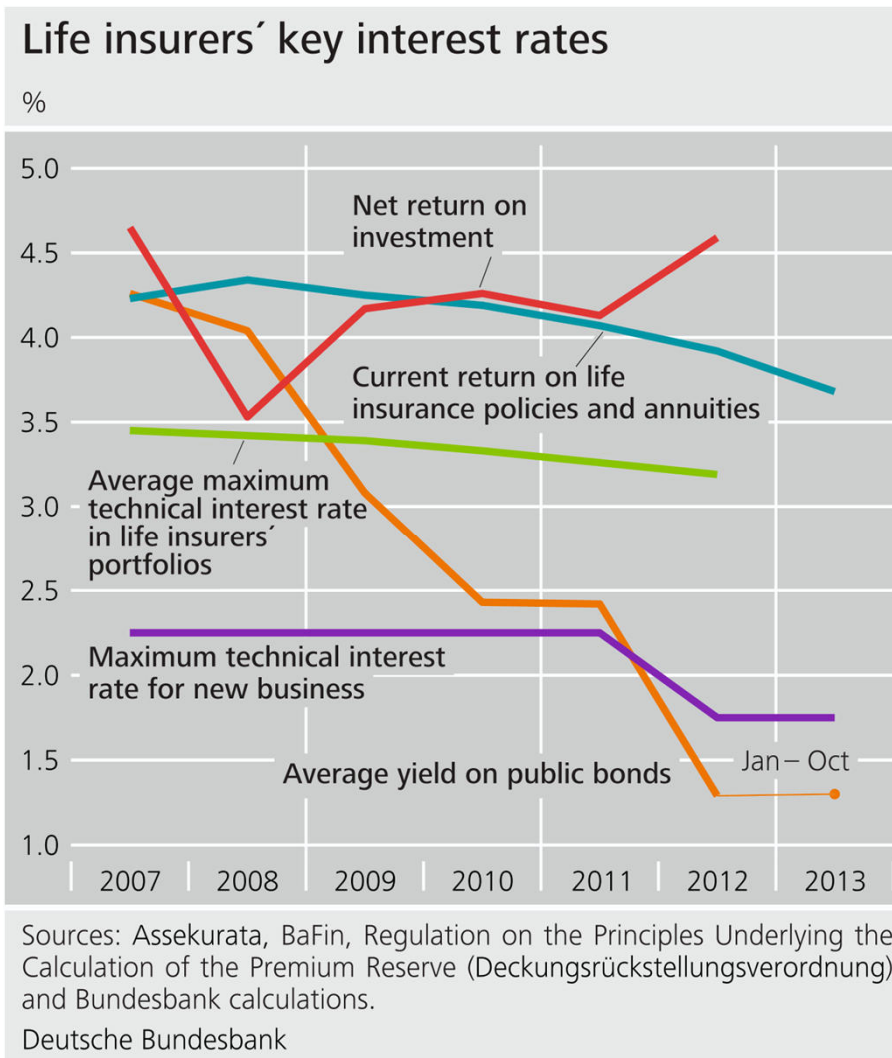
Risks and side-effects of low-interest-rate environment increasing

- Search for yield encouraging greater risk-taking ...
 - ... German banks: still only limited search for yield
 - ... German insurers: have increased holdings of corporate bonds
 - Danger of market participants...
 - ... getting used to exceptional financial conditions
 - ... underestimating impact of possible interest rate reversal, eg on volatility
- ➔ *Be equipped to face volatility and market value losses*
- ➔ *Bear in mind liquidity risks at ETFs*
- ➔ *Prepare macroprudential tools for practical application*

Low-interest-rate environment a burden on German insurers

- Average guaranteed return on outstanding policies: 3.2%
- By contrast, average yield on public bonds: 1.3%
- Funds allocated to additional interest provisions up from €1.5 billion in 2011 to €5.7 billion in 2012
- Valuation reserves rose to €87.8 billion by end of 2012

➔ *In the interests of financial stability, sound and sustainable regulatory framework needed for policyholders' participation in valuation reserves*

