Lars Rohde: Denmark's economy, housing market, krone, and crisis management of mortgage banks

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Association of Danish Mortgage Banks 2015, Copenhagen, 1 October 2015.

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Thank you for inviting me to speak for the third time at the annual meeting of the Association of Danish Mortgage Banks. Let me start by saying how much I appreciate our good working relationship.

Today I will concentrate on these subjects: the Danish economy, the housing market, the krone and finally crisis management, with focus on mortgage banks.

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The Danish economy is in an upswing. Employment has risen steadily over the last two years, and unemployment has fallen. It is now only slightly above the cyclically neutral level. Growth in GDP has been positive for eight quarters in a row at a level above the potential growth rate of the economy.

Strong forces are currently driving the economy – oil prices have dived sharply and the level of interest rates remains very low. The same forces are at work in our key export markets. Moreover, real household disposable income is rising and so is wealth. The drop in equity prices over the last month plays only a minor role in this context. Whichever way you look at it, there is a basis for stronger growth in consumption.

Danmarks Nationalbank expects the growth rate to be 1.8 per cent this year and slightly higher next year. We also predict that employment will grow by another 80,000 or so from mid-2015 until the end of 2017. There is room for both higher employment and wage increases as the cyclical position normalises. But unemployment is low relative to the forecast growth in employment, and therefore most of the increase must come from an expansion of the labour force. Otherwise there is a risk that the current upswing will be very short and result in pressures on the economy.

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The housing market is now picking up in practically all municipalities, and the annual rate of increase in house prices in Denmark overall has risen since New Year. In some parts of the country, prices have begun to rise only recently, so there are still large differences in the housing market across the country.

As such, it is positive that the housing market is picking up. That is a natural element of the current upswing. But in the large towns and cities there is a risk of price increases being self-reinforcing. The rate of price increase for e.g. owner-occupied flats in Copenhagen has been around 10 per cent for several years, and many buyers seem to expect that prices will continue to rise. It goes without saying that price increases on the scale seen in Copenhagen in recent years are not sustainable in the longer term.

During previous upswings, the housing market has been a source of macroeconomic instability and overheating of the economy. This was particularly true during the upswing in the 2000s. A contributory factor was the absence of sufficient automatic stabilisers in the structure of housing taxes. The current housing tax rules have also led to a considerable geographical spread in the rate of taxation – by which I mean the tax payable relative to the value of the property.

In the Danish mortgage credit system, everyone has access to loans if they can pledge sufficient collateral. Marginal lending is typically provided by the banks. But there is reason to exert caution in this respect. In many cases it would be prudent for the banks to require a considerably larger down payment than the 5 per cent of the purchase price that will be included in the rules on good practice for financial enterprises from 1 November. More equity among the households will strengthen their resilience and the robustness of the financial sector.

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It is important that you do not go right to the statutory limits, but only grant loans if you assess them to be sound. Easier access to credit should not be a competitive parameter.

For example, a variable rate mortgage loan should not mechanically be granted, even though the borrower meets the "good practice" requirements and can be approved for a 30-year fixed rate loan with amortisation. At present this means a fixed rate of around 3 per cent. That is very low, and the variable rate may soon rise to a higher level. This should be taken into account when approving a borrower. If it is assessed that the customer may have problems servicing the loan if interest rates rise to a considerably higher level, a fixed rate loan should be granted. Even when this is not required in order to observe the "good practice" requirements.

Total lending by Danish banks and mortgage banks has been virtually unchanged over the last year. But the level is high, also when viewed relative to GDP. And it should be remembered that lending has not declined even though it rose strongly in the pre-crisis years. During that period, the economy overheated, and later it turned out that some banks had eased their credit conditions far too much. So a rise in lending is not immediately on the cards.

Credit institutions operating in such a market should be particularly thorough when assessing potential borrowers. This includes taking into account the fact that house prices can fluctuate considerably. When the housing bubble of the 2000s burst, it became clear that a maximum LTV ratio of 80 per cent for mortgage loans does not necessarily ensure that the value of the home exceeds the value of the mortgage loan when prices fall.

If we look at the mortgage statistics, we can see that lending is increasing most strongly in the urban areas, which is hardly surprising as this is where the largest house price rises are seen. Demand for loans is also highest in these areas. But new loans are also being granted in rural areas, and the number of municipalities where extraordinary prepayments are exceeding new lending is very small. This indicates that if there is sufficient collateral to mortgage, loans are granted. No matter where the property is located. The challenge of declining populations in some areas is not solved by granting more credit.

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Turning to monetary policy, the beginning of the year was unusually eventful. Following the decision by the Swiss National Bank on 15 January to discontinue the minimum exchange rate for the Swiss franc against the euro, we saw an unprecedented increase in demand for Danish kroner.

Against that background, Danmarks Nationalbank took a number of unusual steps. We intervened in the foreign exchange market by selling kroner for a larger amount than ever before in our history, and the benchmark monetary policy interest rate – the rate of interest on certificates of deposit – was reduced to –0.75 per cent. On the recommendation of Danmarks Nationalbank, the Ministry of Finance also suspended issuance of Danish government bonds temporarily, and finally an extraordinary increase of the limit on the monetary policy counterparties' current account deposits at Danmarks Nationalbank was introduced.

These measures had the desired effect. The krone remained stable close to its central rate, and towards the end of February the inflow of foreign exchange ceased. In recent months, the situation in relation to the krone has gradually normalised, and Danmarks Nationalbank has sold foreign exchange in the market for a considerable amount. On the recommendation of Danmarks Nationalbank, the Ministry of Finance has therefore decided to resume issuance of government bonds effective from October 2015. At the same time, the extraordinary increase of the current account limit has been rolled back.

