Torben Nielsen: Financial stability, the Danish perspective

Speech by Mr Torben Nielsen, Governor of Danmarks Nationalbank, arranged by the Bank of Finland, Ivalo, 23 March 2007.

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Thank you for inviting me to talk about financial stability from a Danish perspective.

I will start out giving an outline of the Danish financial system and the changing Nordic banking landscape.

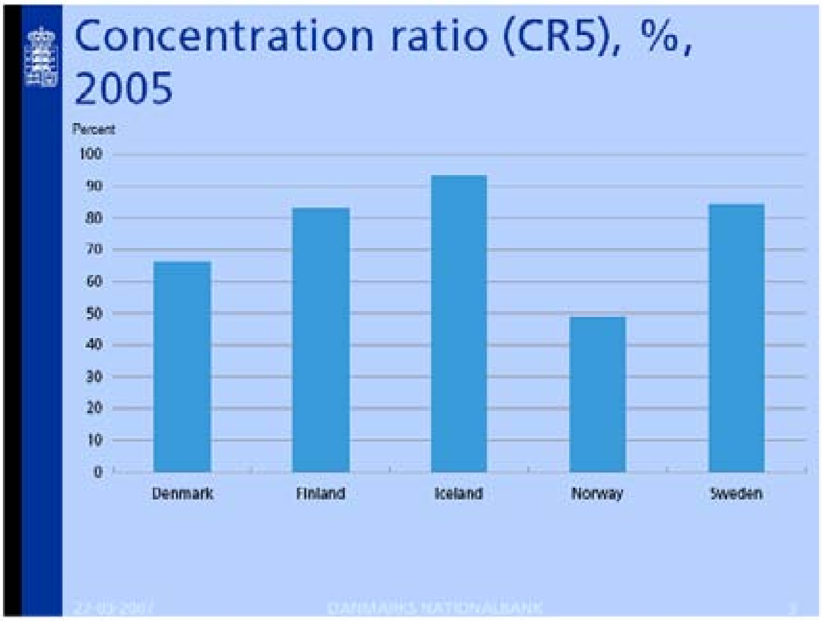
I will then talk about the role of Danmarks Nationalbank in safeguarding financial stability.

Looking ahead, one of our priority areas is stress testing of the Danish financial system. Our ambition is to learn more about how the banks affect each other and the economy in stress situations.

Finally, I will touch upon a topical issue, namely lending to households, household debt and house prices.

The Danish financial system and the changing Nordic banking landscape

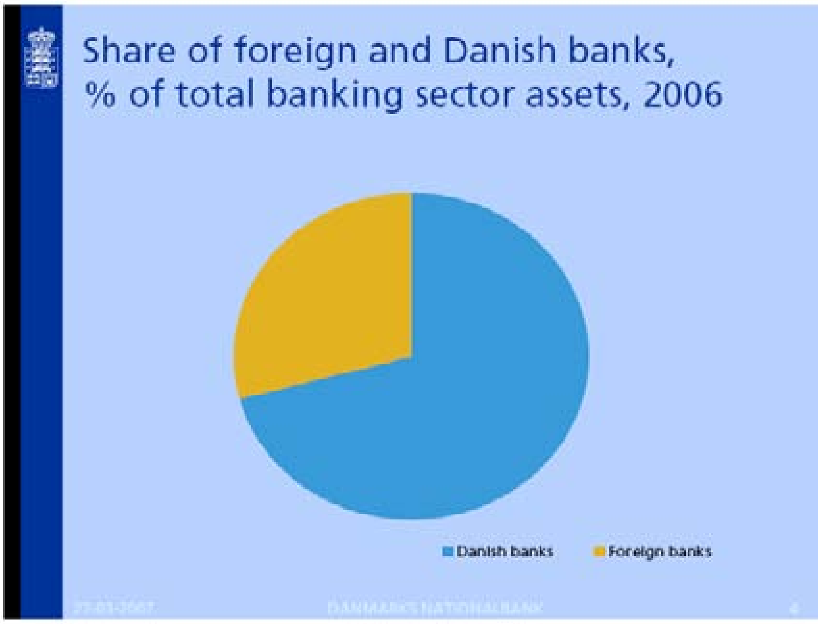
The Danish banking sector is very heterogeneous and is dominated by two large banking groups, Danske Bank and Nordea, which covers more than 45 percent of the Danish banking market. There are a small number of medium-sized institutions, Jyske Bank, Sydbank, Nykredit Bank and FIH, with a total market share of almost 20 percent. And we have more than 150 small banks sharing the residual market share of 35 percent.



