Lars Rohde: Challenges for the housing market and mortgage sector in Denmark

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Association of Danish Mortgage Banks 2016, Copenhagen, 5 October 2016.

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Thank you for inviting me to speak.

I have the following three key messages today:

Developments in the Copenhagen housing market give cause for concern. Annual price increases of almost 10 per cent are not sustainable in the long term. This underscores how important it is that housing taxes dampen fluctuations in house prices rather than amplifying them.

The cost of holding more equity is limited – also for mortgage banks. The return on equity of around 10 per cent required by investors in mortgage banks seems to be on the high side.

It should be possible to resolve any credit institution without major negative consequences for the economy and financial stability – and without the use of taxpayers' money. It is necessary to adjust the mortgage rules in order to ensure this.

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Prices in the housing market have risen notably over the last four years. And they are still rising. This applies to houses and especially to owner-occupied flats – but there are large regional differences. For Denmark overall, the price level appears to be sustainable in view of the development in interest rates and disposable income.

But developments in the Copenhagen housing market give cause for concern. Continued price increases of almost 10 per cent p.a. are unsustainable in the long term.

We are facing a combination of high interest rate sensitivity and house price growth that is on the verge of being unsustainable in parts of Denmark. Formal tests confirm this. Moreover, the option for future interest rate developments is hardly symmetrical. At the current low level of interest rates, the risk of a 3 per cent increase in interest rates is somewhat higher than the probability of a 3 per cent fall.

The government envisages a reform of housing taxes as part of its 2025 plan. Fluctuations in house prices can be reduced via appropriate housing taxes. The current system of housing taxes means that the tax rate falls where prices are rising – and rises where prices are falling. That is un- fortunate. It is essential that housing taxes once again help to stabilise the economy. This will benefit both macroeconomic and financial stability. A discussion of the level of the housing tax rate should not stand in the way of a reintroduction of a stabilising housing taxation system.

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Credit institutions are more robust to falling house prices if they have a high share of equity fund- ing. So it is relevant to consider the cost of equity.

According to the institutions, investors in mortgage banks still require a return on equity of around 10 per cent. That seems to be very high. Especially since the risk-free interest rate is close to zero.

At the same time, market data indicates that last year investors required an average return of be- tween 5 and 7½ per cent on shares in the largest banking groups in Denmark. These groups also include mortgage banks.

More equity increases funding costs only slightly. This also applies to mortgage banks. More equity means that the mortgage bank has larger buffers so that it is safer. Hence, the risk premium falls – and so does the required return on equity.

The required return on mortgage bonds also falls if a mortgage bank becomes safer. However, the balance principle means that this gain is not reaped by the mortgage bank, but by the borrowers. As a result, enhanced capital requirements will have an impact on the distribution of borrowers' costs for interest and administration margins.

In the first part of this year, there was considerable focus on the mortgage banks' increases in administration margins. I would like to emphasise that mortgage banks should have the opportunity to make money, just like other businesses. In the debate, the increases were to a large ex- tent linked directly to capital requirements. As I have previously said, enhanced capital requirements may increase the mortgage banks' costs. But not to such an extent that this can fully ex- plain the observed increases in administration margins.

When we discuss the costs of regulation, it is important to remember that there are also consider- able gains. For example, financial regulation helps to ensure a sustainable and robust economy with strong credit institutions. The mortgage banks themselves also profit directly from good and efficient financial regulation as this can help to ensure that investors – including non-residents – have confidence in the Danish mortgage banks.

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Besides capital requirements, an important element of robust regulation of the financial sector is that we make sure that any credit institution – be it a bank or a mortgage bank – can ultimately be resolved. Resolution should be possible without major negative consequences for the economy and financial stability – irrespective of the size and complexity of the institution. This element has not been in place so far.

In the period leading up to the financial crisis, everyone expected the government to step in if a large and complex credit institution – a SIFI – became distressed. The owners of the institution reaped the profit in good times, but expected taxpayers to foot the bill if things went wrong. This provided an incentive to take higher and irresponsible risks, which increased the risk of a financial crisis.

When the financial crisis erupted, the government provided a guarantee of 2½ times GDP to buoy up the financial sector. It is obvious that the government assumed an almost unlimited risk on be- half of the taxpayers. Fortunately all went well. If things had gone wrong, they would have gone very wrong. The problem was that the alternatives were worse. There were no instruments for handling the situation and nobody knew the consequences of a SIFI failure. The collapse of Lehman Brothers proved this.

So since the financial crisis it has been important to ensure that we never again find ourselves in a situation where society is compelled to come to the rescue of the credit institutions. That is why the European Recovery and Resolution Directive was introduced in 2014. The new rules are to ensure that the economy and financial stability can be protected if a SIFI needs to be resolved.

This makes it impossible for the owners and creditors of the institutions to take society as a hostage so that the government must rescue them. They themselves will have to face up to the con- sequences of unsound decisions and risky actions. In that way, the interests of the institutions are better aligned with those of society in general.

The Recovery and Resolution Directive lays down a new framework for how credit institutions and their creditors must absorb losses. And it gives the authorities instruments for ensuring that they actually do this. At the same time, functions that are critical to society can be continued. The Directive also requires the authorities to make thorough preparations for how to resolve each individual SIFI.

The institution’s equity is lost first. After that, the institution’s debt is lost or used to recapitalise the institution so that it can continue.

As a new element, the authorities must lay down requirements for how much of an institution’s debt that must be particularly suitable for bearing losses. Creditors funding this debt must know beforehand that they risk losing the money owed to them. This risk means that they receive higher interest.