January-February this year was by no means the first time Danmarks Nationalbank had to take resolute action to defend the fixed exchange rate policy. And it will probably not be the last time. Situations where the krone is under pressure seldom resemble previous situations. The triggers and series of events differ from time to time, and although Danmarks Nationalbank in principle applies the same reaction function, our reaction must be adapted to the specific circumstances. Nevertheless, I think we should reflect on the lessons than can be learned from the most recent episode.

Firstly, we must realise that pressure on the krone can go either way. There is no law of nature saying that the krone always tends to weaken in a crisis. On the contrary, Denmark's role as a creditor nation, which means that we have net foreign assets, means that future krone crises are likely more frequently to result in upward pressure.

In January-February, capital flows were larger than in previous episodes when the krone has been under pressure. While the interest rate typically is the most important instrument in a situation where the krone tends to weaken, intervention in the foreign exchange market potentially plays a larger role when capital is flowing into the country. In that situation there is no upper limit to the amount that Danmarks Nationalbank can make available in kroner. The very low level of interest rates in Denmark means that Danmarks Nationalbank profits from the increase in the foreign exchange reserve.

The fixed exchange rate policy has served Denmark well for more than 30 years and is the foundation for stable macroeconomic development. The pressure on the krone gave us an opportunity to demonstrate, once again, that this policy is not up for discussion. Denmark's overall economic policy is aimed at supporting the fixed exchange rate policy, and we have the means and the will to defend the krone. Even if the situation calls for extraordinary measures.

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Finally, I would like to talk about what the new crisis management regime means for the mortgage banks.

Basically, the Bank Recovery and Resolution Directive establishes a common framework for the resolution of credit institutions across the EU. The underlying philosophy is that losses should be borne by those who took the risks. In other words, owners and creditors. Public funds should be protected. Those are the rules applying to other firms, and they should also apply to banks and mortgage banks. That will support market discipline.

It shall be ensured that resolution of an institution does not have serious implications for the economy and for financial stability. The functions that are critical to general economy must therefore be preserved in the event of resolution, irrespective of the organisational set-up. In this way, society in general is not taken as a hostage and forced to bail out an institution in difficulties. That can only be achieved via robust planning of recovery and resolution. Such planning will also ensure that bail-in becomes a real option in the future.

Since mortgage credit is a core element of the Danish financial system, the new framework will obviously affect the individual mortgage banks. Overall, there are three reasons why difficulties experienced by a mortgage bank may have serious implications for the economy and for financial stability. These should be taken into account in our planning.

Firstly, the mortgage credit sector is large and highly concentrated. Mortgage loans make up around three quarters of all lending by credit institutions to households and the corporate sector. And these loans are provided by just a small number of mortgage banks.

Secondly, the mortgage credit sector is closely interconnected with the rest of the financial system, in that mortgage bonds, especially covered bonds – SDOs, are used as liquidity and wealth instruments. So if their value deteriorates, this will affect the rest of the system.

Thirdly, all mortgage banks are based on more or less the same business model. This means that they are also faced with more or less the same risks. If the market loses confidence in a bond issued by one mortgage bank, confidence in and thus funding for the rest of the sector may rapidly evaporate.

Therefore recovery and resolution planning should ensure that a mortgage bank in difficulties will still be able to lend on market terms so that the lending capacity of the system does not decrease. And it is necessary to ensure that the problem is contained within the mortgage bank in question. Finally, it is essential that the government is not compelled to take on any significant risk.

To prevent a situation where resolution becomes necessary, each mortgage bank must prepare a recovery plan. The plan should examine the steps that may be taken if the mortgage bank is in difficulties. This will allow you to spot any weaknesses and inappropriate structures yourselves.

The recovery plan should take into account challenges in relation to both solvency and liquidity. Obviously, it is critical for an institution if losses reach a magnitude that jeopardises its solvency. But that will happen at a very late stage. Doubt about the viability of the business model will arise at a much earlier stage, namely when the mortgage bank can no longer maintain SDO status for bonds issued and fund itself on market terms. So it is crucial for the mortgage bank to have a reliable plan to minimise the risk that this situation arises.

The plan should cover situations where only the mortgage bank itself is under stress as well as situations where stress affects the entire financial system. This has a bearing on the potential courses of action. In a situation where the entire financial system is under stress, the option to divest and access to new capital may be limited.

In the event that a mortgage bank is deemed likely to fail, resolution procedures must be initiated. If this is to be effected in an expedient way, it is necessary to have a robust plan ready. That is the responsibility and task of the authorities. This task is fundamental to financial stability. Together with the two resolution authorities – the Danish Financial Supervisory Authority and Financial Stability – Danmarks Nationalbank is therefore working actively with such plans for the systemically important financial institutions in Denmark.

The work on the resolution plans and the assessment of whether they will work involves a large element of learning by doing. It is not work that will be completed this year. And the plans will need to be updated on a continuous basis.

The mortgage banks are fully comprised by the crisis management regime. However, there is one significant exemption, in that the minimum requirement for own funds and eligible liabilities does not apply to them. This means that bail-in is not an option in connection with resolution. Instead, the mortgage banks must hold a "debt buffer" of 2 per cent of their lending.

Right now, it is an open question whether a plan for resolution of a mortgage bank can observe the resolution targets I have already mentioned without the bail-in tool. This also applies in relation to the special winding-up model which the Mortgage Credit Act provides for. As we have previously said, it would have been better if a minimum requirement for own funds and eligible liabilities had to be set. In a resolution situation it would then have been possible for perform bail-in on uncollateralised liabilities to a sufficient extent to ensure the operation of the mortgage bank and the value of the SDOs – thereby supporting confidence in the mortgage credit system. And the Danish mortgage credit model would not have acquired yet another element that is not in conformity with the market.

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Thank you.