Macroprudential Supervision in Germany

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Macroprudential supervision at the international level

Organizational structure of the German Financial Stability Committee

Financial stability instruments in Germany

Performance of German Financial Stability Committee

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Macroprudential supervision – Systemic risks

− **In response to the world financial crisis two externalities** were identified justifying macroprudential intervention:

1. **Strongly interlinked and in most cases very big financial institutions** causing simultaneous or sequential default (domino effects):

2. **Endogenous mechanisms creating systemic risks:**

   - **Procyclical and self-reinforcing mechanisms** inside the financial system tend to accelerate boom-bust-cycles in financial markets.

   - Greater **willingness to take on more risks** during the boom phase increases the vulnerability of the whole financial system.

   - A **flight to safety** causes a dramatic drop in value of assets and an drying out of liquidity in the financial system, thus severely affecting the real economy. **Fire sales** deepen the crisis.

Institutional design of macroprudential supervision

- **Global level:**
  - **2009:** Financial Stability Board (FSB) → G20

- **European level (EU)**
  - **2011:** European Systemic Risk Board (ESRB): <u>Identification</u> of financial risks and formulation of <u>recommendations</u>

- **National level**
  - Establishment of institutions with the aim of macroprudential supervision.
  - Institution in Germany: German **Financial Stability Committee (G-FSC, since 2013)**.
  - **Note:** ECB is entitled to implement **higher** capital requirements for banks than those defined by national supervisors in case of risks to financial stability.

ESRB recommendations

- In 2011, the ESRB published the recommendation for EU member states to designate **a single institution or board** that is responsible for the conduct of macroprudential policy at the **national level** and that has control over the instruments appropriate for achieving its objective.

- Furthermore, the ESRB recommended that the macroprudential authority should be operationally **independent** and **accountable** to the national parliament.

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German Financial Stability Committee - Establishment

- In 2013 Germany implemented the recommendation of the ESRB to establish a national committee responsible for macroprudential supervision.

- **Main tasks** of the Financial Stability Committee:

  - Discussing the factors that are key to financial stability.

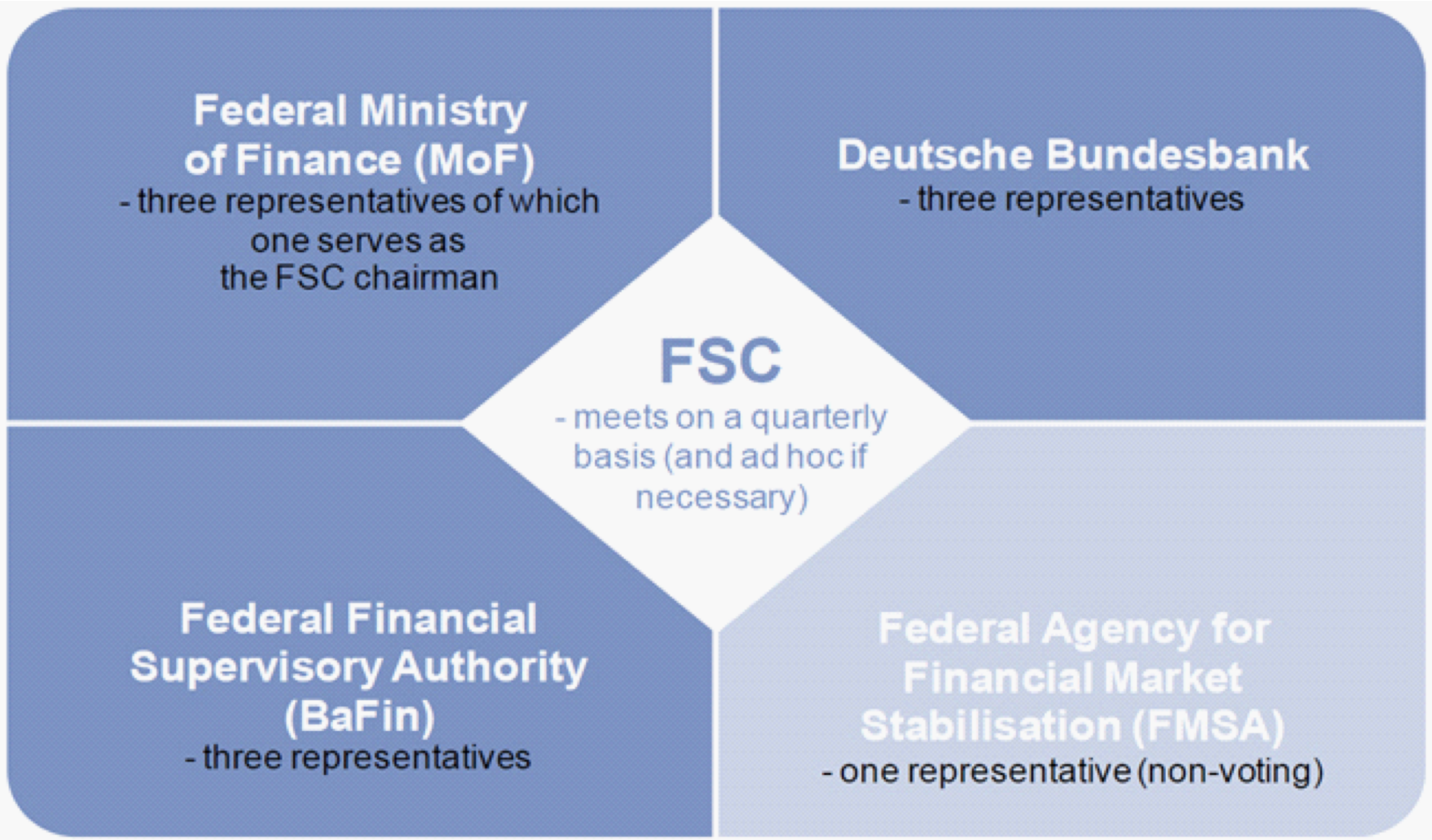
  - Strengthening cooperation between the institutions represented in the Financial Stability Committee in the event of a financial crisis.

