Macroprudential Policy: Safeguarding Financial Stability
Dr. Jens Reich, Deutsche Bundesbank, DG Financial Stability
Berlin – October 24th, 2019
Financial crises are costly for the real economy…
Change real economic indicators during standard recessions and recessions that were preceded by a credit boom, 150 countries 1970-2011.

*Calculations of the German Council of Economic Experts. The chart shows the changes between the year in which the economic expansion reached its peak and k years later.

Deutsche Bundesbank
...have long and lasting effects on public finances...

Which measures affected public debt more intensely in Germany?

1. Support of the banking sector during and after the financial crisis.


3. The impact of both were almost identical.

To answer the questions please open [www.menti.com](http://www.menti.com) and enter the following Code: 10 59 94.
...have long and lasting effects on public finances...

Debt impact of stabilization measures taken in connection with the financial crisis and the European sovereign debt crisis.

I. Financial stability

II. Macroprudential policy
I. Financial stability

II. Macroprudential policy
Systemic risks and financial (in)stability
Definition and sources of systemic risk.

We consider the financial system stable if

- it provides its functions while market participants constantly adjust to changing economic conditions.

A stable financial system

- is able to absorb idiosyncratic and macroeconomic shocks – in particular in times of economic upheaval.
- mitigates contagion and feedback effects, i.e. the FS neither triggers an economic contraction nor amplifies an exogenous shock.

A financial system is instable if shocks hit vulnerabilities.
Systemic risks and financial (in)stability
Definition and sources of systemic risk.

\[
\text{capital ratio} = \frac{\text{equity}}{\text{risk weighted assets}}
\]

- **Adjustment 1:** retained earnings
- **Adjustment 2:** issue stocks
- **Adjustment 3:** shrink asset side

Credit
Systemic risks and financial (in)stability
Definition and sources of systemic risk.

Systemic risk arises from (structural) vulnerabilities of systemic risk:
  • excessive risk taking of large banks and implicit government guarantees for these institutions („too big to fail“),
  • the nature of the financial system as an interconnected network („too connected to fail“),
  • many banks making the same kinds of bad bets („too many to fail“);

Cyclical vulnerabilities of systemic risk (excessive credit growth); and

vulnerabilities with structural and cyclical elements:
  • systematic underestimation of (in particular credit) risk,
  • overvaluation of assets and loan collateral, e.g. real estate, or
  • excessive period transformation (in particular interest rate risk).
No traffic...
... or make traffic safe again.
I. Financial stability

II. Macroprudential policy
I. Financial stability

II. Macroprudential policy
Macroprudential Policy
…and its toolkit.

Vulnerabilities
- credit growth and leverage
- maturity/liquidity transformation
- exposure concentration
- SII, incentives/moral hazard
- financial market infrastructures

Financial Stability

Financial System
- Banks
- Insurer
- Markets
- Infrastructure
3 main categories of macroprudential instruments:

1. **soft**: communication

2. **intermediate**: warnings and recommendations („formal“ communication)

3. **hard**: interventions (e.g. capita-related instruments, sustainability-related instruments, liquidity and funding ratios)
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Key messages:

- Cyclical risks have built up in the German financial system during the long period of growth and low interest rates:
  - Potential underestimation of credit risk
  - Potential overvaluation of assets and loan collateral, e.g. real estate
  - Interest rate risk
- If economic conditions deteriorate unexpectedly, these risks may occur at the same time, reinforce each other, and lead to herding behavior in the financial system (aggravating negative developments).
  - The existing buffers may not be enough to limit contagion effects within the financial system or negative feedback effects to the real economy.
- Now is the time to build sufficient buffers against unexpected developments.
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**Macroprudential Instruments**

3 main categories of macroprudential instruments:

1. **Soft**: communication
   - O-SII Buffer
   - Countercyclical Buffer
   - Capital Conservation Buffer
   - Net Pillar 2
   - Tier 2
   - Additional Tier 1
   - Common Equity Tier 1

2. **Intermediate**: warnings and recommendations ("formal" communication)
   - 0 - 2.5%

3. **Hard**: interventions (e.g. capital-related instruments, sustainability-related instruments, liquidity and funding ratios)
   - 0 - 5%
   - 2.5%
   - 3.6% (Ω in 2017)
   - 2%
   - 1.5%
   - 4.5%

**Systemic risk buffer.**

**In certain cases can be the sum of SII & systemic risk buffer.**

**Assumed upper bounds (values can be higher).**

*Extra CET1 buffer for TBTF risks*
*Extra CET1 buffer for cyclical risks*
*Extra CET1 buffer (micro+macroprudential)*
*Bank-specific additional supervisory requirement (micro+macroprudential)*
*Basic requirement (Basel III)*
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Macroprudential Policy: Safeguarding Financial Stability
Dr. Jens Reich, Deutsche Bundesbank, DG Financial Stability
Frankfurt - July 17th, 2019
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BCBS: L=2; CCCB=0 and H=10; CCCB=2.5

Countercyclical capital buffer for Germany
Quarterly data

- Upper bound
- Lower bound
- Credit-to-GDP ratio gap
- Capital buffer as a percentage of risk-weighted assets

Deutsche Bundesbank
3 Jun 2014, 13:40:24, F1PR0030.Chart

“Operationalising the countercyclical capital buffer” ESRB Occasional Paper Series No. 5 / June 2014
Macroprudential Policy
…and its toolkit: warnings and recommendations.

Dr. Jens Reich
June 17th, 2019
Seite 29
Macroprudential Policy
…and its coordination in Germany … in its European context.
Macroprudential Policy

…and its coordination in Germany … in its European context. 
**Recommendation** to the German government to establish a legal foundation for the creation of **borrower-based** macroprudential instruments for the housing sector:

- capping the LTV ratio
- setting an amortisation requirement
- capping the debt service to income ratio
- capping the debt to income (DTI) ratio
Recommendation to the Federal Financial Supervisory Authority to increase the countercyclical capital buffer from 0% to 0.25%, due to:

- low interest rates and growth: credit risks might be underestimated; resilience of the financial system could be overstated,
- revaluation of assets, the value of collateral might be overestimated,
- interest rate risk and credit risk could occur simultaneously,
- risks can be mutually reinforcing in the financial system.