Compared to the other Nordic countries, the concentration ratio in Denmark – measured by the concentration ratio CR5 – does not stand out.

However, the Nordic banking markets are amongst the most consolidated in Europe – similar to other smaller European economies. In larger countries like Germany and UK we find concentration ratios around 20 and 35 percent, respectively.

The bulk of banking consolidation in the Nordic countries took place just before – in the case of Denmark – and shortly after the banking crises in Finland, Norway and Sweden in the early 1990s. We experienced a second wave around the turn of the century with the formation of Nordea as the most spectacular case. And the most recent event was Danske Banks purchase of Sampo Bank last autumn.



There is a significant presence of foreign banks in Denmark dominated by Nordea. Foreign banks and subsidiaries hold around 30 percent of total assets. Expansion of foreign banks in Denmark has typically not stemmed from organic growth via new branches or subsidiaries, but has instead been accomplished via mergers and acquisitions.

The presence of foreign banks in Denmark is comparable to Norway and Sweden. The Finnish situation is exceptional, since Nordea Bank Finland is counted as a Swedish subsidiary and Sampo Bank as a Danish subsidiary.

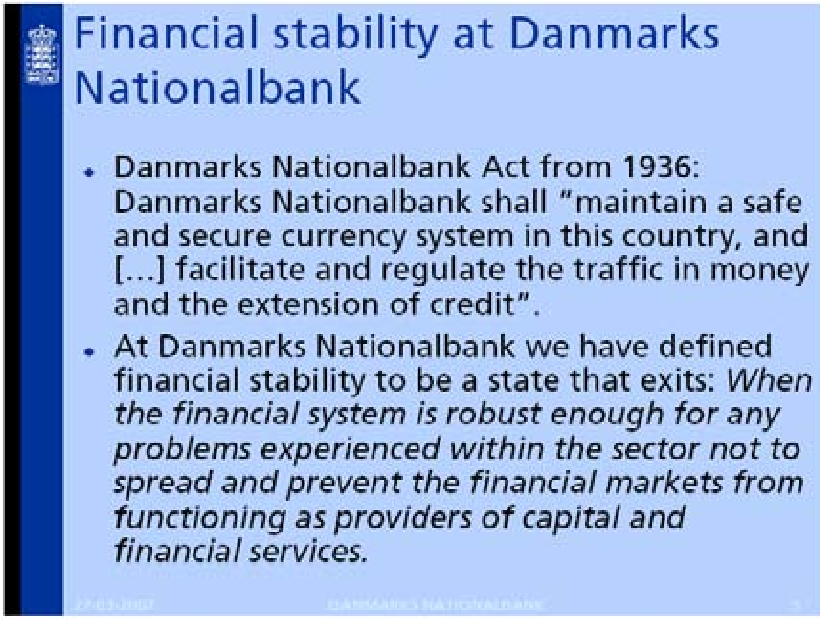
With Danske Banks acquisition of Sampo Bank, the two biggest players in the Nordic-Baltic banking markets are Danske Bank and Nordea. Danske Bank is the largest in terms of lending and total assets, while Nordea is greater as regards equity and market value.

The role of Danmarks Nationalbank in safeguarding financial stability

Danmarks Nationalbank is monitoring and assessing financial stability in Denmark.

The Danmarks Nationalbank Act from 1936 states that Danmarks Nationalbank shall ”maintain a safe and secure currency system in this country, and […] facilitate and regulate the traffic in money and the extension of credit”.

The approach in Danmarks Nationalbank is to consider the general risks to the financial system rather than the risks to the individual financial institutions. The latter is the task of the Danish Financial Supervisory Authority.



