Lars Rohde: The Danish economy against the background of global economic developments

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Association of Danish Mortgage Banks 2014, Copenhagen, 2 October 2014.

* * *

Firstly, I am pleased to note that your annual meeting is on 2 October this year, not 26 September as it was last year. It has been moved from the anniversary of the Peace in Lund on 26 September 1679, when Denmark definitively surrendered the provinces of Scania, Halland and Blekinge to Sweden, to the anniversary of the referendum on 2 October 1972, when a majority of the Danes voted to join the EC. Surely that signals a positive, forward-looking attitude.

As regards the international economy, the 1st half of the year was a little weaker than expected at the turn of the year. Growth is expected to pick up in the 2nd half of 2014 and in 2015.

The US economy grew in the 1st half of 2014, while economic development was weaker in the euro area. The German economy slowed down a little in the spring following strong growth at the beginning of the year. Unlike previously, Greece, Portugal and Spain are now also experiencing sound growth. That is not the case in France and Italy, which are both struggling with considerable structural problems. Their competitiveness has deteriorated over a number of years, and France will not comply with the recommendation to reduce its budget deficit to 3 per cent of GDP by 2015.

Euro area price inflation has been decreasing for some time and was 0.3 per cent in September according to the preliminary data. This is substantially below the ECB's target of inflation close to, but just under, 2 per cent. The ECB's deposit rate, which determines money market interest rates, has been negative since 11 June. Against the backdrop of weakening euro area growth momentum, weak credit growth and declining inflation, the ECB reduced its rates of interest further with effect from 10 September. The deposit rate is now negative by 0.2 per cent. In addition, the ECB announced two new purchase programmes to support lending to the private sector. And loans for up to 4 years are provided at a rate of interest of 15 basis points. In other words, a series of non- standard measures have been introduced. The markets do not expect monetary policy interest rates to be raised again until sometime during 2017. So the period of very low interest rates – also in Denmark – is set to continue for quite a while. Since the turn of the year, the euro has weakened by almost 10 per cent against the dollar, which should push up prices in the euro area.

Danmarks Nationalbank followed suit when the ECB lowered its interest rates and reduced the rate of interest on certificates of deposit to –0.05 per cent. This means that the rate of interest on certificates of deposit, which determines the short-term money market interest rates, is negative once again after having been back in positive territory since the spring. Bond yields have declined further in recent months, from an already low level.

The overall picture is that the Danish economy is on the right track, but is recovering relatively slowly and with considerable fluctuations in quarterly GDP figures. However, employment is rising and unemployment falling. Furthermore, households are well-consolidated and their disposable income and wealth are rising steadily. Consumer confidence has been high for some time. Growth in private consumption has been somewhat muted until now, but has nevertheless been positive in 2014 so far. Looking ahead, Danmarks Nationalbank expects a stronger recovery. The foundations for growth are in place.

The government's Finance Bill operates with a government budget deficit of 3 per cent of GDP next year and a deficit of 0.5 per cent of GDP on the structural balance. That is precisely what the Stability and Growth Pact and the Budget Act allow and leaves no scope for negative surprises. In a normal cyclical situation it is wise to keep a distance to these limits. There is no room for manoeuvre in the event of a serious downturn. At the current point in the business cycle and with the current capacity situation in the labour market, it would definitely be desirable to have a margin to the budget deficit limits.

In the housing market, prices have risen, but with considerable regional differences. Combined with population growth, the very low level of interest rates contribute to pushing up prices in the cities, especially in the Copenhagen area. The recovery in Copenhagen gradually seems to be spreading to its environs, which will presumably dampen price pressures and give the supply more time to catch up.

In some areas of Denmark, house prices are still falling and turnover is low. There is also an overrepresentation of enforced sales. The population is shrinking in these areas and GDP growth is low, and there are no immediate signs that this will change. The regional problems in the housing market cannot be solved by the mortgage credit system.

Fundamental investor confidence in the creditworthiness and liquidity of the bonds is at the core of the Danish mortgage credit system. It is essential to preserve this confidence and thus the safety of the system. The Danish mortgage credit system plays a pivotal role in lending in Denmark, and mortgage bonds are important instruments in the banks' liquidity management.

