Lars Rohde: Reflections on Denmark's sixth bank rescue package

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Danish Bankers Association, Copenhagen, 2 December 2013.

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A few months ago, the sixth Danish Bank Rescue Package was neatly wrapped up. I would like to take this opportunity to acknowledge the political responsibility shown in that connection.

Danmarks Nationalbank welcomes the agreement. It broadly observes the recommendations of the SIFI Committee to identify systemically important financial institutions and impose extra requirements, including stricter capital requirements, on these institutions.

The agreement is an important milestone in the follow-up of the crisis, but it is too early to put our feet up. As the agreement indicates, there are still important issues that the parties need to settle, presumably in 2014. These include crisis management and crisis management buffers. The final level of the Danish SIFI requirements will also be reviewed in 2017 at the latest. If it does not match the level of comparable European countries such as Sweden, Germany and the UK, it will be adjusted.

Compared with the rest of the Nordic region, Denmark is imposing lower capital requirements on SIFIs and phasing them in more slowly. But besides the regulatory requirements there are market requirements. Particularly for SIFIs, which often operate internationally, market standards are typically one step ahead of financial regulation. I am convinced that, irrespective of the regulatory requirements, the market will ensure that actual capital adequacy is evened out over time.

The countercyclical buffer differs from the other capital requirements. It is not an immediate requirement, but a framework that can be activated if credit developments and the economic situation call for it. Unlike the other Nordic countries, Denmark is phasing in this framework gradually. In other words, new legislation will be required if economic developments in the transitional period until 2019 require a larger countercyclical buffer than the limitation of the framework for that year.

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In the same way as Bank Rescue Package 6 underpins the largest credit institutions, the bill to address the mortgage banks' refinancing risk is an important contribution to financial stability.

The immense popularity of loans that are not prefinanced has led to a potential refinancing risk. Unlike in the old days, mortgage banks have a continuous need for refinancing in the market, and they might experience a situation resembling a "run" on a bank. It is very unlikely that this will happen, but the consequences could be enormous. At Danmarks Nationalbank we have pointed out this risk, and the rating agencies have also focused on it.

Let me make it very clear that in Danmarks Nationalbank's opinion compulsory, conditional maturity extension provides a solution to this problem.

The bill leaves no doubt as to what will happen if interest rates suddenly rise very sharply or an auction fails. The refinancing risk is transferred to investors. For the mortgage banks, risk is, once again, limited to credit risk, which was the original idea behind the balance principle.

It is important that the bill includes an interest-rate trigger, so that maturity extension takes effect in connection with very large, but well-defined interest-rate rises. This makes it possible for investors to determine the price of maturity extension.

This structure does not affect Danmarks Nationalbank's role as lender of last resort, but it ensures that the mortgage banks' business model does not rely on Danmarks Nationalbank as back stop. In connection with the preparatory work, Danmarks Nationalbank indicated that the bill does not in itself give reason to change Danmarks Nationalbank's collateral basis.

The bill also presents a credible resolution model. All doubts will be eliminated as to what will happen to mortgage bonds that have not been prefinanced if a mortgage bank is wound up. The bonds will be converted into long-term fixed-rate bonds with the same payment series as the underlying loans.

Irrespective of the bill, borrowers with variable-rate loans will remain sensitive to general developments in interest rates. As long as the Danish economy is in synch with the international economy, increased interest-rate sensitivity may dampen fluctuations in the economy and have a stabilising effect. Variable-rate loans have unquestionably helped to stabilise the housing market during the financial crisis.

Variable-rate loans entail a payment risk for the borrower, while fixed-rate loans entail a price risk. In order to maintain investor confidence in the mortgage-credit system, the mortgage banks should take a portfolio view when assessing their total lending. The future Supervisory Diamond for mortgage banks will lay down the overall framework for the mortgage banks' risk profile, but first and foremost it is the mortgage banks themselves that are responsible for their own risk management.

In the interests of investor confidence and financial stability the mortgage banks should generally stay well within the statutory limits – also after this bill has been passed.

