Nils Bernstein: Developments in the Danish economy and mortgage-credit system

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the Annual Meeting of the Danish Mortgage Banks' Federation, Copenhagen, 29 March 2012.

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Thank you for inviting me to speak here today.

The global economy weakened in the 2nd half of 2011, chiefly as a result of the debt crisis in several European countries. Euro area GDP fell in the 4th quarter, but data releases point to stabilisation.

In the USA there is moderate growth and recovery in the labour market. Euro area unemployment continues to rise, masking considerable differences across member states. In Germany unemployment is falling.

Inflation has declined as previous increases in energy prices have dropped out of the year-on-year statistics, but recent oil price rises pose a risk in this connection.

Yield spreads to Germany have narrowed following the most recent measures taken by the European Central Bank, as well as further steps to tighten fiscal policy and introduce structural reforms in the countries with the highest debts.

The growth outlook is subdued. The latest consensus estimates and forecasts from the international organisations operate with a slight decline in euro area GDP in the first part of 2012, while other advanced economies are expected to post moderate growth rates. Strong fiscal consolidation is underway in Europe in order to restore confidence in public finances and create a basis for sustainable growth. In contrast, monetary policy is highly accommodative and supports economic activity in all advanced economies.

The autumn was weak. The Danish economy virtually moved sideways, reflecting factors such as falling public consumption, and expectations were formed in the shadow of the European debt crisis. However, the situation now seems to be improving somewhat.

Our most recent forecast operates with output growth of just over 1 per cent this year. That is not impressive, but it is higher than the growth expectations for the euro area.

The recovery is primarily expected to be domestically driven.

For some time, households and firms have been consolidating strongly. In the case of the households, this reflects value losses on e.g. houses and equities, as well as the employment situation. Firms, on the other hand, have been hesitant to invest, so that business investment has reached a very low level.

Given the high savings ratio, wealth will, at some point, reach a level that the households find suitable in view of the losses they have had. Normalisation of the low consumption ratio could potentially lead to considerable growth since private consumption accounts for around half of total demand.

Another reason why I believe we can say that the Danish economy is now slowly picking up is that the fundamental balances are sound. We have a large current-account surplus and a relatively strong labour market. Structural unemployment is low – and only slightly below the current rate of unemployment. Interest rates are historically low and underlying prices are stable.

On the other hand, house prices have, on average, dropped by 20 per cent since the peak in 2007 and fell by 8 per cent in 2011. Turnover is low despite the historically low interest rates, and the market seems to be in a deadlock. Given the current interest-rate and income levels, house prices should, in Danmarks Nationalbank's view, not be as low as they are at the moment. Price falls may be self-reinforcing if buyers hesitate, expecting prices to come down even further. So it is difficult to say exactly when the market will turn, but experience from both Denmark and abroad shows that once the market begins to recover, it could move fast.

An important factor behind the large fluctuations in house prices seen since the mid-2000s is the structure of housing taxes. If the property value tax in nominal terms is frozen, as it is now, the effective taxation rate declines when prices go up, and vice versa. Combined with deferred-amortisation loans, this has contributed to stronger fluctuations in house prices. The same applies to the cap on the increase in land tax. As a result, tax on the large increases in value seen during the boom is being phased in now, when prices are falling, making the decline even stronger.

As regards property value tax, the solution is, in principle, simple. Freeze the rate of taxation, not the amount in kroner. With the current outlook for the housing market, this will not lead to higher taxes right now. But more appropriate housing taxes will help to dampen fluctuations in the market – fluctuations that are detrimental to society and impede the implementation of economic policy. The large balance sheets of Danish households, with high gross debt and correspondingly large assets, also speak in favour of curbing house price fluctuations.

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It is now around four years since the international financial crisis really hit Denmark. In the meantime, it has led to the introduction of five bank rescue packages, each one aimed at solving specific problems. In addition, Danmarks Nationalbank has made a number of adjustments to its range of instruments to match market conditions, and credit institutions have been offered extended credit facilities at Danmarks Nationalbank. The latest addition – the option to raise 3-year loans – has given credit institutions an extra source of long-term funding. In many ways, these options match those provided by the ECB for European banks. The ECB's 3-year loans have been in high demand. 800 European banks participated in the most recent operation.

The first 3-year operation in Denmark will take place tomorrow. The second operation will be in September, and I think it would be wise to consider the two operations overall. Needless to say, interest will depend on the individual credit institution's situation, as well as developments in the private-sector capital markets. It is up to each credit institution to decide whether or not it wants to participate. Seen from Danmarks Nationalbank's point of view, there is no reason to turn down this opportunity if it makes business sense.

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A financial crisis has direct costs in the form of e.g. credit losses, but also indirect costs in terms of e.g. growth. So far, a characteristic of the Danish bank rescue packages has been that the sector itself has borne the direct costs related to these packages. This is a good principle, which has helped to reduce the negative impact on government finances. Events in Europe over the last year have highlighted the significance of sound public finances. It is of fundamental importance to us all that the Kingdom of Denmark has a high credit standing internationally.

