SPEECH

BY GOVERNOR LARS ROHDE AT THE ANNUAL MEETING OF FINANCE DENMARK 2019

DANMARKS NATIONALBANK

CHECK AGAINST DELIVERY

2 December 2019

Thank you for inviting me to speak here today.

I would like to start by talking about a topic that is high on the global agenda right now: climate change.

While there is considerable uncertainty as to what will happen, there is little doubt by now that climate change will have major implications for large parts of our society.

It has become clear that political actions are required in order to halt the negative developments. A higher price for CO_2, so that it reflects the costs of carbon emissions, is the cheapest and most effective approach.

Climate change is a shared and global challenge. Consequently, stronger international cooperation is important.

But it is also important that we all learn more about how climate change can affect the economy and the financial sector. That is why a growing number of central banks have begun to look at climate change in relation to their core tasks.

Decades of inaction in relation to climate policy mean that we now have only a limited time span to respond. And the longer we wait, the shorter time we will have to create a green economy. Less time for transition means greater risk for the economy and for the financial sector.

Climate change is already visible in our surroundings. We frequently see large- and small-scale damage created by extreme weather in different parts of the world. In Denmark we have seen e.g. droughts, gales and flooding.

Many of you presumably remember the December hurricane in 1999. The damage caused that evening and night amounted to around kr. 13 billion.

Flooding with extensive resultant damage may become a recurring phenomenon in the future. One of the reasons will be rising sea levels.

Danmarks Nationalbank has calculated how the collateral behind the credit institutions' housing loans will be affected in a scenario in which sea levels rise considerably. In that case, the risky share of the banks' collateral will increase notably.

These calculations are one example among many of why it may be necessary to invest heavily in e.g. coast and climate protection if we are to avoid the worst consequences of climate change.

It is widely agreed that the physical risks related to climate change can be reduced if we can strengthen the transition towards a green economy at the global level. The costs of this transition may be substantial. Especially firms and industries that have a particularly strong carbon footprint will be challenged. Ultimately, these challenges may rub off on the financial sector via e.g. losses on lending and investment.

Conversely, the necessary transition will also create opportunities and a need for new skills. So in some respects the transition towards a green economy resembles the changes driven by globalisation.

A robust financial sector may contribute to the green transition by ensuring continued allocation of capital. Consequently, financial institutions should include climate-related risks in their risk management.

In the same way, central banks and authorities should include climate-related risks in their work. A major goal should be that the requirements for financial institutions reflect the actual risks. For example, artificial discounts should not be given with a view to accelerating the green transition. And conversely, capital requirements for CO_2-intensive assets should be tightened if these prove to be linked to greater risks.

At Danmarks Nationalbank, we have begun to look at the significance of climate change in relation to our task of ensuring a robust economy and financial stability. Since climate change is a cross-border challenge, solutions must also be found in cooperation with others.

That is why Danmarks Nationalbank has become a member of the "Network for Greening the Financial System", a group of central banks and supervisory authorities. Within this network, 48 members on a voluntary basis exchange experience and discuss how to manage environmental and climate-related risks in the financial sector.

Today we have also published an analysis shedding light on a number of climate-related risks to which the financial sector is exposed. Next year we plan to develop a stress test of the Danish banks and mortgage banks in which focus will be on climate-related risks.

Financial Stability
Now, let me turn to the sector and its soundness. A few days ago, we published our semi-annual analysis of financial stability in Denmark. The good news is that the largest institutions – the systemic credit institutions – are still posting high earnings. The systemic credit institutions achieved a return on equity of 8.4 per cent p.a. in the first six months of this year.

If we look at how they did this, it is worth noting that profits have to a considerable extent been boosted by factors that are unlikely to continue in the coming years. Loan impairment charges continue to be very low. At the same time, extensive remortgaging has had a positive impact on the financial results.

The long period of low interest rates combined with a flat yield curve has led to falling core earnings for the banks. Weaker earnings will reduce the institutions' first line of defence against losses. However, I note that several institutions have launched initiatives to safeguard future earnings, and focus is on streamlining operations in order to reduce costs.

Well-functioning IT systems and a tight rein on costs will be key competitive parameters for banks in the coming years. This creates an underlying need for consolidation, also within the financial sector.

Digitalisation and new legislation give more players access to the market for bank products. From the payments market we know that digital solutions have a tendency to create natural monopolies because it costs less to perform one extra transaction once the digital infrastructure is in place.

In recent years, we have seen tech giants, such as Apple and Amazon, enter the financial market. Experience from both the USA and China shows that these firms are extending their original core business to include payments and subsequently also financial services such as lending.

