Nils Bernstein: Proposals for mortgage credit regulation

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the annual meeting of the Danish Mortgage Banks' Federation, Copenhagen, 30 March 2011.

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Growth in the global economy has accelerated over the last year and has become more robust. But recent events have, once again, shown how unpredictable the world is. The turmoil in the Middle East – with an armed conflict in Libya – and the natural disaster in Japan with its alarming consequences will not halt the global economic upswing, but they will have an impact.

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Combined with a number of other factors, the upswing has contributed to a global price hike. Inflation is driven by rising food and commodity prices. Commodity prices are now almost back at the high level seen before the financial crisis. It looks as if the crisis just led to a short interruption of an upward underlying trend in commodity prices.

With higher inflation, the level of interest rates is likely to normalise sooner than the markets have previously expected. The anchoring of inflation expectations is important if the higher prices are not to spill over to wages and trigger a price-wage spiral. The European Central Bank has stressed its commitment to keeping inflation at bay, and there is reason to believe that an undesirable price-wage spiral can be avoided, as long as there is plenty of spare capacity and labour.

The financial crisis and not least the European sovereign debt crisis have clearly shown that there is a need for stronger economic cooperation in the EU. And so far the EU has been ready to respond to this need. The first important step was taken in the autumn, when the Commission and the Van Rompuy task force presented their proposals for strengthening the Stability and Growth Pact and other aspects of economic cooperation. The member states have now agreed on a series of amendments to strengthen fiscal discipline and – as a new element – introduce a surveillance mechanism to prevent fundamental macroeconomic imbalances in EU member states, including those outside the euro area.

The second important step was taken on 11 March, when the heads of state or government of the euro area member states agreed on the Euro Pact. The pact is first and foremost a strong political signal of shared determination to introduce initiatives to strengthen competitiveness, employment, fiscal discipline and financial stability. As a non-euro area member state, Denmark did not have to join the Pact. At Danmarks Nationalbank we are pleased to note that there was broad support for doing so in the Danish parliament, Folketinget. But I should add that words must always be followed by action if the Pact is to have any value.

The third important step is the agreement to establish a permanent crisis resolution mechanism – the European Stability Mechanism, ESM. This debt-financing mechanism is to be established for euro area member states from mid-2013 and will replace the temporary financing mechanism for euro area member states in sovereign debt difficulties. Together with IMF funding and possibly bilateral contributions, the ESM will help to ensure adequate responses to future sovereign debt crises. An important element of the plan is that the ESM will offer loans only if macroeconomic stabilisation programmes are implemented at the same time, imposing stringent economic policy obligations on the recipient member state.

Danmarks Nationalbank welcomes these improvements of the framework for economic cooperation. Since our currency is closely tied to the euro, Denmark will benefit from operating within the same overall economic framework as the euro area member states, thereby contributing to robust economic cooperation in the EU. But the strength of the cooperation can only be put to the test in practice.

The need for stronger economic cooperation is reflected in the different economic situations of the individual EU member states at present.

The best-performing member states are characterised by a long period of moderate wage inflation relative to productivity developments, as well as balanced public finances. Germany and Sweden are cases in point. It is also worth noting that these two member states did not have housing bubbles that burst.

At the opposite end of the scale we find a group of member states with large sovereign debt problems and sagging competitiveness. Their large government budget deficits and external deficits as well as their high government debts reflect that consumption and investment have been exceeding output for a long time. This can continue for a while, but naturally it is not sustainable in the long run. Consumption and investment have been driven by factors such as rapidly rising house prices that subsequently plummeted.

Denmark is probably somewhere in between these two extremes.

For the last 5–6 years, the Danish economy has seen an excessive boom followed by a deep recession that we are only slowly working our way out of.

In the wake of the crisis, the private sector has been consolidating strongly. Corporate investments are low compared with earnings, and over the last 18 months private consumption has increased far less than disposable incomes. This means that consumption as a ratio of disposable incomes is low by historical standards. Real disposable incomes are likely to grow at a much slower pace in the coming years, but nevertheless we expect private consumption to increase somewhat, so that the consumption ratio will approach its normal level. We also expect a certain increase in private investment as firms benefit from rising demand, both at home and abroad.