In recent years, the credit rating agencies' changing views of the Danish mortgage credit system have attracted much attention – by the mortgage banks and by the press. While there is general agreement that Danish mortgage credit starts with an "A", the question is how many "A"s a given business model and portfolio composition should have.

Today, I would like to make it clear that the purpose of regulating mortgage credit is not to ensure that all mortgage bonds are always "triple A" rated. Regulation sets limits, within which the mort- gage banks must operate. Where the mortgage banks choose to position their business models and risk profiles within these limits is up to the individual mortgage bank. A "triple A" rating may require a considerable margin to the limits – and if so, the mortgage banks must ensure precisely that if they want this rating.

From a legislative perspective, it is fairly straightforward to make mortgage credit almost 100 per cent risk free. If the LTV limits are sufficiently low and the maturities of bonds must match the maturities of the loans, I am sure that this is possible. But at present legislation lays down minimum requirements that give the mortgage banks flexibility and room for manoeuvre. That imposes an obligation on each mortgage bank to keep a suitable margin to the limits and avoid a race to the bottom.

Bonds with the option of maturity extension – including if the interest rate trigger is activated – are gradually becoming the market standard as short-term bonds are refinanced. Experience from the auctions shows that demand remains high – investors have accepted the new market standard. As we had expected, they do demand a modest excess yield of a few basis points, but they still bid heavily at the auctions, where bid-to-cover ratios were high in August and September.

I am actually pleased to see that investors put a price on the interest rate trigger. That was basically the objective: to give investors an opportunity to calculate a price for the potential maturity ex- tension of bonds. With the interest rate trigger, it is not up to the authorities, in practice, to decide whether or not an auction has failed. Investors know in advance that the borrowers will be protected by the trigger in a short-lived crisis. This allows investors to focus on the probability of the trigger being activated – rather than on a total market collapse. And the fact that the trigger comes at a price shows that investors are aware of the possibility of maturity extension.

Seen from Danmarks Nationalbank's perspective, the act on maturity extension has served its purpose. A robust mechanism has been introduced for handling the mortgage banks' refinancing risk – also in the event of resolution. The probability that the tail risks would materialise was very small, but the potential implications were huge.

After the introduction of the legislation on maturity extension, it has been discussed whether the legislative amendment could have an impact on competition between banks and mortgage banks.

One could get the impression that the mortgage banks wish to use legislation to protect them- selves from competition by restricting competitors. The same applies in relation to the forthcoming Supervisory Diamond. That is not how these initiatives should be viewed. On the contrary, competition in the market for home loans is healthy – and so is the arrival of new players on the market.

Banking and mortgage banking are based on two separate business models. A bank has many different sources of funding. A mortgage bank relies wholly on issuance of mortgage bonds to finance its lending. A bank lends money for many different purposes – with and without collateral. A mortgage bank solely provides collateralised loans for purchase of property. A bank takes on many different types of risk. A mortgage bank practically only takes on credit risk. I can see absolutely no reason why two so different business models should be subject to exactly the same regulation. If a mortgage bank wants to have the same opportunities as a bank, it must obtain a banking licence.

In relation to competition between banks and mortgage banks, it should also be kept in mind that a certain shift in market shares over time does not necessarily indicate unequal terms of competition. Since 2008, there has been a tendency for lending by mortgage banks to grow, while lending by banks has been declining. It is a natural tendency during times of crisis that it is advantageous to raise loans against real property as collateral via a simple, transparent model such as the Danish mortgage credit model. But do not be surprised if some of the loans start flowing back to the banks' balance sheets in the coming years. The banks' loans are tailored to the individual customer's needs. It goes both ways. The borrower achieves increased flexibility, and the bank adjusts its terms and conditions to the individual customer. In a healthy, well-functioning financial sector, borrowers shop around, and in some cases the outcome is that they move their loans.

The Danish Financial Supervisory Authority has presented a proposal for a Supervisory Diamond for mortgage banks. It is a good initiative to introduce a Supervisory Diamond for mortgage banks as is already known from the existing Supervisory Diamond for banks. The corners of the diamond are to be used in connection with supervision and are to serve as early indicators if a mortgage bank is beginning to assume too much risk. All corners of the diamond are relevant areas that could lead to increased risk. But irrespective of the diamond, the mortgage banks still bear the main responsibility for their risk management.

