Lars Rohde: Developments in the world economy, the Danish economy and in its mortgage credit system

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Danish Mortgage Banks' Federation, Copenhagen, 9 April 2013.

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Since the autumn, the financial markets have seen positive development. Above all, tensions related to Southern European countries have eased, which has been reflected in falling interest rates and inflows of private-sector capital into these countries. Most recently, the turmoil in connection with Cyprus and Italy has had little effect on other EU member states. This shows that the financial markets have become more resilient. However, the positive trend is not yet reflected in the real economy of the euro area, which remains weak. At the same time, the USA and the rest of the world are in a moderate upswing.

Growth has been negative in the euro area since late 2011, and a further decline is expected in the first part of this year. Unemployment is rising, but with considerable variation between the member states. The Southern European countries are burdened by high unemployment, including high youth and long-term unemployment. In fact, the situation is so bad that it has triggered social and political unrest. That gives cause for concern. Moreover, there is a risk of reform fatigue in these member states, which will make it more difficult to implement reforms e.g. in the labour market, even though there is not really any alternative.

The negative growth in the euro area over the last year reflects falls in both investment and private consumption. Firms are consolidating rather than investing. This also applies to the financial enterprises, many of which presumably want to build up buffers against potential shocks. At the same time, credit conditions for households and the corporate sector have been tightened. The stricter regulatory requirements imposed by the authorities are likely to have a similar effect initially, but calculations by the ECB and others indicate that a more robust financial sector benefits society overall. At any rate, it is necessary to build up larger buffers in all parts of the economy in the wake of the financial crisis and the sovereign debt crisis.

The USA is struggling with its own budget problems, and there is political disagreement on how to tackle them. Lack of will to compromise will result in relatively strong fiscal tightening this year as automatic tax rises and cutbacks come into force. But perhaps this is not the worst that thing could happen in a long-term perspective. There is an urgent need to balance revenue and expenses, even if it results in a temporary reduction of growth; otherwise there is a risk that confidence in government finances weakens considerably. This could have drastic implications.

On the bright side, consumer price inflation remains low and stable in the advanced economies. Although the central banks are pumping out liquidity, there are apparently no immediate inflationary pressures. But there is a risk that the very low nominal interest rates continue for too long. This could lead to inappropriate risk behaviour in an attempt to achieve higher returns. Uncertainty about the growth outlook for the global economy has diminished as the euro area turmoil has abated. The European Commission, among others, expects that the euro area economy will still be characterised by weak domestic demand in 2013, partly due to the ongoing necessary fiscal consolidation in a number of member states. As a result, growth is likely to be negative this year and only moderately positive next year. On the other hand, US economic growth is expected to accelerate over the coming years and will be close to its potential level by the end of 2014 – despite the current budget problems. Conversely, the German economy, which has performed well for some time, slowed down towards the end of 2012. According to the European Commission's forecast, growth will be lower in Germany than in Denmark this year.

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The Danish economy underperformed last year. Output fell by 0.5 per cent and is expected to pick up only slightly this year. Throughout 2012, households reduced consumption and investment. Danish households have high gross debt relative to disposable income, but the ratio stabilised in 2012. That is positive. They also hold considerable assets in the form of pension savings and free financial wealth, besides their homes.

Price inflation in Denmark has declined sharply in recent months, and Danmarks Nationalbank expects inflation to land at 1.3 per cent for 2013 overall. That is below the expected rate of wage increase. So despite low wage increases, the vast majority of wage earners are likely to see a small increase in real wages. Combined with the low interest rates, this will boost disposable income and hence also consumption. However, no strong recovery is expected. A flat trend in employment and a still vulnerable housing market will put a damper on growth. Private consumption and GDP are estimated to grow by only 0.7 per cent and 0.8 per cent respectively this year.

Unemployment has been virtually flat since 2010 at a level somewhat below that seen prior to the overheating of the economy in 2006–08. Danmarks Nationalbank expects unemployment to rise a little towards the summer of 2014, after which it will decline as the economy picks up.

At approximately 9 per cent of GDP in 2012, the financial savings surplus of Danish firms and households is very high. It is normal for the private-sector savings surplus to reflect cyclical fluctuations, but this time around the pattern has been more pronounced than during previous recessions, also when compared with the situation in Denmark's neighbouring countries.

