Lars Rohde: The importance of credit institutions’ capitalisation, financial regulation development

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Danish Mortgage Banks’ Federation, Copenhagen, 7 April 2016.

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Thank you for inviting me to speak at your annual meeting.

Today I will focus on the importance of credit institutions’ capitalisation, financial regulation developments and a few significant consequences of the very low interest rates.

My key messages are: It is in everyone’s interest that credit institutions are well-capitalised. The risk-based approach should be retained in financial regulation. And we must have a realistic approach to how much special Danish circumstances will be taken into account in future. I will also observe that the credit institutions’ own targeted returns seem to be rather high, and that a long period of low interest rates involves considerable inherent risk.

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My first topic is equity capital and financial regulation.

Robust equity is of paramount importance if people are to have confidence in a financial enterprise. The financial crisis showed that many financial institutions were insufficiently capitalised. As a result, some of them were not resilient to the losses incurred in the wake of the overheating. This inability to absorb losses exacerbated the economic downturn. Since then, much has been done to increase the resilience of the financial system, both internationally and in Denmark. For example, capital requirements have been enhanced. The financial system has become more robust than it was before the financial crisis.

The improved capitalisation of Danish credit institutions is without question an advantage, whether or not it is a result of financial regulation. There is nothing to indicate that the increased capital requirements have led to a lack of lending capacity or led to lower growth in Denmark.

It is also in the interest of the credit institutions themselves to be well-capitalised – and even more so after the introduction of the new EU bail-in regime. It is now the owners and creditors who must bear the losses of a distressed institution. And it is at least as important to be well-capitalised in the eyes of the market as in the eyes of the supervisory authorities.

Important work is underway in relation to resolution planning for credit institutions. As regards the mortgage banks, it is chiefly a question of ensuring that the authorities can handle a distressed mortgage bank. Without the use of taxpayers’ funds. And in such a way that the lending capacity of the institution is retained and there is no knock-on effect on the rest of the system.

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The capital adequacy rules are based on the principle that a financial institution’s capitalisation should reflect the actual risk on the institution’s balance sheet. This is why e.g. the risk-based capital requirements apply. They are aimed at ensuring that the institutions’ capitalisation is adequate so that they can resist shocks. At the same time, the risk-based capital requirements contribute to improving the institutions’ risk management.

The internal models used by most large institutions to calculate their risk-weighted assets have been criticised internationally. It has given cause for concern that the risk weights calculated can differ substantially across institutions, even if the exposures are similar. For many institutions, the risk weights have also declined notably over the years.

The Basel Committee, which proposes standards for financial regulation of banks at the global level, has recently published a consultative document proposing certain limitations on the use of internal models for calculating risk-weighted assets.

It is yet too early to assess the full consequences of the Basel Committee's proposal. Nor is it possible to say whether it will be possible to take special national circumstances into account when the proposal is incorporated into EU regulation.

Danmarks Nationalbank finds that the risk-based approach should be retained. That is in line with the position of the Danish government and with your view. Therefore, we support the continued use of internal models for calculating risk-weighted assets. At least to the extent that the credit institutions have sufficient data for the use of such models to make sense. In other words, there should not be any floor requirements if the documented risk of losses is very low.

It is also important that both credit institutions and authorities take a thorough and critical view of whether the internal models reflect the institutions' risks.

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Regulation of the financial sector is mostly determined at the international level. There may be elements that we in Denmark find inexpedient. And it is possible that EU regulation is gradually doing away with national discretions.

There can be no doubt that it is in the interest of Denmark to have a level playing field for credit institutions. If everyone wants special rules, the playing field is no longer level.

The Danish mortgage credit system is based on our special statutory requirements. Furthermore, it relies heavily on a well-functioning land registration system and a creditor-friendly system of enforced sales.

We have seen that the Danish mortgage credit model does not always fit into the framework of new international financial regulation.

In recent years, we have also seen a clear tendency for mortgage banks to resemble other banks more and more.

Our expectations must be realistic. And we must face the fact that there are limits to the number of special arrangements that the Danish mortgage credit sector can obtain when new international regulation is introduced. Instead, our ambition should be to fit Danish mortgage credit into the framework laid down by the international standards and rules.

We can do so by seeking to influence this framework. But we should choose our battles carefully.