One corner of the diamond seeks to reduce the need for refinancing. This is an area that you and we have focused on for some time, and considerable adjustment has already taken place. It is positive that the Supervisory Diamond will ensure further progress along this path. The indicator limits the percentage of loans to be refinanced within any one calendar half-year. It is important that mortgage banks with large bond series continue to spread their auctions over all four quarters – even if they do meet the indicator limit within each half-year. Spreading the refinancing requirement reduces the risk that many borrowers will see their interest rates fixed at a high level at the same time, while also reducing the volume of bonds that can experience maturity extensions at the same time.

However, the Supervisory Diamond is not suitable for limiting the individual household's use of deferred amortisation. The mortgage banks have granted many households deferred amortisation loans right up to the LTV limit of 80 per cent. That makes the mortgage credit system vulnerable if house prices fall.

It is essential to design the mortgage credit system in such a way that bonds remain secure and the system is still robust in periods when house prices fall. The level of interest rates has a strong impact on house prices. If interest rates remain at the current very low level for a long period, prices may rise substantially, but if interest rates go up, house prices could fall sharply. The wide- spread use of variable rate loans means that many homeowners have no protection of their home equity if interest rates rise. That requires a certain degree of financial resilience. So it is important for homeowners to build up home equity over time, thereby moving away from the maximum LTV ratio.

To supplement the Supervisory Diamond, Danmarks Nationalbank therefore recommends introducing legislation to reduce the maximum limit for deferred amortisation loans as a ratio of the value of the home at the time of mortgaging. This may cause house prices to rise a little more slowly for a while, but the effect will be limited. The reduction should apply to deferred amortisation loans underlying covered bonds, covered mortgage bonds or mortgage bonds issued by banks and mortgage banks. In this way, borrowers will automatically build up a certain distance to the maximum LTV ratio over time. That will further underscore the mortgage credit system's high degree of security – even if house prices are plummeting.

Finally, let me turn to the banking union. Some of you have expressed concerns that enhanced banking cooperation might not leave room for the Danish mortgage credit model. I understand your concerns. As you know, it has required considerable political muscle in recent years to ensure exemptions for Danish mortgage credit in European regulation. But I am not in doubt: Denmark, Danish homeowners and the Danish mortgage credit sector have a strong interest in Danish membership of the banking union. A good way to ensure the future of Danish mortgage credit is to participate in the single supervisory mechanism – preferably at an early stage when habits have not become ingrained yet. Outside the banking union, anything could happen. Suppose that all sorts of decisions are made by those in the union – why should they consider the wishes of a marginal little player from the north who does not even want to join in? They will not have evil intensions, but on the other hand they are hardly likely to worry too much if gains within the union come at a price for those outside the union.

If Denmark joins the union, it will be a different situation altogether. Can the mortgage credit sector participate in this cooperation? Yes – I cannot imagine Denmark joining the union at expense of the mortgage credit. Besides the fact that the ECB has a general obligation to take different business models into account, I believe there is a real chance of obtaining further security in the form of an explicit statement in a potential Danish participation agreement. The ECB would have to help find sensible solutions for the Danish mortgage credit sector, and along with the familiar faces from Århusgade they will be paying you supervisory visits. Overall, this provides the best conditions for spreading awareness of the Danish mortgage credit model.

Today, on the anniversary of the referendum on Danish membership of the EC, I think it would be appropriate to highlight an important aspect of the banking union that is sometimes overlooked in the debate on the single supervisory and resolution mechanisms: the banking union extends and strengthens the single market for financial services. It offers increased competition on prices and products to the benefit of Danish citizens and firms. For competitive financial enterprises based in Denmark, growth opportunities increase because the banking union provides a level playing field.

I realise that Denmark will not be joining the banking union in 2014. But in 2015 we will know more about how it functions and which banks it comprises. I would be greatly surprised if Danmarks Nationalbank does not have the same point of view then as now. We are firmly convinced that Danish participation in the banking union will serve the interests of ordinary Danes best.

Ultimately, it is for the politicians to decide whether Denmark should participate in the banking union. But it is important that we have an in-depth debate in Denmark about this significant issue before the decision is made.

Thank you for your attention.