One of the reasons for the high savings surplus of Danish firms is the low investment activity, but has the situation evolved into an actual "investment crisis"? I think that would be an overstatement. Business investment plunged during the crisis in 2008–09, and since then its share of gross value added has been below the average for the last couple of decades. But this is purely attributable to building and construction investment. The investment ratio for plant and equipment has risen over the last couple of years and by the end of 2012 it was close to the average since the mid-1990s. This is not the first time investment in plant and equipment responds to the early signs of an upswing, while building investment follows suit at a later stage. So in Danmarks Nationalbank's opinion the current low level of investment is to a large extent a natural cyclical phenomenon, not an indication of a structural investment crisis.

In contrast, corporate savings are substantially higher than usual, also in a cyclical context. At some point, when confidence is restored, this could boost investment. The change could be swifter than expected. On the other hand, there is also a risk that foreign growth falls below expectations, with negative implications for the Danish economy.

Obviously, some sectors are struggling more than others, but that is unavoidable in a constantly changing world. Focus should be on creating attractive framework conditions for output in Denmark.

Viewed in isolation, weak wage increases improved competitiveness in 2012. The recent strengthening of the effective krone rate has had the opposite effect, but nevertheless, the deterioration of Denmark's competitiveness which occurred during the overheating in the 2000s is being rolled back by the market forces. With unemployment only slightly above its structural level, wage inflation has declined notably, and perhaps more than anyone had believed it would. This underscores the value of a well-functioning Danish labour market and contrasts with the situation in the debt-ridden Southern European countries, where unemployment reached a very high level before wage inflation could be reduced.

In other words, the Danish economy is adjusting to the situation and no political interference is required. Denmark is positioned for growth and demand is likely to normalise as the output gap gradually closes in the coming years.

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The negative sentiment in the housing market has curbed economic growth in Denmark for some time. But now we are seeing the first budding signs of improvement. Prices have stabilised over the last year and have begun to rise in some market segments – particularly owner-occupied flats in the cities, notably in Greater Copenhagen. Although the milder winds may also blow across other parts of the market, there are bound to be areas that will not feel them and where prices will continue their downward trend. The housing market is becoming polarised. This is to a large extent due to migration within Denmark, with parts of the country experiencing negative population growth and economic decline, while e.g. the Copenhagen area is prospering.

In Danmarks Nationalbank's assessment, house prices are below the level to be expected – based on historical evidence – given the current levels of income, taxation and interest rates. On the basis of these underlying conditions it is estimated that house prices will rise slightly for Denmark overall in the coming years. This estimate is subject to considerable uncertainty. The difficult, not to say impossible, part is to predict exactly when the mood changes, irrespective of the underlying conditions.

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The Danish mortgage credit system is unique. No doubt about it. The system has proved its worth during the financial crisis and the subsequent sovereign debt crisis, and these have been genuine stress tests. In spite of the odds, it has been possible to expand lending to households and corporates and sell bonds in the market – increasingly to investors abroad.

All along, investors have had confidence in the credit ratings of the bonds and the high liquidity in the mortgage credit market. Pension funds are large investors in mortgage bonds, and banks to a large degree use short-term mortgage bonds for liquidity management.

Hence it is hardly surprising that the Committee on Systemically Important Financial Institutions has identified the market for Danish mortgage bonds as systemically important. Actually, the Danish Mortgage Credit Act already provides for SIFI legislation in relation to mortgage credit. The Act lays down stringent rules for the relationship between lending by mortgage banks and the issuance of bonds to finance the loans. The aim is as far as possible to prevent mortgage banks from incurring other risks than the credit risk on the borrower.

The mortgage credit system is a natural part of owning a home in Denmark. The various loan types on offer are familiar to homeowners, and conversion of loans has become a favourite pastime. As homeowners we have got used to a highly efficient lending system under which we pay a low market interest rate plus a fairly modest margin. We have become used to a choice of options – with or without amortisation, adjustable or fixed rates.

In principle, freedom of choice is a good thing for the individual citizen, but it is up to you to ensure that this does not jeopardise financial stability. I am inclined to say that your loan types have been a little too accommodative to customers. For example, it has been possible to mortgage up to 80 per cent of the value of the home for an adjustable-rate loan with deferred amortisation. This has been very attractive to customers, but has increased the risks incurred by the mortgage banks.

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Firstly, the extensive use of adjustable-rate loans has introduced a refinancing risk which did not exist under the old mortgage-credit model since all loans were "prefinanced". If a mortgage bank which has issued fixed-rate loans only becomes distressed, it can stop new lending and avoid having to go to the market for financing. With adjustable-rate loans, the mortgage bank must go to the market regularly, "come hell or high water".

So as a result of the long-term adjustable-rate loans financed via bonds with much shorter maturities, the mortgage banks' balance sheets now have a bank-like characteristic which they did not use to have. The mortgage bank might experience a situation resembling a "run". This type of risk did not exist previously.

