SPEECH

BY GOVERNOR LARS ROHDE AT THE MACROPRUDENTIAL POLICY CONFERENCE IN COPENHAGEN 2018

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CHECK AGAINST DELIVERY

Dear guests,

I am very pleased to welcome you to this macroprudential policy conference in Copenhagen.

The conference is a result of our excellent cooperation with the European Department at the IMF and the Center for Financial Frictions at Copenhagen Business School.

The ambition for today is to have an open debate about the merits and limitations of macroprudential policy. And to discuss current challenges and the way forward.

To me, the essence of where we stand today with macroprudential policy is best captured in a quote by the Danish philosopher Søren Kierkegaard: "Life can only be understood backwards; but it must be lived forwards."

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So let me start with the beginning.

10 years ago, the financial crisis demonstrated that financial risks can potentially affect both the financial system and the real economy. It also underlined that financial crises are expensive and affect the welfare of citizens.

The lesson was that we need to ensure that the financial system can serve the real economy in good and in bad times. There was a clear need for better and more comprehensive regulation.

As a result, macroprudential policy moved up on the political and academic agenda. The idea being that dosed correctly, prudential measures could reduce the likelihood and costs of financial crises.

In my view, there are three important things we have to focus on to reduce the likelihood and costs of a financial crisis in the future:

1. It is important that the incentives in the banking sector reflect those of any other private company.
2. It is important to limit procyclical behaviour of borrowers and lenders.
3. It is important to build strength in good times to overcome bad times.

Let me elaborate.

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First, on getting the incentives right.

One important lesson from the financial crisis is that bail-out creates the wrong incentives for banks. We need to break with the old model where profits are privatised and losses are socialised.

To avoid excessive risk taking by shareholders, creditors and management, all banks must be able to fail.

Therefore, in my view, the most important EU initiative since the crisis has been the Bank Recovery and Resolution Directive. The purpose of credible resolution plans is to ensure that all credit institutions can be resolved – without the use of taxpayer funds and without distressing the economy.

The Directive paves the way for credit institutions to be treated like all other private sector corporations: Shareholders and creditors risk losing their money and management their jobs.

To get it right, we need to ensure that the interests of shareholders, creditors and management are aligned with those of society.

It is therefore essential that policy-makers stand by the Directive. There is no room for exceptions. There is no room for hesitation. And we should not surrender to sceptics. Once you question the Directive, incentives are distorted and tax payers' money is back on the line.

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Second, even if banks can fail there are still externalities in the system. We need to limit risks from procyclical behaviour of borrowers and lenders.

In good times, lenders and borrowers may be too optimistic and take on too much risk. In bad times, highly indebted households can amplify boom-bust dynamics by reducing consumption. This may have negative implications for the real economy.

As the Danish economy recovered, several measures have been implemented targeting new housing loans. This has been done to address the procyclical effect of over-optimistic borrowers and lenders at an early stage.

The goal has not been to control house prices. The goal is to ensure the resilience of borrowers. And thereby increase the banks' robustness.

It is crucial to evaluate the effects of such measures. There is a clear need for more research in this field both by central banks and by academics.

Today, we have published an analysis of the effects of initiatives that were taken in early 2016. The initiatives focused on housing loans in the two largest cities in Denmark; Copenhagen and Aarhus. They included restrictions on lending to highly leveraged borrowers.

Our analysis indicates that the initiatives have contributed to reducing new lending to highly leveraged households. But the effects have been modest.

However, we already anticipated this result. So in 2017, the Danish Systemic Risk Council recommended additional measures. This resulted in restrictions on available loan products for highly indebted households.

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Third, the tag line of this conference is "While the sun is shining, prepare for a rainy day". And today the sun is shining. At least from a Danish perspective.

We can happily say that the real economy is in a balanced upswing. However, we also see that risks are building up in the financial system. So there is no doubt – this is the time to build strength.

In particular, it is time to build up countercyclical strength.

Let me put this into perspective.

In 2008, banks faced large amounts of stress and increasing losses. This led to a government-funded capital injection in 2009 because we feared that we could be facing a credit crunch. If we have a sizeable buffer in place before the next financial storm hits, it can be released. And thereby serve the same function as the capital injections did during the financial crisis.

So how big should the countercyclical capital buffer be? The capital injection in 2009 was about 6.2 billion euro. A buffer of 2.5 per cent equals approximately 4.7 billion euro.

In my view, in order to have a countercyclical capital buffer that can make a difference, 2.5 per cent appears reasonable.

When it comes to the countercyclical capital buffer, we can make two possible mistakes. We can build up a sizeable buffer and it is not needed for a long time. Or, we do not build up the buffer in time and then we need it. I would rather make mistake number one.

It is the job of the Danish Systemic Risk Council to recommend increases and release of the buffer. However, the responsibility of taking timely action lies with the policy-makers.

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Before I tell you about the rest of the day, I would like to say a few words about responsibility and timely action.

When conducting macroprudential policy we need to ensure democratic accountability while avoiding inaction bias.

Democratic accountability is important because measures such as restricting how much individuals can borrow have direct distributional effects.

In Denmark, the responsibility is with the Minister for Industry, Business and Financial Affairs. While it is the task of the Danish Systemic Risk Council to reduce the risk of political inaction bias.

The Council can make recommendations and the minister then has to comply or explain. This ensures democratic accountability but it does not completely eliminate the inaction bias.

The set-up with comply or explain can lead to a self-imposed inaction bias by the Council. If a recommendation by the Council is not followed, the Council's credibility is challenged. If this is repeated, the Council risks becoming irrelevant.

Therefore, the model's long-term success depends on policy-makers' continued implementation of the Council's recommendations.

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Before I leave the stage to our first speaker, let me just say a few words about the day to come.

In the next hour, we will examine the reasoning for macroprudential policy from an international perspective, from a financial stability perspective, and from a theoretical perspective.

We hope this will establish common grounds for the discussions we will have the rest of the day.

My co-hosts Poul Thomsen from IMF and David Lando from Copenhagen Business School will guide you through session 2 and 3. Here, I would like to let you know that both session 2 and 3 are conducted using Chatham House Rule.

The keynote speech will be given by William R. White from C.D. Howe Institute in Toronto. He will give you some food for thought about "What is macroprudential policy not?"

I am looking forward to an interesting day with some juicy discussions.

I now leave the stage to the first speaker Francesco Mazzaferro, Head of the European Systemic Risk Board Secretariat.