

## SPEECH

# SPEECH BY GOVERNOR LARS ROHDE AT THE ANNUAL MEETING OF THE DANISH BANKERS ASSOCIATION 1 DECEMBER 2014

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## CHECK AGAINST DELIVERY

Thank you for inviting me to speak today.

I would like to start by describing international developments. After that, I will comment on the Danish economy and the capitalisation of firms and of the agricultural sector. And finally, I will talk about the issue of Danish membership of the Banking Union.

The world economy continues to grow at a modest pace, while the euro area is still waiting for the upswing. This situation is attributable to, inter alia, the conflicts in Ukraine and the Middle East, which have reduced consumer and business confidence, possibly by more than could be expected. The slowdown since the summer has led to downward adjustment of growth forecasts for Germany and other countries. On the other hand, the USA and, to some extent, the UK are seeing robust growth in economic activity.

Euro area consumer prices are being curbed by falling energy prices. At a more fundamental level, wage growth is low. Inflation is currently well below the European Central Bank's target of just under 2 per cent. Combined with weak growth, this in early September led the ECB to announce two new purchase programmes for securities issued by the private sector. However, only a very small share of production is limited by shortage of credit. The overriding issue is lack of demand and, to a somewhat lesser extent, lack of access to labour. So we should not have too high expectations that more credit will in itself lead to a surge in investment and employment.

At the end of October, the Federal Reserve decided to discontinue its purchases of government and mortgage-backed bonds. It has been important to avoid turmoil in this connection. And indeed, the decision was expected in the markets and reflects the continued improvement of the US economy. It also underlines the divergence between the US and euro area economies.

In all the major economies, monetary policy is supporting growth by reducing market interest rates and risk premia to very low levels. On the flip side, a prolonged period of low interest rates and low volatility could result in underestimation of risks and excessive risk exposure among credit institutions and their customers.

A sudden reversal of the international hunt for yield could cause prices to plummet, and the trend may be intensified by sales spirals and queues at the exit, which may have a knock-on effect across asset classes. A shortage of liquidity in the market could further accelerate the process.

There are currently no indications that major systemic risks have built up in the Danish financial system. All the same, there is reason to be on guard. Credit institutions should ensure that they are able to withstand both direct losses due to price adjustments for financial assets and the derived effects of the potential market turmoil triggered by such adjustment – e.g. because market access becomes more difficult.

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Turning to the real economy, the Danish economy has grown since the end of 2012 if we adjust for falling output of North Sea oil and gas these years. Growth has been driven mainly by domestic demand.

Developments in the labour market have been positive over the last year. Employment has risen sharply, and unemployment has fallen. According to Danmarks Nationalbank's estimate, the current unemployment gap is only around 10,000, so if the recovery continues, it will soon close. The potential for increasing the labour force is greater, but this is also more difficult.

Inflation is also low in Denmark due to factors such as falling oil prices. In the coming months, price inflation will remain low, but looking ahead we can expect inflation to pick up as the effect of falling energy prices fades away.

Interest rates in Denmark have continued to fall, to historical lows, and the low level of interest rates is set to continue for some time yet. In spite of this, investment activity is low and corporate savings high. This is the case not only in Denmark but in most advanced economies and no-one can really say when this circle of restrained private consumption and low investment appetite will be broken.

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It is not purely bad that corporate savings are high. Other things being equal, a firm is more robust to economic shocks the higher its equity is relative to its total assets. That reduces the risk that the firm will fail. It also reduces the probability that the firm's bankers will suffer losses on their lending to the firm. Hence, a high solvency ratio has a positive impact on financial stability.

A high solvency ratio also gives the individual firm greater flexibility when choosing between alternative sources of funding and greater certainty of obtaining the desired funding. An analysis by Danmarks Nationalbank shows that since the financial crisis erupted, loan capital in the Danish banking system has to a large extent flowed to the soundest, most profitable and productive firms. This is healthy in a banking system and should induce firms with small buffers to consider

whether it might be a good idea to increase their capitalisation. This applies not only to limited liability companies, but also to sole proprietors – including farms, for example.

In the pre-crisis years, the Danish agricultural sector experienced a land price bubble that inflated prices per hectare to unrealistic levels. The high land prices were to a large extent used to pledge land as collateral for raising further debt. Since 2008, the average price per hectare has almost halved. This has left many farmers with high debts and a low equity base. This makes them more vulnerable to fluctuations in the prices of agricultural produce, which have shown considerable volatility over time.

The shaky foundations of Danish agriculture were partly masked by favourable conditions for the sector in the period 2010-13, with good prices and rising terms of trade. At the same time, farms could be financed at historically low rates of interest. Nevertheless, return on equity was unsatisfactory for many farms. This points to fundamental structural problems within the agricultural sector.

The prices of grain, pigs and milk have fallen since the spring, partly on account of Russia's boycott of western agricultural produce. However, prices have not fallen more sharply than we have seen on many previous occasions, and the current price level is relatively normal in a long-term perspective. Production and sale of highly volatile goods such as agricultural produce require well-consolidated production units that are resilient to such repeated price fluctuations. The current situation has highlighted the weak capital base of many farms. Capitalisation must be strengthened.

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Now I will turn my attention to the Banking Union. On Tuesday, 4 November 2014, the EU's Single Supervisory Mechanism entered into force. Responsibility for major supervisory tasks in the participating member states was transferred to the ECB. This marks an important step in the implementation of the Banking Union.

Seen from the outside – from Denmark – it is difficult to spot any change. But we must not be mistaken. 4 November 2014 was a red-letter day in Europe. The member states participating in the Banking Union have set the future course for supervision and crisis management of their banks.