The sector has worked actively with this issue, e.g. by spreading auctions. Whereas all adjustable-rate loans were previously refinanced at the same time, auctions now take place several times a year. Around half of the refinancing now takes place in other months than December. As far as I know, you are also working actively to move customers further along the yield curve, e.g. via changed price structures and advisory services. This is good news and will reduce the immediate risk of a doomsday scenario.

But there is another potentially destabilising mechanism. If higher interest rates on adjustable-rate loans undermine the borrowers' ability to pay, rising interest rates may hit the mortgage banks like a boomerang by way of increased losses which could ultimately jeopardise their solvency.

Danmarks Nationalbank's analyses show that households would currently be resilient to fairly large interest-rate rises without any threat to financial stability.

Nevertheless, the combination of credit risk and considerable refinancing risk can be toxic, given the popularity of adjustable-rate loans. A negative spiral may arise if there is the slightest doubt about the mortgage banks' ability to meet their obligations to investors.

In other words, the widespread use of adjustable-rate loans makes it necessary to structure the mortgage-credit business with a view to retaining investor confidence. This can be achieved by strengthening the robustness of the mortgage banks to losses by reducing loan-to-value ratios, increasing earnings – i.e. administration margins – or boosting capitalisation. In my opinion, reduction of the loan-to-value – LTV – ratio for adjustable-rate loans to, say, 60 per cent would be a good and simple way to address this challenge. And no legislation is required; it can be achieved completely voluntarily.

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Secondly, issuance of covered bonds and covered mortgage bonds has introduced a new risk type, since the LTV ratio must be kept at 80 per cent or less throughout the maturity of the loan. If that is not the case, you must pledge top-up collateral. In this way the bonds become more collateralised as the LTV ratios must always be observed. That is positive – also in relation to refinancing risk. But the extra collateral must be financed, and it may turn out to be quite expensive.

The solution is ***not*** to introduce the possibility of opting in or out of the obligations relating to covered bonds or to be more complacent about meeting the top-up requirements when housing prices fall. That could dent the credibility of the system. If doubts arise as to a mortgage bank's willingness and ability to defend the status of a capital centre issuing covered bonds, investors will perceive this as an increase in the credit risk on not only that capital centre, but also the rest of the mortgage bank. And to make things worse, the lack of confidence is likely to spread to the other mortgage banks too, thereby jeopardising financial stability.

If a mortgage bank chooses to issue covered bonds, it must take on the responsibility linked to ensuring the robustness of its business, even if housing prices fall. It is possible to ensure this robustness within the existing legislative framework, e.g. by introducing lower LTV ratios for loans based on covered bonds or by ensuring a sufficient buffer of capital well in advance.

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Thirdly, the first deferred-amortisation loans, which were introduced about 10 years ago, are due to expire soon. The 10-year limit was introduced to ensure that mortgage banks took the value of the underlying collateral into account. And that is indeed relevant today.

A deferred-amortisation loan may be the right choice for the individual homeowner. But since mortgage banks granted deferred-amortisation loans right up to the LTV ratio of 80 per cent in the boom years with soaring housing prices, it is hardly surprising that some homeowners now find that their properties cannot sustain the loans.

This has triggered a debate on whether it is necessary to take steps to expand the existing framework for prolonging deferred-amortisation loans. I cannot recommend that. It would not support the robustness of the Danish mortgage credit system if homeowners do not reduce at least the peak of the loan that exceeds 80 per cent, especially since the rate of interest is currently close to zero – much lower than it was when these loans were raised. And according to Danmarks Nationalbank's calculations most homeowners are able to meet the extra costs of financing the remainder via a more expensive bank loan with amortisation.

So all in all, I think you are able to address these challenges yourselves if you take a slightly more conservative approach to lending. Avoid going right to the limits – that will increase robustness.

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The first meeting of the Systemic Risk Council was held yesterday. The Council discussed the current situation and risks to financial stability in Denmark.

I am pleased that the Council is now in operation. An important lesson from the financial crisis has been that it is necessary to focus on systemic risk. The Council is to contribute to preventing and addressing future systemic financial risks, thereby shielding the real economy and the financial system against a new financial crisis. Obviously we cannot avoid normal cyclical fluctuations. The Council will regularly monitor risk developments and issue observations, warnings and recommendations to the relevant authorities.

We have a considerable task ahead of us and there are many important issues that I look forward to discussing – and learning more about. I have taken on the task of chairman with a great degree of humility.

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Thank you for your attention.