Although it is difficult to predict both short- and long-term developments, the financial sector may be seeing the emergence of new business models in which data and network effects will play a decisive role.

As regards the banks' capitalisation, we can see that the largest institutions meet their capital targets, but that excess capital adequacy has shrunk in recent years. This is attributable to increasing capital requirements, while the level of capitalisation has been stable.

We note that there is substantial variation in excess capital adequacy across the largest institutions, and in a few institutions it constitutes less than 2 per cent of risk-weighted exposures. This must be deemed to be a low level of excess capital adequacy – not least because capital requirements are expected to increase in the coming years.

In our assessment the institutions should reconsider their capital targets so as to ensure an appropriate distance between capitalisation and capital requirements.

The need to reconsider capital targets is underscored by the results of our most recent stress test. It shows that a few of the systemic banks will fall short of their capital buffer requirements in a severe stress scenario – even if the countercyclical capital buffer is assumed to be released.

The institutions can improve their capitalisation by issuing new capital or by disbursing a smaller share of earnings. Disbursements to shareholders in the form of dividends and buy-backs of own shares were historically high in 2015-2018. During that period, an average of 86 per cent of the profit for the year was disbursed.

This year, it looks as if the level of disbursement will be considerably lower. Lower disbursements will contribute to increasing capitalisation, making it easier to meet higher capital targets.

The banking union

The issue of Denmark's participation in the strengthened banking cooperation – or the banking union, as it is called – is returning to the political agenda.

Perhaps I should start by commenting on the linguistic confusion resulting from the term "banking union". The banking union is not a union of banks. Nor is it a cooperation between banks, as the official Danish name could indicate.

The banking union is cooperation at the European level between national authorities and two European authorities on supervision and crisis resolution of banks.

"The strengthened banking authority cooperation" would be a more appropriate name. If only it had sounded a little more natural.

I presume you are all aware that we at Danmarks Nationalbank have been in favour of this cooperation ever since the issue was first discussed in 2014 and 2015. At that time we believed that it would be right for Denmark to participate in the banking union. And we still believe that.

Why?

Basically because we believe that we should do what we can to ensure financial stability in this country. There can be no doubt that participation in the banking union will strengthen overall supervision of Danish credit institutions. An extra layer will be added: an international dimension and international competences in addition to those already existing in the Danish Financial Supervisory Authority.

After all, the banking union is a combined mechanism. The national supervisory authorities continue to play a key role. They do so within the single supervisory mechanism, SSM, which supervises the very largest institutions.

This may not sound all that attractive to you. But from a financial stability perspective, and for Denmark as a whole, it is definitely an advantage. Overall, we will have a stronger financial supervisory authority. We should seize this opportunity without delay!

For you, it will also mean a more level playing field in relation to your competitors in the euro area. Such enhanced competition will also be a clear advantage for Danish households and firms.

Now and then concerns are expressed as to whether the single supervisory mechanism will have sufficient understanding of the Danish financial sector. And in this context our unique mortgage credit system is often mentioned.

These concerns are unfounded. The SSM currently handles many different business models in the euro area member states. And, as I have already mentioned, the Danish Financial Supervisory Authority, which has profound insight into the Danish system, will be a key player in the mechanism.

The Danish Financial Supervisory Authority will continue to be deeply involved in day-to-day supervision of all Danish credit institutions. On top of that, Danish participation will mean that the Danish Financial Supervisory Authority will be fully represented on the Supervisory Board at the ECB. The Supervisory Board will make supervisory decisions concerning institutions supervised directly by the SSM.

Decisions by the SSM must subsequently be approved by the ECB's Governing Council. That is a formality. When the banking union was agreed, there were no other legal options than to make the SSM part of the ECB.

That is why the Governing Council must approve its decisions, but this has never been intended nor proposed to mean that the Governing Council should play an actual role in relation to supervisory decisions. So it is of no significance to Denmark's influence that even if we participate in the banking union we are still not represented on the Governing Council.

Experience from the first five years of the banking union has confirmed that supervisory decisions are considered and made by the Supervisory Board and then formally approved by the Governing Council without further ado.

To be on the safe side, Denmark made sure that the set of rules applying to the banking union includes special provisions for non-euro area member states joining the banking union. A non-euro area member state can opt out if decisions are made that this member state does not agree with. It is not likely that this option will be exercised. But it helps to ensure that Denmark, as a non-euro area member state, will in fact be on an equal footing with the euro area member states as regards terms and conditions and rights within the banking union.

Five years ago, we believed that we ought to the banking union. Since then our conviction has only become stronger!

Thank you.