At Danmarks Nationalbank we have defined financial stability to be a state that exits: "*When the financial system is robust enough for any problems experienced within the sector not to spread and prevent the financial markets from functioning as providers of capital and financial services."*

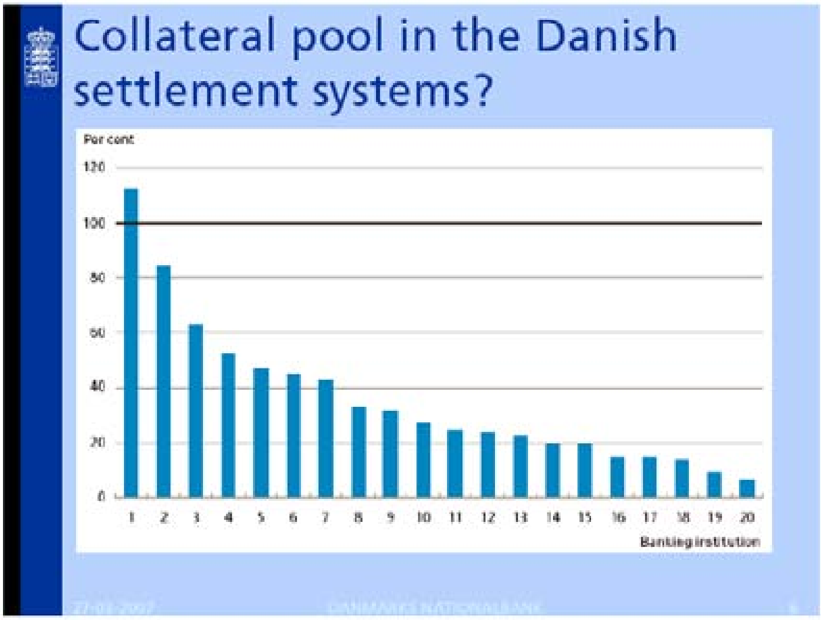
And how do we actually solve our tasks in relation to financial stability?

Firstly, we seek to analyse the key risks to the financial sector. This includes situations that are very unlikely to arise, but which could potentially involve high costs to society. We perform stress tests on the financial system in order to calculate how large an adverse impact the existing buffers are able to absorb. We have been publishing these analyses in our annual Financial Stability report since 2002.

Denmark has now, for some years, been enjoying favourable economic conditions, which benefit the financial sector, and the Danish banking institutions show record-high earnings. Overall, the financial institutions in our latest financial stability report were found to be robust, and there still seems to be no black clouds in the horizon that could threaten financial stability in Denmark.

Another task for Danmarks Nationalbank in relation to financial stability is to ensure that Denmark has a secure and effective financial infrastructure that can safely be used for settlement of payments, securities trading and other financial transactions. Danmarks Nationalbank now has a statutory obligation to oversee payment and settlement systems in Denmark.

Part of the IMF's Financial Sector Assessment Program of the Danish financial sector in 2005-06 was to assess the core elements of the Danish financial infrastructure in relation to international standards. The IMF recommended a few changes. Danmarks Nationalbank will work with those responsible for the systems to ensure that the necessary improvements are made. However, we will not blindly adhere to all recommendations.



For example, the IMF recommends that we establish a buffer pool to ensure the settlement of securities transactions and retail payments even if the largest participant is not able to settle its payment obligations. Danmarks Nationalbank finds that the best safeguard is to ensure that participants have easy and flexible access to liquidity, combined with participants' large portfolios of securities that can be pledged as collateral for loans from Danmarks Nationalbank. The figure shows the largest Danish banking institutions' maximum net outgoing payments as a ratio of their liquidity reserves in 2005 where on each day the banking institution with the largest payment obligation is excluded from the settlement. The figure shows that Danish banks have plenty of liquidity reserves even when the largest bank fails to settle. Consequently, we do not currently see any need for special measures to ensure settlement in the Danish systems.