  - Handling of warnings and recommendations issued by the ESRB.

  - **Reporting annually to the lower house of parliament**. So far the G-FSC has published four annual reports with an in-depth discussion of the present state of financial stability in Germany.

  - Issuance of warnings and recommendations.

German Financial Stability Committee - Composition



- The board structure ensures cooperation among the different institutions whose actions have a material impact on financial stability.

German Financial Stability Committee – Role of the Bundesbank

- **Because of its macroeconomic expertise the Bundesbank** takes a leading role in the G-FSC.

- The **Bundesbank** mainly acts as an “analytical” institution. It is empowered to analyze important factors and to identify major risks to the stability of the financial system.

- It provides the committee with an annual report on financial stability in Germany.

- It formulates warnings and recommendations.

- It examines and assesses the implementation of recommendations by national authorities.

- Being a member of the Financial Stability Committee is not a threat to Bundesbank's independence.

German Financial Stability Committee – Decision making

- The Financial Stability Committee’s decisions require a simple majority.

- Decisions regarding warnings and recommendations and their publication should be taken **unanimously**.

- Decisions on warnings and recommendations may **not be taken without consent of the Deutsche Bundesbank**!

- Of course, **ultimate responsibility** for safeguarding financial stability lies with **political bodies** (Federal Ministry of Finance or Federal Financial Supervisory Authority (BaFin).

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German Financial Stability Committee – Instruments

- Macroprudential instruments can generally be categorized according to the legal strength of the intervention:

- **Soft intervention (communication):**

  - Publication of analyses and assessments of financial stability without legal consequences.

  - Development of a macroprudential policy strategy.

  - Reports and press conferences.

German Financial Stability Committee – Instruments

- **Intermediate intervention (warnings and recommendations):**

  - Warnings do not entail concrete instructions for action.

  - Recommendations offer specific guidance on what measures to take.

  - Warnings and recommendations could be made public or left confidential. In order to guarantee transparency, under normal conditions they should be made public.

  - Recipients could be state authorities or the federal government.

  - Recipients have to make clear to the G-FSC in which way they plan to implement recommendations or why no action is envisaged (**“comply or explain”**).

German Financial Stability Committee – Instruments

– **Hard intervention tools (selection and design of instruments):**

- Instruments must be enshrined in law to guarantee democratic supervision.