Based on the above, Danmarks Nationalbank expects growth in Denmark to be just under 2 per cent p.a. this year and the next few years. This is slightly higher than the expected growth rate in the euro area, and also higher than the underlying growth in Denmark's output potential. As a result, net unemployment is set to decline slowly towards its structural level of around 100,000. Structural unemployment is the level of unemployment that is sustainable in the long term and that is compatible with low and stable Danish inflation in line with that of the euro area.

Although the loss of output was unusually large during the crisis, unemployment was so low at the outset that net unemployment has not risen much above its structural level after the crisis. Furthermore, as I have already mentioned, the economy is set to grow at a solid pace by Danish standards in the coming years.

We can also see that the European sovereign debt crisis has made international investors far more aware of whether individual countries are pursuing responsible fiscal policies.

That is why Danmarks Nationalbank repeatedly urges the Danish government to maintain the tight fiscal policy planned for the coming years. We do not need any new stimulus packages at the moment. If, contrary to expectations, the international economy goes into reverse again, it would be sad if Denmark uses up all its fiscal policy room of manoeuvre right now – at a time when the economy is actually moving forward.

If our expectations are exceeded, it would not be good to have exploited the scope for growth beforehand. In that case the risk of renewed overheating would be imminent.

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Denmark experienced strong cyclical fluctuations in the last decade. They were not only attributable to the international financial crisis, but were to some extent self-inflicted. Partly because fiscal policy had been eased during the boom, and partly because we have introduced a number of housing market structures that amplify rather than dampen cyclical fluctuations. These include the freeze on property value tax in kroner and the development of new loan types, notably loans with deferred amortisation. They are also known as loans with payment holidays. Since more than half of all mortgage loans are now with deferred amortisation, the holiday has almost become permanent.

The freeze means that the effective property value tax declines in a boom when house prices go up. On the other hand, it cannot decline when house prices go down. Analyses in Danmarks Nationalbank's most recent Monetary Review (English version to be issued) show that price fluctuations can be dampened if the property value tax is, once again, allowed to move in parallel with house prices.

Our analyses also indicate that home buyers to some extent see amortisation of mortgage loans as an expense in line with, say, interest and housing taxes. So the use of deferred-amortisation loans amplifies fluctuations in house prices. If prices go up, loans with amortisation entail a larger increase in overall payments to service the loan compared with deferred-amortisation loans. The higher costs dampen the demand for housing and curb the price rise. Conversely, if house prices fall, loans with amortisation entail a larger decline in the payments compared with deferred-amortisation loans. This stimulates the demand for housing and helps to buoy up the market. In other words, loans with amortisation help to stabilise house prices. This favourable effect is lost as deferred-amortisation loans gain ground. Our analyses show that deferred-amortisation loans have contributed more to the fluctuations in house prices than the freeze on property value tax.

To dampen the strong fluctuations in the housing market, Danmarks Nationalbank has suggested that the link between property value tax and property value should be re-established and that access to new deferred-amortisation loans should gradually be phased out.

There have been widespread concerns that our proposals could be detrimental to the housing market. On the contrary; the aim is to increase stability and provide a bulwark against excessive fluctuations in both directions. As for the potential problems in connection with the transition to a more stable system, I would like to emphasise two factors.

Firstly, our proposals do not affect existing deferred-amortisation loans. We simply suggest a gradual and gentle lowering of the threshold for new mortgage loans with deferred amortisation.

Secondly, we do not propose restoring the property value tax to the somewhat higher level applying before the tax freeze was introduced in 2002. That is another issue – which I will not discuss here.

We are merely suggesting that further erosion of the property value tax should be prevented by letting taxes match developments in property value in future. This could act as an automatic stabiliser. If interest rates suddenly begin to rise unexpectedly, pressing house prices down, our proposal means that the property value tax automatically decreases, and this will dampen the price fall.

The stabilising effects of these proposals would provide considerable gains for the economy. That would also be in the interests of homeowners. If our proposals are rejected, we would like to hear other suggestions for preventing large future fluctuations in house prices that could jeopardise economic and financial stability.