A third area that we are looking at is situations where the financial system is affected by dramatic external events. These could be acts of terrorism, widespread epidemics, natural disasters or other situations where the financial system threatens to collapse. Danmarks Nationalbank chairs a task force with participation of the Financial Supervisory Authority and sector representatives that later this spring will present suggestions on how to ensure coordination of the financial institutions' business continuity plans in such situations.

Finally, Danmarks Nationalbank acts as lender of last resort to the Danish banks. Danmarks Nationalbank can extend loans to a bank that urgently needs liquidity and cannot procure it in the market, even though the bank is solvent. Fortunately, we are rarely called on to do that.

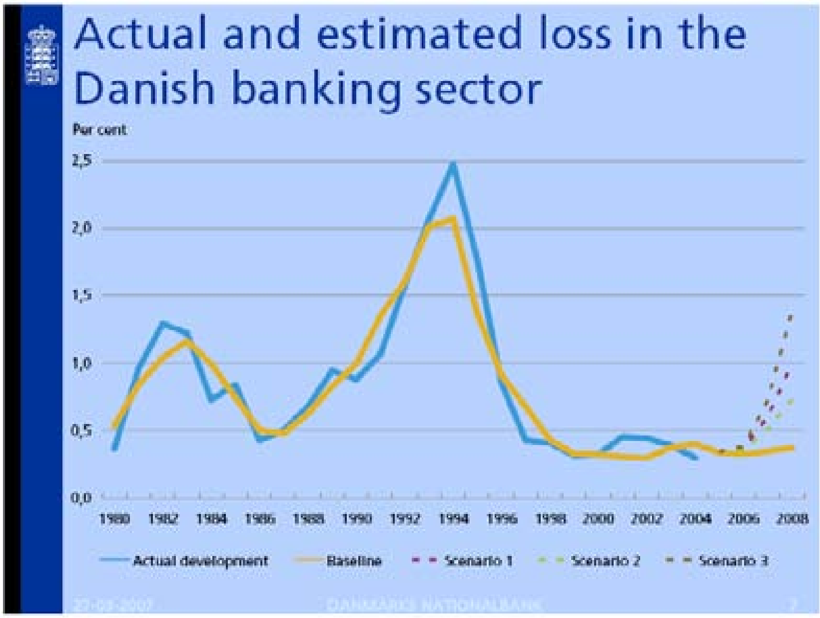
Should a situation occur where it is necessary to rescue an ailing bank, Danmarks Nationalbank's position is that a market-based solution should be found. Nothing definite can be said beforehand about Danmarks Nationalbank's role. It would depend on a concrete assessment of the situation and the – direct or indirect – consequences for the Danish banking system and Danish society.

Stress testing

As I mentioned before, IMF visited Denmark in connection with its Financial Sector Assessment Program. The overall conclusion of the FSAP was that Denmark's financial systems are resilient and well supervised and that the financial sector shows a high degree of compliance with the international standards.

Part of the FSAP was stress testing based on "bottom-up" and "top-down" approaches. For the bottom-up" approach, the largest banking institutions in Denmark were asked by the Danish FSA to estimate the effect of certain macroeconomic stress scenarios against the background of the institutions' own data and models. The results were compared to the "top-down" approach, prepared by the IMF and Danmarks Nationalbank, which focused on overall patterns in the banking sector's losses on loans and guarantees on the basis of model calculations.

The next slide shows result of the "top-down" analyses performed by Danmarks Nationalbank.