- The list of instruments consists of all instruments already recommended by the ESRB (concerning capital, liquidity or borrower requirements).

- Conceivable measures could also encompass **other forms of intervention** (i.e. tax regulations to combat excesses on the real estate markets).

- **Selection of suitable intervention tools** presupposes the analysis of the specific stability risk, the impact chain (or “transmission process”) and the legal framework for the instrument’s use.

- This analysis of the transmission process must cover possible **side effects** of their use and any interaction between tools that are deployed in parallel.

German Financial Stability Committee – Rules vs. discretion

- Basically, the G-FSC aims at **rule-based decisions**.

- Under a rule-based regime, the first step is to **establish suitable (forward-looking) indicators**.

- There have to be defined certain **thresholds** which – if breached – should trigger the activation of intervention tools.

- **Advantages** of a rule-based regime: Transparent, predictable, consistent use of instruments over time, facilitates steering of market expectations.

- **However**, uncertainty about the identification and interpretation of relevant indicators inevitably requires some degree of discretion.

- Accordingly, discretionary decision on the timing and intensity of macroprudential measures require intensive explanation.

Basel III-based macroprudential instruments - Countercyclical capital buffer (CCB)

- Strategic goal of Basel III: Requiring banks to build up more capital in good times, which can be “eaten up” in bad times.
- Capital conservation buffer is not really countercyclical. His main task is to solve the regulatory paradox.
- With Basel III an additional countercyclical buffer has been introduced to avoid the emergence of boom-bust-cycles in financial markets.
- **In times of booms this buffer contributes to slow down speculative bubbles**, in times of busts the accumulated capital stands ready to participate in losses.
- Ideally, this buffer reduces the probability or at least the amplitude of financial market crises.

Basel III-based macroprudential instruments - Countercyclical capital buffer (CCB)

- As the countercyclical capital buffer has to be implemented **in a rule-based but discretionary manne**r the competent **national** authority (BaFin) has to decide if and how this buffer has to be applied.

- CCB is calculated quarterly (period-end value of aggregate credit / 4-quarter moving-average of GDP).

- The corridor for CCB ranges from 0% to 2,5% of RWA (after a three-years transition period until 2019). Capital has to be provided as **core capital**.

- Banks have to fulfill the higher capital requirements **within 1 year**.

- **Calibration is based upon appropriate financial market indicators.**

- The best indicator is the **Credit-to-GDP-ratio** as in the past a significant deviation of this ratio from trend indicated financial market crises.

Basel III-based macroprudential instruments - Countercyclical capital buffer (CCB)

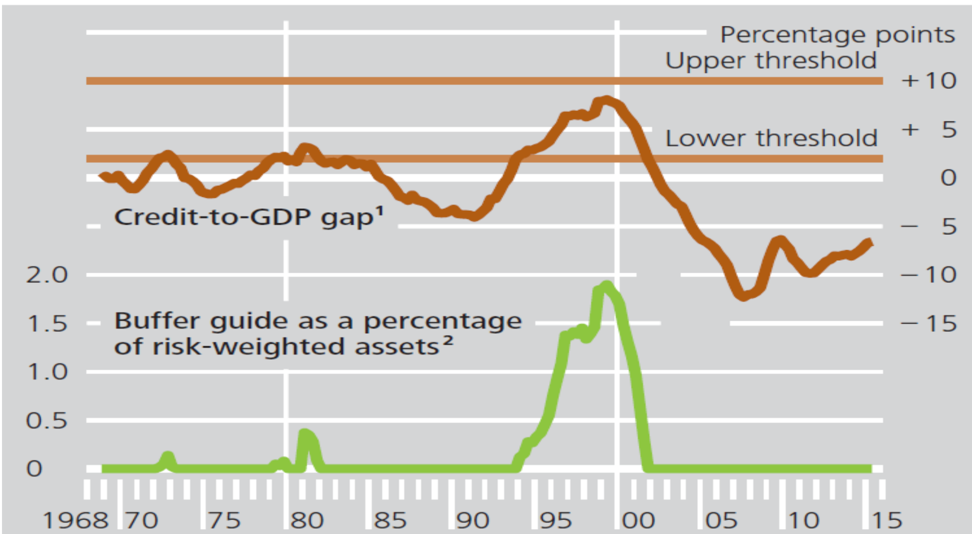
− Besides the Credit-to-GDP-ratio, further indicators can be applied in the national context if appropriate. For example:

- Real loan growth and indebtedness of the private non-financial sector
- House prices, mortgage loans, credit standards
- Indicators for external imbalances (current account)
- Mispricing of risks (real bond yields, yield spreads for corporate bonds)
- Solvability of banks (share of non-performing loans)
- Indicators for stress in the financial system (credit default swaps)

Basel III-based macroprudential instruments - Countercyclical capital buffer (CCB)

Countercyclical capital buffer for Germany Chart 2.1.1

Quarterly data



Sources: Deutsche Bundesbank, Federal Statistical Office and Bundesbank calculations. **1** The credit-to-GDP gap shows the deviation of the credit-to-GDP ratio from its long-term trend. A large positive gap can point to excessive credit growth and indicates that the buffer should be activated. **2** The buffer guide increases linearly with the credit-to-GDP gap in the interval between zero and 2.5. The buffer rate will typically lie within this interval. The buffer guide will only ever be greater than zero if the credit-to-GDP gap exceeds 2 percentage points (lower threshold). The buffer guide reaches its maximum of 2.5 when the credit-to-GDP gap reaches or exceeds 10 percentage points (upper threshold).

Deutsche Bundesbank

- Countercyclical capital buffer has been operational in Germany since 2016.
- **Calibration**: Starting with a credit-to-GDP-ratio of 2% (lower threshold) the CCB is rising linearly by 0.3125 PP as the ratio increases by 1 PP.
- At the upper threshold the buffer has reached its maximum of 2.5%.
- Currently the CCB is set at 0% by the Federal Financial Supervisory Authority.

Countercyclical capital buffer (CCB)

- There are two main causes which should trigger a reduction of the CCB:

1. Declining potential risks (economic growth, financial stability).

2. Materialization of risks, i.e. occurrence of losses.

- In the first case, the buffer will be reduced gradually. The decision will be based on a broad assessment of risk indicators.

- In the second case, a prompt release of capital could be appropriate.

Basel III-based macroprudential instruments - Countercyclical capital buffer (CCB)

- **Problems**:

  - A persistent period of strong credit-growth drives the trend-component upwards, reducing the gap and, thereby, weakening the stabilizing power of the CCB.

  - If the financial cycle and the business cycle point in opposite directions the CCB might have a pro-cyclical impact.

    - Accordingly, regulation in Germany stipulates that in case of a negative growth rate of GDP (yoy) the CCB should not be revised upwards but remain at the level of the previous period.

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German Financial Stability Committee - Performance

- The G-FSC addressed its first recommendation in June 2015 in its annual report to the German parliament to **lay the legal conditions for certain instruments to regulate the residential property market**. The G-FSC recommended four instruments:

- **Loan-to-value limit**: Upper limit for the total volume of loans in relation to the market value of the residential property which is used as mortgage.

- **Amortization period**: Maximum length of time until a certain fraction of the loan has to be amortized and/or a maximum duration for total amortization.

- **Debt-Service-To-Income-Ratio**: Upper limit for total financial obligations from all liabilities (including from the loan applied for) to total income.

- **Debt-To-Income-Ratio**: Upper limit for total debt of each individual customer (including the loan applied for) in relation to his or her income.

German Financial Stability Committee - Performance

- There is a certain percentage of new loans which are exempt from the upper limits (**contingent of excess**) as well as a “de minimis limit” for small loans (50.000 Euro).

- The G-FSC recommended to establish legal conditions **to collect data** about the **leverage** of property finance and **amortization** of loans.

- As there is no European regulation these legal provisions have to be provided within **national law**.

- Moreover, the G-FSC recommended to improve the data base for commercial property.