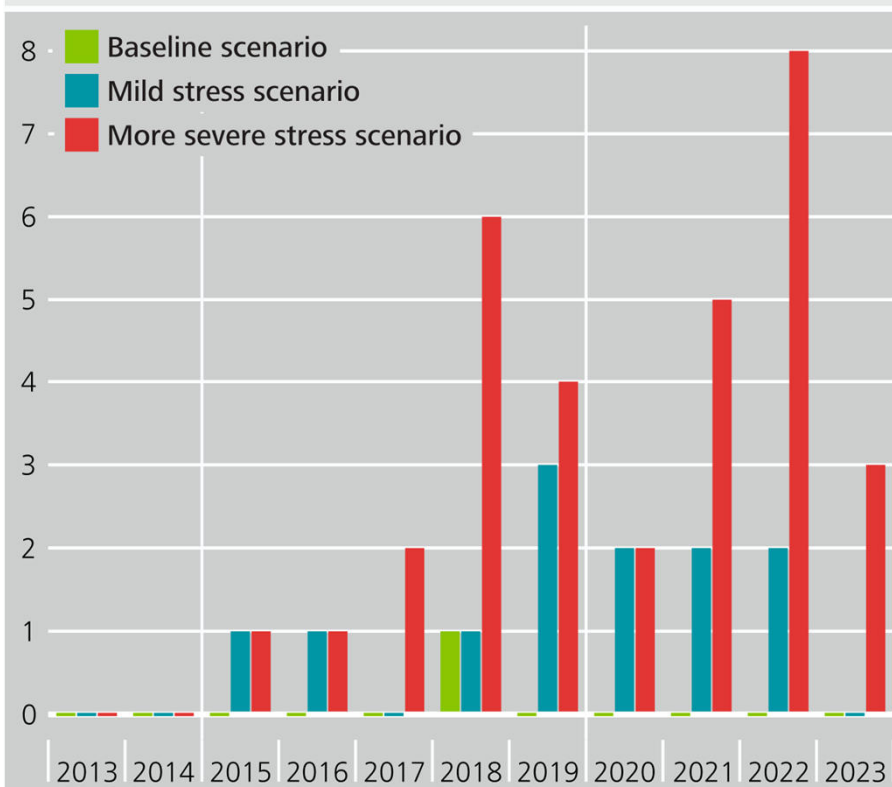


Low-interest-rate environment harbours considerable potential risks for life insurers

- Number of life insurers which will no longer fulfil the own funds requirements under Solvency I by 2023:
 - **Mild stress scenario:**
Total of 12 life insurers (market share of around 14%)
 - **More severe stress scenario:**
Total of 32 life insurers (market share of around 43%)
- Stress scenarios do not take the repercussions of the transition to Solvency II into account

→ *Ensure that transition to Solvency II is conducive to stability*

Number of life insurers with a coverage ratio of less than 100%



Sources: BaFin and Bundesbank calculations.
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Three scenarios on changes in the net return on investment for 85 German life insurers

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Considerable risks and weak underlying profitability at German banks

- Credit risks “in rear-view mirror”
 - Claims on debtors in countries hit by debt crisis
 - Claims of 12 major German banks from portfolios with heightened default risk constitute 5.4% of total assets:
 - Shipping loans: €86 billion, of which €23 billion with public partial loss guarantee
 - Foreign commercial real estate: €105 billion, of which UK 22%, USA 21%, France 12%
 - Securitisations: €94 billion, of which 52% RMBSs*, 19% CDOs**, 10% CMBSs***, 8% securitised student loans
- Potential risk going forward
 - Economic downturn
 - German residential real estate market

* Residential mortgage-backed securities

** Collateralised debt obligations

*** Commercial mortgage-backed securities

Recession would be particularly felt by major banks

- Assuming a severe recession, operating income falls by
 - almost €15 billion in 2014
 - another €5 billion or more in 2015
 compared with a baseline scenario
 (For comparison: operating result in 2012: €11 billion)
- ➔ *Banks would benefit from reducing risky assets and building up capital*

Macro stress test: earnings components of selected banks in stress scenario*

Deviation from baseline scenario, € billion

Item	2013	2014	2015
Net interest income	0,0	0,0	- 0,1
Net fee and commission income	0,0	- 1,7	- 0,5
Net trading income	0,0	- 8,3	- 3,0
Valuation result from lending business	- 0,2	- 4,7	- 1,5

* The analysis covers 12 major German banks.