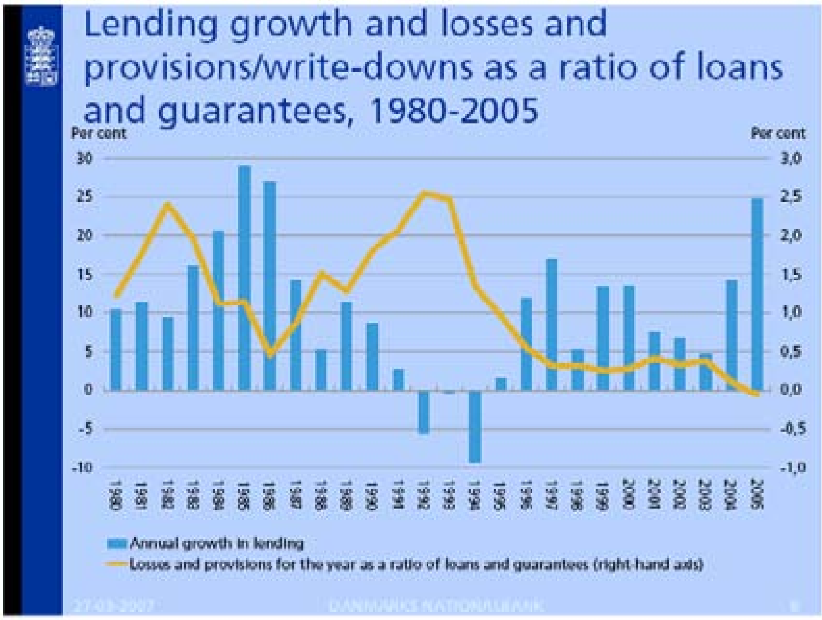


Historically, a correlation can be observed between the development in unemployment, domestic lending as a ratio of GDP and the banking sector's losses on loans and guarantees. Danmarks Nationalbank has estimated a simple model which makes use of this correlation in the projection of the banking sector's total losses on loans and guarantees in given scenarios.

The blue line represents the actual, historical losses to the banks, while the yellow line shows modeled calculations of the historical development. The broken lines show the expected development in the different stress scenarios.

3 stress scenarios with increasing severity were used. In the most severe scenario a slowdown in the domestic economy is exacerbated by a tightening of the ECB's monetary policy. This scenario implies a 30 per cent drop in housing prices in Denmark and a decrease in GDP by 3 per cent over three years.

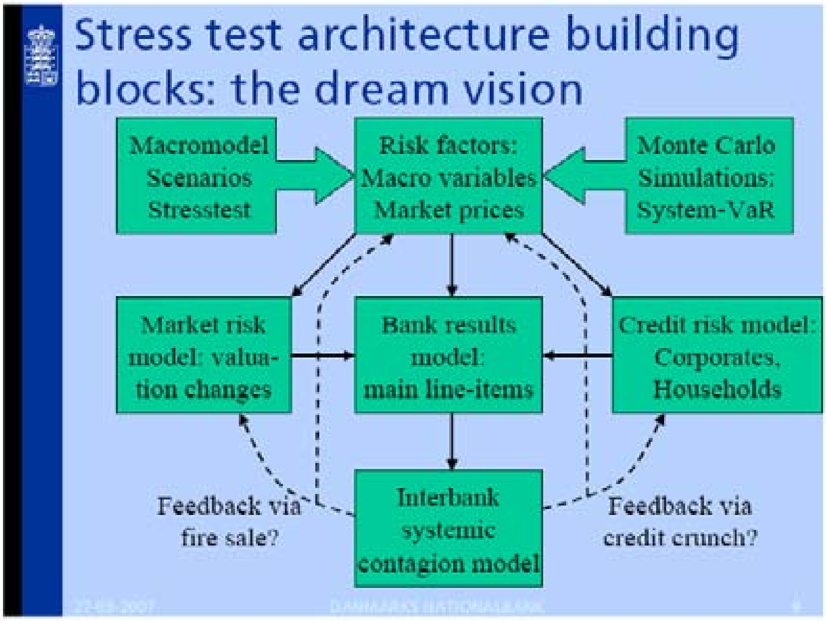
The result of the stress test is that the banking institutions' losses on loans and guarantees will rise by almost 1.5 percentage points over the 3 year period. This is somewhat lower than actual losses in the early 1990s where losses and provisions reached 2.5 percent on average.



Looking ahead we have decided to further develop our stress testing abilities at Danmarks Nationalbank. Our ambition is to learn more about how the banks affect each other and the economy in stress situations.