German Financial Stability Committee - Performance

- In **October 2016**, the Ministry of Finance published a **draft legislation** concerning the legal amendments necessary for the application of the **four** macroprudential instruments mentioned above.
  - A legal foundation for the **collection of the data** was not part of this draft!
- After discussions in parliament both income-related instruments were deleted from the list of instruments.
- This cancellation followed heavy intervention by the banking lobby, mainly by small and medium sized banks.
  - Concerns about the **administrative burden** of data collection.
  - Suspicion that provision of the legal foundations is tantamount to the implementation of these instruments. → Loss of profitable business.

German Financial Stability Committee - Performance

- **In its 2016 annual report** the G-FSC discussed the consequences of zero interest rate policy for the German financial system.

  - The committee came to the conclusion that the financial system in Germany is sufficiently robust und resilient.

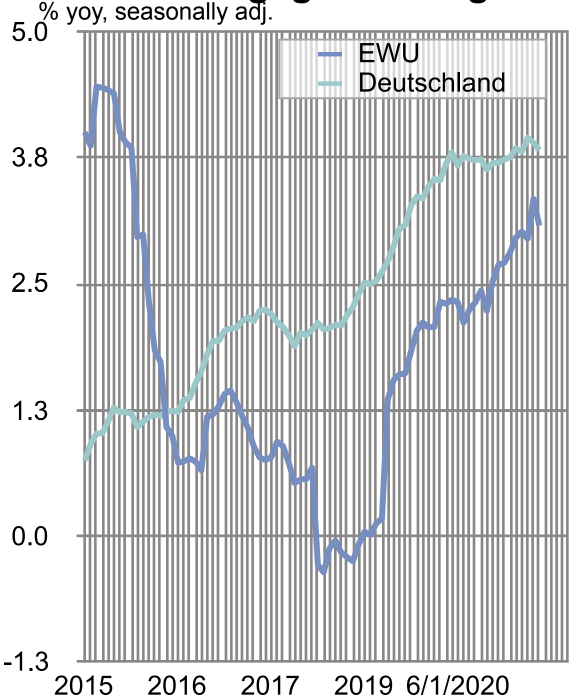
- **In its 2017 annual report** the G-FSC endorsed the general conclusion of a robust and resilient financial system in Germany.

  - Besides, the G-FSC warns about an increase of the average maturity of banks' assets (rising maturity transformation) as it aggravates **interest rate risks** associated with an exit of the zero interest rate policy.

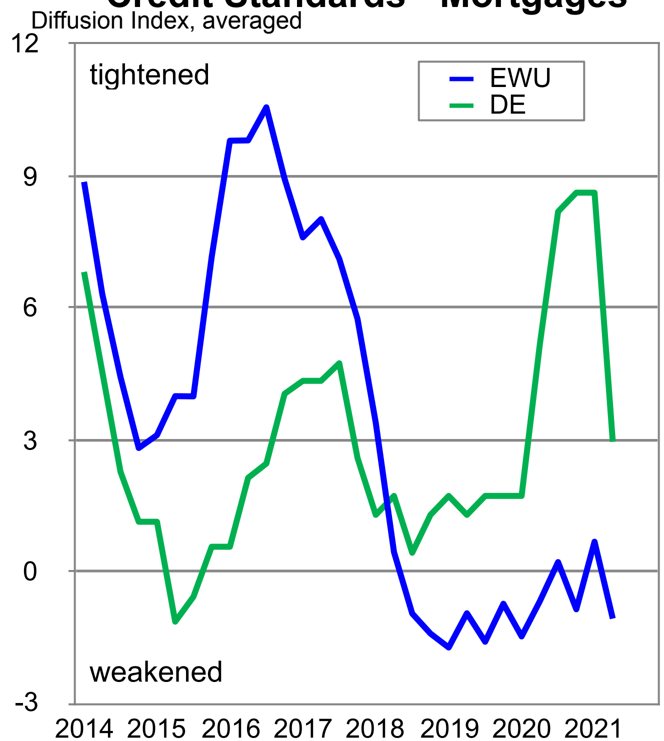
  - Despite a **moderate over-valuation in big cities**, so far the real estate market does not represent a substantial risk to the German financial system.

German Financial Stability Committee - Performance

Mortgage Lending



Credit Standards - Mortgages



Source: Bank lending survey.

- Moderate **mortgage lending** growth and sufficiently tight **credit standards** do not point to serious risks in the German financial system.

Thank you!