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During the last 18 months, the Danish Productivity Commission has analysed the reasons for many years' low productivity growth in Denmark. Some sectors are more severely affected than others. The Commission has also presented a long list of proposals for improving productivity in various parts of the economy.

The financial sector plays an important role in Danish society as a provider of capital to households and firms, and it also offers products such as pension saving schemes and hedging of various types of risk. In addition, the sector ensures that domestic and cross-border payments can be transacted efficiently. So from society's point of view it is important that this sector is as efficient as possible – which means that its production costs should be as low as possible.

A rough indicator of developments in labour productivity in the financial sector can be obtained by looking at domestic lending – or alternatively financial assets – relative to employment in the sector. Calculated in this way, labour productivity was more or less constant in the decades before the liberalisation of the financial markets, which really took off in the early 1980s.

Liberalisation of capital flows across borders and deregulation of the financial sector in Denmark have provided considerable welfare gains. These gains are the result of lower prices and a larger product range, coupled with better opportunities for planning individual savings, consumption and investment. At the same time, financial sector productivity has increased substantially.

In fact, since 1980 productivity has grown by an average of 4–5 per cent annually in the financial sector. But in recent years lending by banks and mortgage banks relative to employment has been stagnant or shown a weak trend compared with previously. Domestic lending by banks relative to employment has even fallen.

Compared with the rest of the EU, Denmark is among the member states with the largest balance-sheet sum or domestic lending per employee. But in terms of cost-to-earnings ratio, Denmark is in the middle of the table. This could indicate that, at least on average, there is scope for further efficiency improvements in Danish credit institutions in the coming years. However, there are large differences within the sector. Comparisons of individual Danish and foreign banking groups show that some Danish banks are fully able to match the most efficient foreign banks. But at the same time a number of Danish banks are less efficient than the top Danish and foreign banks. For these banks, the scope for improvement is even greater than the average numbers indicate. Badly managed banks have been a key factor behind the sector's problems in the years after the financial crisis and the preceding overheating of the economy. I welcome the Danish Bankers Association's new code of management. In your own words, this code is to address the "individual cases of bad management, mismanagement and inexpedient management structures seen during the crisis".

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Turning to the international agenda, negotiations on a banking union are currently underway. Danmarks Nationalbank is following these negotiations closely. No decision has yet been made about Danish participation, but the banking union will, in any case, have great importance for Denmark. Even if Denmark opts out, two of the largest banks in Denmark will be subject to supervision by the ECB in relation to considerable parts of their euro area activities. At present, these two banks account for more than 50 per cent of total lending by Danish banks.

At the same time, it is essential to all EU member states that the project is a success. Financial stability in the euro area is a prerequisite for financial stability throughout the EU and has a large impact on future growth in the EU. At the same time, it is important that the banking union strengthens the single market for financial services.

A well-functioning banking union requires strong confidence in the single supervisory authority. An important step will be taken with the ECB's assessment of the assets and risks of credit institutions subject to direct supervision; this will take place in the coming year. A credible exercise of that nature will give the banks involved a solid, and in some cases much-needed, stamp of quality.

It is positive that the Danish Financial Supervisory Authority plans to replicate this exercise for the large Danish banks, to the extent that it is possible. In this context I would like to mention the results of Danmarks Nationalbank's most recent stress test, which will be published soon. They show that in all the stress scenarios the large banks have a Common Equity Tier 1 ratio of more than 8, which is the threshold in the ECB's stress test. Recent years' improved capitalisation is a major reason for this.

Danmarks Nationalbank generally takes a positive view of the banking union outlined. It is an important step towards strengthening the single market for financial services and hence cross-border competition. Competition forces both banks and firms to be "on their toes" and improve their skills. That is healthy and good for everyone.

It is important that euro area and non-euro area member states can participate in the banking union on equal terms. Otherwise, there is a risk that the single market for financial services becomes fragmented.