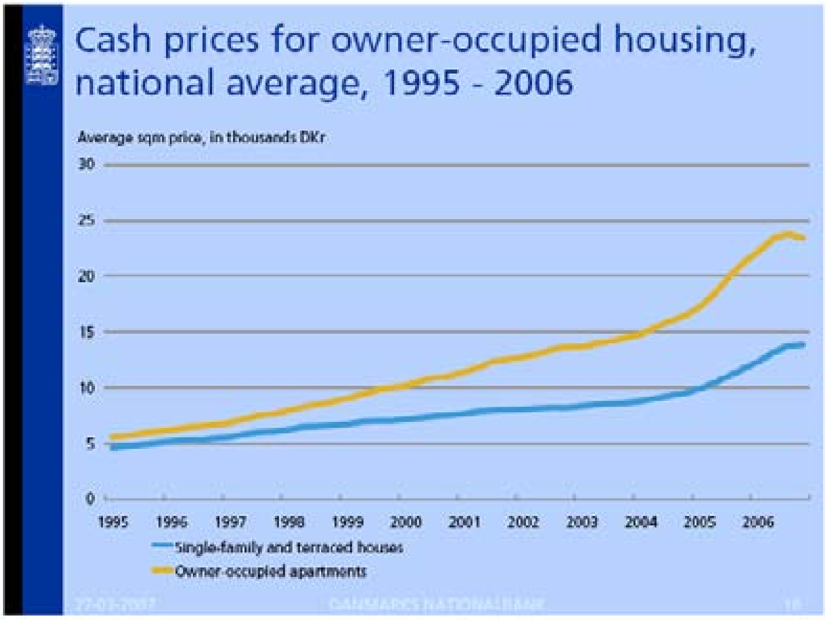
The work on stress testing is still in its infancy. We are trying to define a stress testing architecture and in this process we are among other things taking a close look at developments in other central banks.

SLIDE 9 shows our stress test architecture.



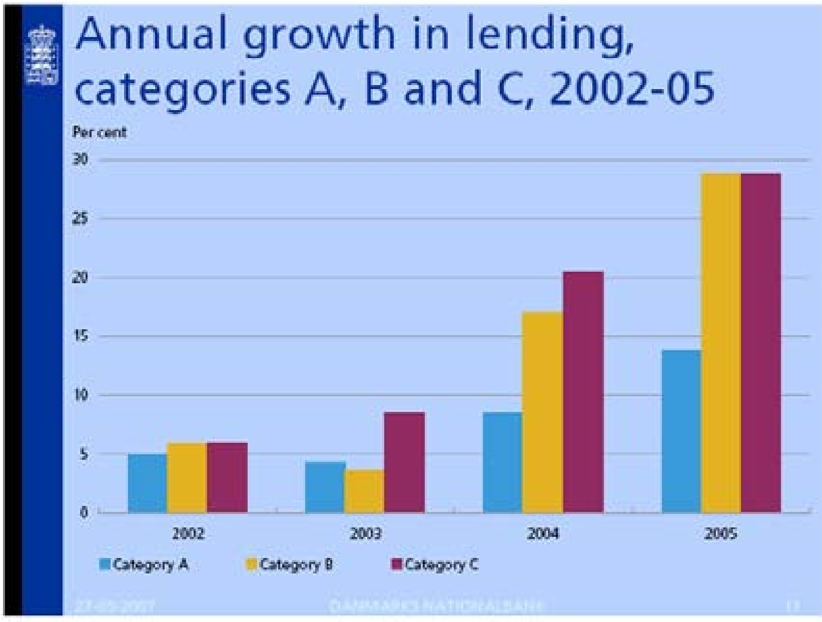
Lending to households, household debt and house prices

The economic conditions of homeowners in Denmark are underpinned by a strong housing market, and housing prices have accelerated in recent years. Lately, price increases have leveled off, c.f. SLIDE 10.