A challenge in relation to Denmark's efforts to influence developments in international regulation is that much of this regulation is initially conceived by the Basel Committee, where we do not have a seat. We only have a say from the stage where the rules are transposed into EU regulation. So the main channel of influence goes via the EU cooperation. By the way, the European Commission should be given credit for generally listening to the Danish views. At least if our argumentation is convincing and supported by empirical data. On the other hand, we must accept that non-membership of the banking union closes another possible channel of influence on international financial regulation – the ECB.

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More changes to financial regulation are likely to be introduced in the coming years in the form of new initiatives from the Basel Committee as well as changes to EU regulation resulting from the banking union.

According to the Basel Committee, the forthcoming changes are not aimed at increasing the total capital requirements for the financial sector.

But for the individual institution the new requirements could mean that it should prepare for increased capital adequacy requirements. Therefore, it would be wise to ensure robust capitalisation. This can be done by raising capital in the market or by retaining a larger share of profits.

In this connection I would like to make it clear that an increased share of own funding relative to debt funding does not entail any substantial extra costs for a credit institution.

More equity capital makes the institution more robust and reduces the returns demanded by both bond owners and shareholders. And the return on and risks related to the assets are the same irrespective of the method of funding. Moreover, right now might be a good time to boost the capital buffers as equity investors' expected returns are currently low.

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Given the very low level of interest rates, the targets set by credit institutions for return on equity seem to be rather high. According to these targets, an investment in a Danish bank or mortgage bank should yield a considerably higher return than an investment in Danish government bonds. The reason for this high risk premium is not obvious to me. And certainly not if we take into account that the institutions have increased their capitalisation in recent years and are now seen as safer investments.

The high targeted returns give cause for concern as they may trigger a need to increase the risks taken by credit institutions. This can be done on the assets side, e.g. via more risky lending. Or on the liabilities side via higher leverage ratios. I hope that the high targets are not based on this type of strategic considerations. The credit institutions should carefully consider whether the current targeted returns are consistent with a prudent level of risk.

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The long period of low interest rates may have had an impact on the expectations and behaviour of firms and households. The risk that interest rates may rise is disregarded. Most people have clearly become accustomed to low interest rates. In relation to financial stability, this requires enhanced vigilance. If interest rates rise, this may lead to losses on the credit institutions' assets and the collateral behind their lending.

For households, the costs of borrowing to purchase a home are historically low at present, even if the announced increases in administration margins are taken into account. How the administration margins are determined is no concern of ours. However, I would like to emphasise that there is a link between the very low level of interest rates, which also leads to a modest return on a credit institution's equity, and the need for a certain level of earnings from other sources so that capital can be accumulated with a view to increasing lending.

It should also be noted that improved earnings and better capitalisation of a mortgage bank benefit its customers by way of lower funding costs. This is reflected in the yield payable by the customers on the underlying bonds.

Combined with migration to the cities, the very low interest rates have led to a period of strong growth in house prices in some parts of Denmark. Adjusted for seasonal fluctuations, house prices continued to rise at a robust rate in the 2nd half of 2015 and at the beginning of this year. But there are signs of a slowdown compared with one year ago. Trading activity has generally declined over the last year. This could indicate that price pressures will ease in the future.

Although substantial interest rate hikes are not on the cards for the time being, it is important that borrowers are resilient to higher loan costs if interest rates do rise. Households can achieve this by: increasing the fixed interest period, keeping their loan-to-income and loan-to-value ratios at a prudent level, and amortising their loans. All these measures protect them against higher interest rates.

I have also noted that the mortgage banks comply with the Danish Financial Supervisory Authority's new lending guidelines in many respects. These are sound principles that would have boosted the robustness of the financial sector, had they been observed in the mid-2000s. Even though the guidelines are observed, the leverage ratio may still be high for first-time buyers who borrow right up to the LTV limits. A high leverage ratio makes borrowers vulnerable to even small price falls in the housing market.

Let me conclude by summarising my key messages:

- Well-capitalised credit institutions are in everyone's interest.
- The risk-based approach should be retained in financial regulation.
- A level playing field is in Denmark's interest, and we should have a realistic approach to how much the Danish mortgage credit system will be taken into account in future international financial regulation.
- The credit institutions' own targeted returns seem to be rather high. And finally:
- A long period of low interest rates involves considerable inherent risk.

Thank you for your attention.