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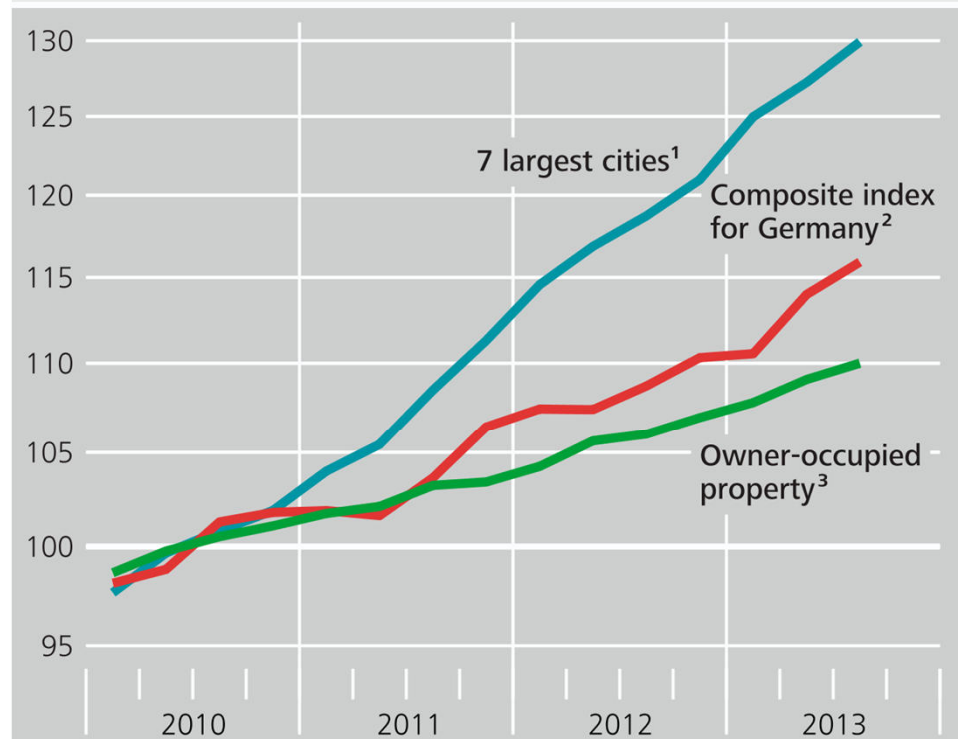
Assuming a severe recession on the scale of 2009; ie
 2014: 5.1% decline in GDP
 2015: 1.0% decline in GDP

Residential real estate prices in urban centres up in 2013 too

- **Seven major cities**
 - 2005-2008: just under 5%
 - 2009-2012: just over 24%
 - 2013: expected to rise by around 9%
 - Overvalued by up to 20%
- **Germany as a whole**
 - 2005-2008: -1%
 - 2009-2012: just over 8%
 - Price increase in first half of 2013 of between 3% and 4%

Residential property prices in Germany

2010 = 100



1 Source: Bundesbank calculations for freehold apartments based on data provided by BulwienGesa AG; the 7 largest cities are Berlin, Cologne, Düsseldorf, Frankfurt am Main, Hamburg, Munich and Stuttgart. **2** Source: Hypoport AG. **3** Source: The Association of German Pfandbrief Banks (Verband deutscher Pfandbriefbanken).

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F2PR0052.Chart

In Germany, no substantial risks to financial stability from rising property prices at present

- Interplay of credit growth and credit standards crucial for financial stability
 - At 2.2% in 2013 Q3, growth in mortgage loans still moderate
 - Debt sustainability of households remains robust
 - Experience in other countries has shown that real estate markets can pose a risk to financial stability if interest rates remain low for a prolonged period of time
 - Requests for information from German banks, which are still ongoing, give further insight into financing of residential real estate
- ➔ *Conservative standards still important and necessary when issuing mortgage loans*

Central counterparties (CCPs) gain systemic importance

- Increasing use of CCPs
 - 57% of new index CDSs moved to CCP clearing*
 - 42% of globally outstanding OTC interest rate derivatives cleared through a CCP**

- Risks concentrated at CCPs
 - ➔ *Ensure strict risk management provisions for CCPs*
 - ➔ *Establish suitable recovery and resolution regimes for CCPs*
 - ➔ *Do not create new vulnerabilities*

* 2013 Q2

** Mid-2013

Clearing of credit default swaps through central counterparties

Percentage share of total global new contracts

Counterparties	Product group	2012 Q4	2013 Q1	2013 Q2
Dealer - Dealer	Index CDS	28	41	57
	Single-name CDS	22	24	21
Dealer - Customer	Index CDS	1	4	25
	Single-name CDS	-	-	-

Source: Depository Trust & Clearing Corporation (DTCC).

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Risks from European sovereign debt crisis: what needs to be done?

- *Euro-area economic policy: continue consolidation and reform process*
- *Refocus monetary policy on core task of safeguarding price stability*
- *Phase-out preferential regulatory treatment of government bonds on banks' balance sheets in the medium term*

Risks from low-interest-rate environment: what needs to be done?

- **Banks and insurers**

- *Risk perceptions must factor in eventual reversion of interest rates and refinancing terms to a normal level and possibility of rising volatility on financial markets*
- *Conservative credit standards needed for mortgage lending*
- *Life insurers: strengthen capital; review payout amounts*

- **Public authorities**

- *Aim for a sound and sustainable regulatory framework for life insurers' valuation reserves*
- *Prepare macroprudential instruments for practical application*



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