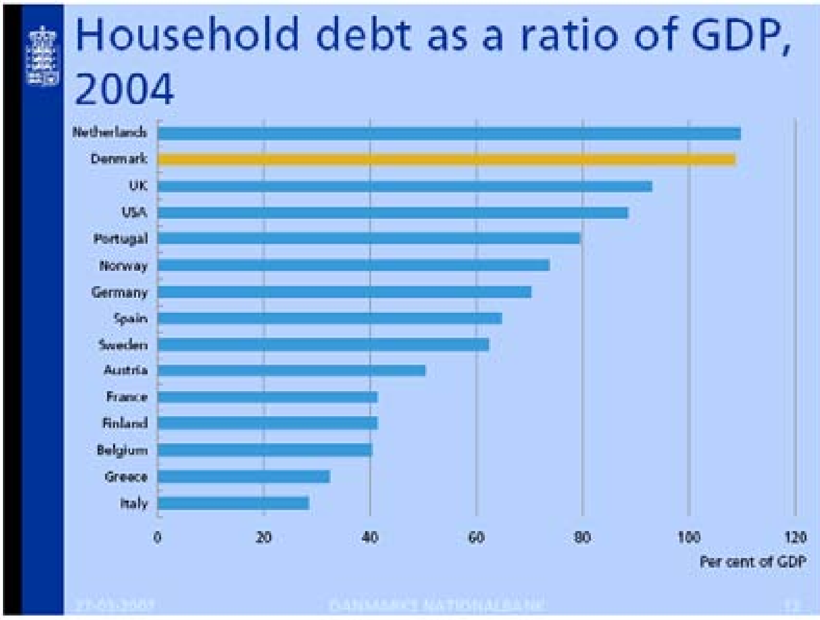


The recent rising house prices especially reflect improvement in the economic fundamentals. The Danish economy is growing strongly, interest rates remain low, unemployment is falling, and disposable incomes are increasing. At the same time, the introduction of new loan types, e.g. deferred-amortisation, has helped to sustain price increases. The freezing of property taxes has also affected prices.

Lending growth is high in Denmark. SLIDE 11 shows the lending growth of big banks, medium sized banks and small banks. Growth in lending to households accounts for almost half of total lending growth, and 60 per cent of the household element stems from lending for home-financing purposes. On top of that we have seen lending growth of mortgage credit institutions to households of around 10 percent.



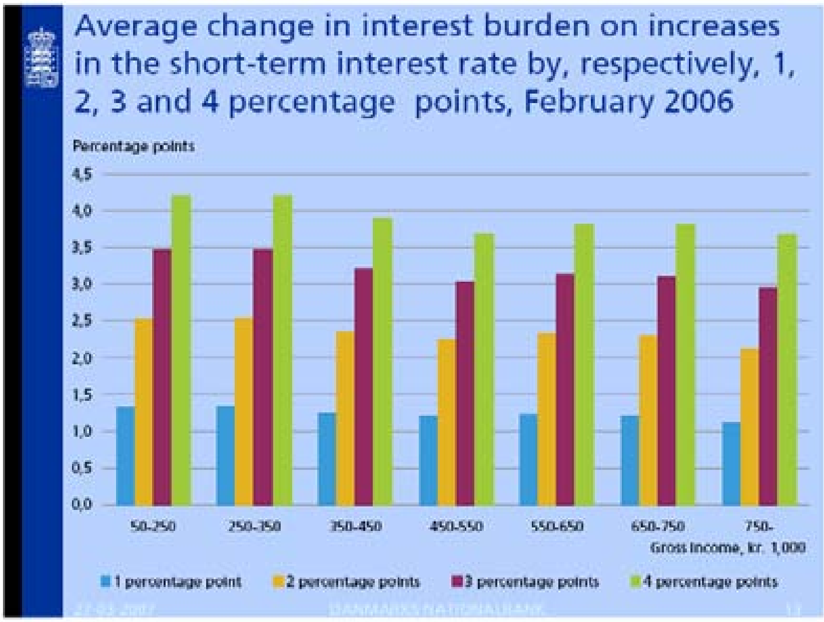
Danish households hold large gross debt compared to households in other countries. SLIDE 12 shows the debt as a ratio of GDP. Households in countries such as the Netherlands and the UK also have high levels of indebtedness.



The debt has increased during the last decade, but the development in the debt of Danish households does not differ significantly from other countries. The level of debt is thus high, but the development during the last 10 years is not extraordinary in a European context.