I think we can say that Denmark has addressed the problems as they arose. By this I mean that distressed banks have been brought to our attention, and we have found solutions – either winding-up via the Financial Stability Company, mergers with other banks or tailored solutions. The result is a banking sector with a number of large banks and many small banks.

Some Danish banks are still struggling, and the near future will also bring mergers and perhaps resolution of banks. But I believe that the problems have now been reduced to a size that is manageable within the existing framework – although a few adjustments may be necessary. As I see it, the model with the Financial Stability Company has worked well and provided a robust and constructive approach to solving the problems.

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The largest credit institutions are those that we call systemically important financial institutions, or – in financial lingo – SIFIs. These institutions are important to society as a whole and to financial stability. For everyone's sake it is essential that these private-sector enterprises do not suddenly find themselves in dire straits so that the government must take over. In future these large institutions must therefore be required to have extra strong defences. For example, they must have extra capital, the option to convert loan capital into subordinate capital as well as recovery plans, and they may be subject to additional supervision. The aim is to ensure that they do not end up in a situation where they become distressed. The Danish government has set up a committee to make recommendations in this area. Its work should have high priority.

The group of large credit institutions also includes the mortgage banks. You are already comprised by special legislation to ensure that confidence in the mortgage-credit system is always intact. As you often point out yourselves, this system has stood the test of a couple of centuries. Particularly during this financial crisis and the turbulent market conditions seen in the last four years, Danish mortgage bonds have proved their high quality and liquidity.

In my opinion, the SIFI committee provides a welcome opportunity to investigate whether, ultimately, mortgage-credit legislation provides a sufficient and appropriate contribution to the defences protecting Danish mortgage bonds.

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When you argue the case for the strength of the Danish mortgage-credit system in a historical context, it is also necessary to consider the major changes that have taken place over the last 10 years. Firstly, the volume of adjustable-rate loans has increased substantially. This has created a refinancing risk, as 30-year mortgage loans are financed by short-term bonds, often with maturities of only 1 year. Secondly, the option to defer amortisation has made it possible for borrowers to borrow more with an unchanged monthly payment. This has pushed up house prices and increased the vulnerability of borrowers and mortgage banks. Thirdly, the requirement to pledge top-up collateral for covered bonds if house prices fall has given mortgage banks an extra obligation. The rating agencies also contribute to this requirement.

We have previously drawn attention to these factors and encouraged you to find solutions. I appreciate that you have put on your thinking caps.

A number of good suggestions and ideas have been put forward, and I take this opportunity to comment on them. Several aspects must be taken into account when determining the most appropriate measures. Measures which respect that there is a certain degree of standardisation of bonds, as this increases liquidity in the series and makes the market more transparent for investors. Two of the primary success criteria are the handing of refinancing risk and the need for top-up collateral, but stable framework conditions for the housing market also play a significant role in the current situation. I also think that it would be wise for you already to start considering the future international liquidity requirements.

In the long term, two-tier mortgaging and a conservative loan policy will reduce the need for top-up collateral in periods when house prices are falling. Two-tier mortgaging will have the faster impact of the two. I realise that you are facing different challenges in this area, and it may therefore be natural to choose different solutions.

Danmarks Nationalbank has previously suggested another, more indirect way of reducing the potential need for top-up collateral – by gradually phasing out deferred amortisation for mortgage loans with a view to dampening fluctuations in house prices. A cautious approach to deferred amortisation would also support the robustness of both borrowers and mortgage banks.

Turning to refinancing risk, you have sought to spread the auctions for refinancing adjustable-rate loans over the year as we agreed. This means that a smaller bond volume is refinanced at any given time. So if an auction is a failure and the number of investors is insufficient, this situation will be easier to manage. One mortgage bank has already spread its auctions almost evenly on three dates. The rest have initiated the process and have from 2011 to 2012 increased the share of underlying bonds that do not mature at the turn of the year from 14 to 23 per cent.

But more can and should be done to reduce the refinancing risk. For example:

– If refinancing is spread over the whole year and refinancing auctions are conducted well in advance, this will reduce the impact of short-term shocks in the financial markets considerably.

– Use of longer-term financing will reduce the total volume of loans to be refinanced within a given period. That will increase robustness.

In addition, the ability of the individual borrower to bear the refinancing risk can be increased. If individual loans are financed using several bonds with different terms to maturity, short-term market turmoil will affect only a small share of each loan. This will strengthen investor confidence, even in a situation with a brief, but strong increase in interest rates.

I see no urgent need for further specific legislation in these areas as you are seriously addressing the challenges yourselves.

Let me recapitulate:

Solutions may differ, but should serve the following purposes – in random order:

– refinancing risk must be reduced, – the need for any top-up collateral must be met before it becomes relevant, – the procyclical impact of home financing should be dampened, – and the vulnerability of homeowners to extraordinary changes in financing conditions must be reduced.

It will require a huge effort, but you have already come a long way. Keep up the good work!

Thank you for your attention.