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Both internationally and in Denmark economists are discussing the lessons to be learned from the financial crisis, and the future regulation of the financial system in the light of this experience. As I see it, an artificial distinction is being made in Denmark. In simplified terms you could say that there is broad understanding that the requirements for banks must be tightened. In contrast, there seems to be little understanding that the same could apply to the activities of mortgage banks. In my opinion, we also need to focus on mortgage credit.

Danmarks Nationalbank's proposal to phase out deferred-amortisation loans and realign property value tax is one response to the lessons learned from the financial crisis. It can also provide part of the answer to another important question: how do we ensure the underlying collateral of covered bonds if house prices fall? I have previously pointed out that the need to provide additional collateral in that situation could have a destabilising effect, and I have encouraged the Ministry of Economic and Business Affairs to look into the issue. The problem is that mortgage loans granted on the basis of covered bonds cannot exceed 80 per cent of the value of the home. If the price falls so that the total mortgage exceeds 80 per cent of the value, the mortgage bank must raise additional collateral to bridge the gap. A permanently lower loan-to-value ratio for mortgages would directly address this issue, but as you know, it was not possible to muster support for this solution when covered bonds were introduced.

Slow and gentle phasing-out of deferred-amortisation loans would help to solve the problem, as falls in house prices would be cushioned and the mortgages would gradually be repaid, thereby reducing the risk of conflicting with this rule. We need mechanisms that will automatically support compliance so that it will not be necessary to issue new debt instruments at a time when house prices are falling. But I am open to other suggestions. You just have to remember that money is most difficult to come by when you need it the most.

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Let me now turn to the popular adjustable-rate mortgage loans. Variable-rate loans can actually help to stabilise the economy, provided that the Danish economy is moving in synch with that of the euro area. In that situation we will "import" euro area interest rates, which will fit in well with economic developments in Denmark. But if we are at another cyclical stage, it is, of course, important for fiscal policy to compensate for this.

For a number of years, variable-rate loans have meant lower expenses for homeowners. The more widespread use of these loans make households more vulnerable to rising interest rates. If the yield on the bonds used to finance adjustable-rate loans rises, homeowners must foot the bill – even if the increase is extraordinarily high, perhaps in connection with a currency crisis. It is very important that homeowners are aware of this risk and have taken it into account in their budgets. I have the impression that most households will be resilient to the rise in interest rates resulting from ordinary cyclical developments.

What concerns me most about adjustable-rate loans is their inherent refinancing risk. Mortgage banks offer 30-year loans financed via short-term bonds – often with annual refinancing. Another lesson learned from the financial crisis is that there is a real risk that these markets will stop functioning at times, or that interest rates soar to extraordinary levels.

I have already said on several occasions that it is a good idea to spread the auctions, and I would like to acknowledge – once again – the initiatives taken in this respect. I strongly encourage all mortgage banks to follow suit.

Refinancing risk is part of the product design. This is the risk that the forthcoming regulation on stable financing is addressing – and should address. The details are not in place yet, but it is planned to take effect in 2018. This will require major structural adaptations that cannot be achieved overnight. The mortgage-credit market is like a super tanker. It takes time to change the course and gradually adapt, so preparations must start well in advance. Mortgage banks should already begin to develop products that will adequately address the issue of refinancing risk.

I have also made it clear to the financial institutions that use of Danmarks Nationalbank's lending facilities is not an acceptable solution for managing refinancing risk. I take this opportunity to repeat that message. Securities should only be pledged as collateral to Danmarks Nationalbank in connection with ordinary monetary-policy operations. If we find that the system is being misused to support the housing market, we will take action and perhaps have a friendly talk with the institution in question. We have done that before. Eligibility as collateral must not be a precondition for a given mortgage-credit product.

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Today I have presented a number of proposals for regulating various issues in relation to mortgage credit in order to make the system more resilient to future developments. The financial crisis has demonstrated that rare misfortunes do actually strike from time to time. This should be taken into account in financial regulation. This applies not only to banks – but also to mortgage banks.

Finally, I would like to thank the Federation for our good cooperation during the past year and for inviting me to speak at today’s meeting.

Thank you for your attention.