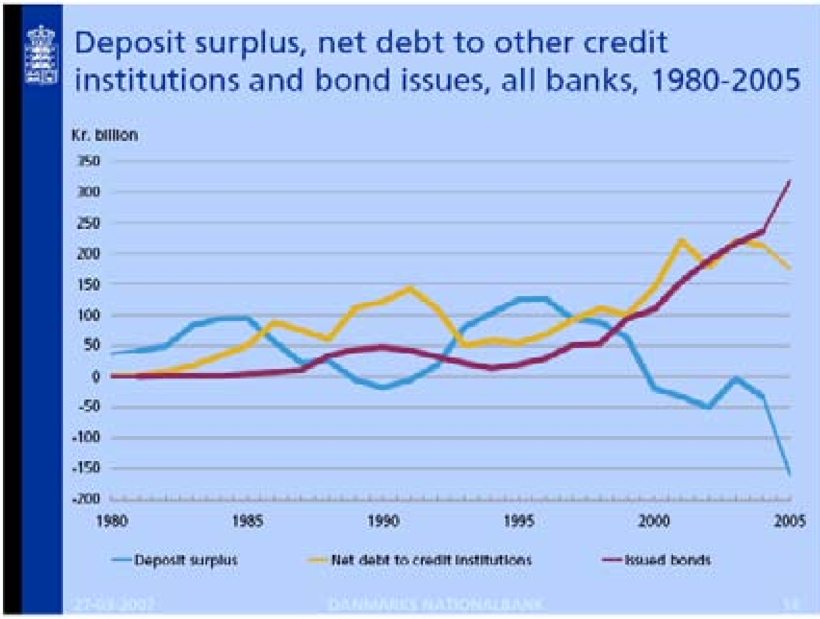
The high gross debt ratio, combined with a shift to an extensive use of adjustable-rate mortgage-credit loans instead of fixed rate mortgages, makes the households more vulnerable to rising interest rates.

We have calculated the households' additional mortgage interest burden if interest rates rise (SLIDE 13). On average, mortgage interest expenses will increase by 1.2 percent of the house-hold's gross income if interest rates rise by 1 percentage point, but there are considerable variations. Some households will be financially challenged if interest rates increase by a few percentage points. This could impose losses on banks and mortgage-credit institutes. Nevertheless, our overall assessment is that the development in homeowners' exposure to rising interest rates does not threaten the functioning of the financial system – or financial stability. To put it bluntly, the failure of a number of households to meet their obligations to their credit institutions is not necessarily a financial stability problem.



The banking institutions have gained market shares from the mortgage-credit institutions by offering mortgage loans ("prioritetslån", loans collateralised by real estate). Often the excess liquid proceeds for the customer are placed in a deposit account subject to the same interest terms as the loan. Against this background, a proportion of the banking institutions' lending growth is reflected in increased deposits.

The increase in lending has been stronger than the increase in deposits from the non-financial sector. This has eroded the traditional deposit surplus in Denmark, obliging the banks to resort to other sources of funding to make up for the difference, e.g. by issuing bonds and borrowing from other credit institutions, c.f. SLIDE 14.



We are in these weeks in the process of finalising the implementation of covered bonds legislation in Denmark according to the Capital Adequacy Directive.

Previously, only mortgage-credit institutions have been allowed to issue mortgage credit bonds in Denmark.

But as a consequence of the new legislation, this sole and exclusive right of mortgage credit institutions will be abolished and banks will be able to fund mortgage loans by issuing covered bonds (in Danish "særligt dækkede obligationer) on a level playing field with the mortgage credit institutions.

The new legislation will introduce a new possibility for banks to fund their deposit deficit and possibly thereby benefit financial stability in Denmark.

Covered bonds are expected to benefit competition between the banking institutions and the mortgage-credit institutions.

Looking ahead, there is no reason to expect a downturn in the housing market in Denmark in view of the currently very strong Danish economy. In certain regions, downward price correction cannot be ruled out, however. For homeowners that purchased when prices peaked, a potential drop in prices would be a setback, but is hardly likely to threaten the economy or financial stability in Denmark.