There are also parts of the institution’s debt that are seen as unsuitable for bearing losses, so that creditors will always get back their money. A sector-financed Resolution Fund has been established, which will bear the losses instead of the debt that is unsuitable for bearing losses.

The Resolution Fund can be used only if this is necessary in order to safeguard the economy and financial stability. This also requires that owners and creditors have borne a substantial share of the losses. The requirement regarding debt that is particularly suitable for bearing losses is to ensure that the Resolution Fund is used only if the losses are very large.

In order to resolve a SIFI in an appropriate manner, it is essential that the authorities have a well- prepared plan. The plan should describe how the authorities can assume control of the SIFI, re- structure it so that it becomes viable again, and return it to the market. It must be possible to implement this plan swiftly and communicate it clearly to the market, as faith in the resolution pro- cess is essential if it is to succeed.

With the Recovery and Resolution Directive, it has been ensured at the European level that the necessary legislative framework is in place for handling the next financial crisis, should it arise. And yes, it will come. It is important that we are well prepared for it. But we still have a lot of work ahead of us in preparing resolution plans for the individual SIFIs before we can say that the job has been done.

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Mortgage credit is a key element of the Danish financial system. At the same time, the individual mortgage banks are sufficiently large to be important in themselves. Most of the credit granted within the economy is channelled through the mortgage sector. In this respect, Denmark differs from virtually all other countries. Moreover, mortgage bonds are deemed to be so safe that the banks use them in their liquidity management. So the mortgage banks are closely linked to the rest of the financial sector. Obviously, this makes it essential that the mortgage credit is function- ing both in good times and in times of crisis.

After the financial crisis, the mortgage banks helped to support the economy. They did so by in- creasing lending, while the banks reduced theirs. But it should also be remembered that some circumstances during the financial crisis were favourable to the mortgage banks. Interest rates dived sharply. In combination with the widespread use of adjustable rate mortgages and deferred amortisation, this meant that homeowners could service their mortgage loans even though un- employment rose and house prices fell. In other circumstances the outcome would have been much worse. Fortunately that was not the case. But we cannot count on being so lucky when the next crisis hits us.

Mortgage bonds are a very safe product. Legislation provides extensive protection for investors. Even if resolution of a mortgage bank becomes necessary, they are likely to get their money back.

It is difficult to assess the risk that a mortgage bank will have to be resolved at some point in the future. It cannot be assessed on the basis of statistics saying that mortgage banks have not previously become distressed.

Firstly, mortgage credit has been systemically important in Denmark more or less since its introduction in the late 18th century. So when the going has been tough for the sector, the government has made sure that this would not jeopardise the economy. In future, the mortgage banks must also be able to stand on their own feet in bad times. That is a sound principle.

Secondly, regulation of the sector has changed substantially over the years. And obviously, the institutions' business models have also changed over the last 200 years. After all, you cannot say that the system of motorways in Jutland is 4,000 years old just because the Ancient Road Hærvejen runs through the peninsula.

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At the initiative of Denmark, a special rule relating to mortgage banks was introduced in the Recovery and Resolution Directive. This means that – unlike bank debt – mortgage bank debt cannot be written down or converted into new equity. Hence, the authorities cannot lay down requirement stating how much of a mortgage bank's debt must be particularly suitable for bearing losses. And the Resolution Fund cannot be used to protect mortgage bonds against losses.

However, this special rule can be applied only if national legislation ensures that a mortgage bank can be resolved without major negative consequences for the economy and financial stability.

The special rule means that if a mortgage banks is to be resolved, we must use the liquidation model already existing in Danish legislation. It is about discontinuing an institution that has de- faulted, as opposed to the EU rules, which are about reconstructing and continuing a credit institution that has in effect defaulted, so that the economy and financial stability can be protected.

The Danish liquidation model implies two key problems.

Firstly, the liquidation model will, in the case of mortgage banks, mean that the mortgage bank's lending is discontinued in a controlled manner as loans are gradually repaid. The mortgage bank will no longer be able to issue new loans. Due to the size of the mortgage banks, this means that the financial sector's total capacity to grant loans becomes insufficient.

Secondly, the mortgage bond holders will suffer losses in connection with the liquidation – even if there are sufficient funds to ensure that they ultimately get back their money. The losses will come in the shape of late payments, lower prices and reduced liquidity in the bonds. If there is a risk that the mortgage bank is liquidated, the price and liquidity of the bonds will fall when uncertainty arises regarding the viability of the mortgage bank. Such losses can undermine confidence in mortgage bonds in general. In that case the other mortgage banks will have difficulty in obtaining funding because the risks incurred by mortgage banks are very similar.

As I have already mentioned, the banks own a considerable share of the mortgage bonds. For

them, it will have huge consequences if they suffer losses on these bonds. It will increase their required capitalisation in a situation where their capital is already under pressure.

The bottom line is that mortgage bonds are unsuitable for bearing losses.

The state of the economy would presumably be seriously challenged if a mortgage bank were to become distressed. Liquidation of a mortgage bank would have serious implications for financial stability, for homeowners and hence also for the economy. We must not bring Denmark in a situation where there is pressure on the government to guarantee mortgage bonds totalling 1½ times GDP if the mortgage banks experience difficulties. That will only add to the challenges facing the economy.

The preconditions for applying the special rule for mortgage banks does not exist. It is necessary to adjust the rules on mortgage credit. It has to be possible to continue the activities of the mort- gage banks that are important to society.

It will be contrary to the lessons learned from the financial crisis if we meet the future without a viable model for mortgage bank resolution if this becomes necessary. Crisis situations may arise unexpectedly and swiftly. When they are here, it is too late to take action. So it is important to find a solution and implement the necessary legislative amendments.

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Thank you for your attention.