They have chosen to have one strong authority to supervise all their banks in future. And they have chosen to transfer responsibility for crisis management to a Single Resolution Board from January 2016. This Resolution Board will guarantee credible and consistent application of the bail-in rules in relation to distressed banks. The claims of unsecured creditors will be converted into equity or written down. Tax payers will no longer have to help clear up the mess left by irresponsible banks.

In the debate on the Banking Union it is now and then argued that – if we participate – Danish banks risk having to pay for problems experienced by banks in other member states. In my view, that point of departure is wrong. After all, when it comes to distressed banks, the key element of the Bank Union is bail-in, not bail-out.

The Banking Union creates the basis for a gradual strengthening of the single market for financial goods in the coming years. Common rules and uniform implementation will lead to less bureaucracy and will be a good thing for competitive banks, which will have better opportunities to compete across national borders. This can be expected to lead to increased price and product competition, to the benefit of households and firms in the participating member states.

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The Danish Bankers Association has published a report with deliberations on Danish participation in the Banking Union. I agree with large parts of your analysis.

For example, I agree when it comes to competition and financial stability aspects. As I have just said, the Banking Union can be expected to create potential for more competition. And it will strengthen financial stability to have a single authority that is expected to be better at preventing, predicting and managing financial crises.

Those are sound observations. Therefore I am a little surprised to see that the overall conclusion of the Danish Bankers Association is that Denmark should wait and see before deciding whether to join the Banking Union.

The Danish Bankers Association lists a number of outstanding issues to be clarified before we make up our minds. For example, the report mentions uncertainty about how the Banking Union will handle distressed banks. And it mentions uncertainty as to how the market will assess the Union.

As I see it, this wait-and-see conclusion leaves one central question unanswered: What, exactly, is it we should wait for? Both the handling of distressed banks and market players' assessments of the Banking Union will be dynamic processes.

It may have been sensible to wait for the results of the asset quality review and stress test concluded by the ECB in October. But what are we waiting for now? What will it take before we have enough information to make a decision?

Wait and see – without clearly indicating what we are waiting for – is de facto a 'no'. A 'wait and see' decision is precisely – a decision. If we are not participating, we are de facto outside the cooperation which the participating member states have now begun. I find that unwise.

In all fairness, I should say that it would not be a disaster if we waited or if we chose to opt out. There is a life outside the Banking Union. But non-participation will have some implications and

bring some challenges that we will have to take into account in the coming years, should that be the path we choose.

The implications may seem small today, but in the longer run they could be considerable.

Going forward, Denmark cannot expect to be compared with the members of the Banking Union when international players try to assess the risks in the Danish banking sector. Instead, relevant benchmarks will be Sweden and Switzerland. As in Denmark, the assets of the largest banks in these countries amount to approximately 1.5 times GDP. In these countries, which will not be joining the Banking Union, the authorities already impose stricter requirements on the largest banks than we do. People will invariably begin to ask whether the Danish requirements are sufficiently high. And so will Denmark's Nationalbank.

In addition, it will become relatively more costly for international investors to invest in Danish credit institutions. Inside the Banking Union, investors will have to study one single rulebook and the ECB's implementation of this rulebook before assessing which of the many banks within the Union to invest in. We will be a small country outside the Banking Union. Investors will have to understand our unique national setup – and where it deviates from the Banking Union – before assessing which Danish banks they might want to invest in. That will require a lot in terms of communication from banks and authorities. But no matter how good our communication is, international investors will need to be compensated for the extra resources spent understanding our particularities.

When we discuss the Banking Union, one issue always crops up in Denmark – and not without reasons. That is the Danish mortgage credit system. And, indeed, the mortgage credit system is one of the uncertainties that make the Danish Bankers Association say 'wait and see'.

Again, I do not quite follow your argument. In recent years, Denmark has applied considerable political muscle to ensure that our mortgage credit system has a place in the new single European regulation. We have negotiated with 27 member states, all with their separate national interests to safeguard. And the negotiations went well.

This does not mean that current regulation is the end of the road. Rather, a game changer has been introduced. Decisions will be taken by the members of the Banking Union. They will, as a matter of course, negotiate and reach a conclusion among themselves – and will then stand together as one large group that cooperates closely when it comes to banking. The outsiders, on the other hand, will be a small, diverse group.

In that situation we may ask ourselves how we can best protect the Danish mortgage credit system. By participating in future negotiations within the group of cooperating member states? Or by opting out together with a few other member states that have no particular interest in supporting our mortgage credit model?

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As you know, it is not for the Danish Bankers Association or Danmarks Nationalbank to decide whether Denmark should participate in the Banking Union. It is a political issue. The politicians determine when the time is right to make a decision – and they make the decision.

But those of us who play a role in the sector have an obligation to be frank and honest about our views and opinions.

Danmarks Nationalbank firmly believes that both credit institutions in Denmark and the Danes in general have an interest in participating in the Banking Union. Together with the Danish mortgage credit sector we should knock on the front door of the Union.

The Banking Union aims to provide security for citizens. No element of the Union makes it more expensive to be a homeowner or bank customer. On the contrary – increased competition could make it less expensive.

The Banking Union will have a huge impact on Denmark – whether or not we choose to participate. Therefore we need a broader debate so that the pros and cons become crystal clear. In this connection I can already reveal that Danmarks Nationalbank's assessment will be elaborated on in our upcoming Monetary Review.

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Finally, I would like to take this opportunity to thank you for our good cooperation in relation to the establishment of the Straksclearing express clearing system. It has been a large project for all of us. But now we have upgraded the Danish payments infrastructure so that it is possible to transfer money instantly between accounts in different banks. Today I think we can all see the advantages of having implemented this project that brings Denmark right up to date in the field of payments.

Thank you.