In addition, Danmarks Nationalbank finds it essential that the banking union includes an insurance element in relation to the systemic institutions in Denmark. A single, strong bank resolution fund could ensure that. For the euro area member states, the ESM – the single euro rescue fund – provides extra insurance and will act as the ultimate back stop when all other funds have been depleted. Again, it is important to ensure equal treatment of participating euro area and non-euro area member states.

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Now I would like to turn to the economy. The USA is in an upswing and growth accelerated a little in the 3rd quarter. Both the OECD and the IMF expect activity to pick up further over the next year. The upswing is being driven by private investment and consumption, supported by rising employment and an improved housing market.

In the euro area, macroeconomic developments have matched expectations, which is something we have not seen for quite a while. The weak positive growth is set to continue into the 2nd half of 2013, but still with large differences within the area. Especially German domestic demand is beginning to fuel growth. Unemployment is low in Germany and wage inflation rising, but Germany's competitiveness remains strong. The UK has seen a continuous series of positive economic indicators, and so has Sweden to some extent, although the Swedish economy did slow down in the spring. Overall, the outlook is getting brighter in some of Denmark's largest export markets.

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In Denmark, both households and firms have begun to take a more optimistic view of their own finances and the Danish economy in the last six months, but for the households this has not really been reflected in increased spending yet. All the same, the stage seems to be set for increased private sector spending. Households and firms have been consolidating for a while, and the level of unemployment is stable and not high by historical standards. Moreover, financial conditions are strongly expansionary with a low level of interest rates.

The housing market has shown positive signs over the last year with rising cash prices. However, there is wide regional variation. So far, prices have predominantly risen in the Copenhagen area, while no improvement has yet been seen in the areas outside the cities. Presumably it will come if the market continues to pick up. All the same, there are regions in Denmark where the population is declining as many, especially young, people migrate to the cities. Outside the cities, the supply of homes for sale is high in many places, and there are no indications that the situation will change.

For the corporate sector, the outlook is slightly better, possibly because investments have been brought forward before the investment window closes at the end of the year. But activity remains low in the construction sector. Firms have accumulated considerable savings surpluses, and the future framework for banks and mortgage banks is to a large extent in place. So it is not lack of financing opportunities that is dampening the level of investment.

Another positive factor is that some of Denmark's largest export markets seem to be keeping up steam, as I have already mentioned. All in all, there is reason for cautious optimism about the Danish economy, although we still have little tangible proof that the upswing has started. Inflation has been very low over the last year, both in Denmark and in the euro area. In Denmark, a number of factors – from energy prices to indirect taxes – are keeping inflation at bay. With low inflation and well-anchored inflation expectations, the ECB's Governing Council expects to keep the ECB's key interest rates at the current level or lower for some time yet.

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The financial markets and the financial sector are now on a stable course, so Danmarks Nationalbank plans to phase out the additional borrowing options introduced in connection with the financial crisis.

The 6-month loans which Danmarks Nationalbank has offered to credit institutions since 2011 will be phased out from July 2014. Loans already raised will run until they mature.

At the same time, the list of assets eligible as collateral for loans from Danmarks Nationalbank will be restored to normal. This means that banks' credit claims and sector company shares will be phased out of the collateral basis.

Danmarks Nationalbank has carefully considered these changes and assessed the consequences for the sector overall and for the individual credit institutions. In Danmarks Nationalbank's assessment, the credit institutions can handle these changes. Use of 6-month loans has been very limited, and the assets to be phased out have only to a modest extent been pledged as collateral to Danmarks Nationalbank. And the credit institutions will still be able to meet the statutory liquidity requirements.

Overall, both the sector as such and the individual institutions will still have sufficient eligible assets for execution of Danmarks Nationalbank's monetary policy and settlement of payments.

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Finally, I would like to touch upon our concerted efforts in relation to the new retail payments infrastructure. This year, it became possible for citizens and firms to transfer money within the same day. If we meet at the same time next year, I expect real-time transfers to be possible around the clock. These initiatives will bring productivity gains for banks, for Danmarks Nationalbank, for citizens and for firms in Denmark. I take this opportunity to express my appreciation of the sector's work on this project and of our good cooperation.

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Thank you for your attention.