SPEECH

GOVERNOR LARS ROHDE'S SPEECH AT THE PWC BANKING SEMINAR

DANMARKS NATIONALBANK

CHECK AGAINST DELIVERY

22 November 2021

INTRODUCTION

--- Slide 1: Today's programme ---

Thank you for inviting me to speak here today. The last eighteen months have been a roller coaster ride, with a rapid down slope followed by a rapid recovery. This also applies to the banking sector.

As the pandemic took centre stage, several reforms of the banking capital requirements were lined up behind the scenes. Now it is time for us to consider them again.

I am going to devote my speaking time to the following topics:

- The Danish economy – from pandemic to recovery
- Phasing out of relief packages – we can finally see the end to these packages
- The current state of the banking sector – Danish banks are well equipped for recovery
- And finally, the European Commission's proposed capital requirements – the completion of the Basel III framework.

FROM PANDEMIC TO RECOVERY

--- Slide 2: The pandemic produced a sharp global downturn, but impacted different countries very differently ---

As we all know, the pandemic caused the most severe economic downturn in recent history. Virtually all countries were hit simultaneously. And global economic activity contracted by nearly 4 per cent last year.

But the economies regained their footing almost as quickly as the rug was pulled from under our feet. But there have been – and still are – wide differences in the pace of recovery across countries.

In an international comparison, the Danish economy has weathered the pandemic relatively well so far. The downturn was milder, and the recovery faster. If asked why, I will emphasise three factors.

First, so far, the covid-19 pandemic's grip on Denmark has not been as firm as on many of the major European countries. This is due, in part, to the quick launch of government measures – especially the first lockdown in March last year. Thanks to the swift response, restrictions were milder and less lengthy in Denmark. For instance, industry and construction were not locked down at any point in Denmark, and Denmark did not resort to outright curfews.

Second, a number of extraordinary government measures have kept Danish businesses and households afloat. At the time, this was sensible and helped to reduce the severity of the downturn.

Third, it is difficult to derail a well-balanced economy. And, in my opinion, the Danish economy was a balanced economy before the pandemic struck. We were experiencing a moderate boom without any signs of overheating – with households and businesses that had been consolidating since the financial crisis and with solid government finances.

In addition to these three factors, I would like to mention a couple of other factors that also, so to speak, helped bolster the Danish economy's immune system. The corporate structure has played a key role. The Danish economy is not very reliant on tourism, and Danish exports are fairly resilient to global economic fluctuations. Denmark is one of the most digitalised countries in the world, which has also paid off. Generally, digitised countries have weathered the pandemic better than less digitalised countries, because technology made it easier to carry on with normal everyday life, even during lockdowns.

--- Slide 3: The Danish economy is already now operating above its potential ---

Having looked back on how the Danish economy has performed, I will now turn my attention to the future.

The Danish economy is currently performing well. We probably have a slight head start over our Nordic neighbours and our usual benchmark countries in our recovery and cyclical upturn. Earlier this year, economic activity was back at the pre-pandemic level, as was employment. The Danish economy is operating close to or even slightly above its cyclically neutral level. In other words, we are heading back in a moderate boom.

But the way out of the pandemic is uncertain and untried. This autumn, the number of infections is up, and European infection rates are again attracting attention. The greatest economic challenges may be behind us, but the course of the economy will continue to depend on the course of the virus in the future.

Another major question right now is: How persistent are the pressures we are seeing on global supply chains, prices and labour markets?

There is no clear-cut answer, but I will share some of my observations.

Supply chain disruptions are the result of repeated lockdowns and reopenings, along with various unfortunate circumstances. This *stop-and-go* approach has resulted in shifts in consumption and production patterns. We expect the pressures to ease as the pandemic eases, and the global balance between consumption of goods and services is restored. In recent weeks, we have seen the first signs that pressures are easing. But the world should still exercise patience. International organisations do not expect the backlog to be cleared until sometime in 2022.

As far as inflationary pressures are concerned, annual consumer price inflation in the USA and the euro area is higher than we have seen for a number of years. Price inflation is largely driven by steep increases in energy prices and changes in direct and indirect taxes. This could indicate that price pressures are temporary. For instance, international organisations such as the IMF and the World Bank expect energy prices to normalise over the coming year.

But I would like to draw a line in the sand here. What is happening in the USA and what is happening in the euro area and in Denmark are not the same. US prices have generally risen more, and US price increases have been more broadly based across goods and services groups. One reason is that the US recovery has been stronger than in the euro area and Denmark. And there are several indications of considerable pressure on the US labour market and wages, which could produce more persistent price pressures going forward.

In the euro area, pressures are likely to build at a slower pace. Here, the economy still has considerable spare capacity, and wage pressures are moderate. In Denmark, there are no indications at present that wage growth has taken off. Even though wage increases in the 2nd and 3rd quarter of 2021 were at their highest since the late 2000's, they have still not been markedly above the collective wage agreements for the private sector that were agreed before the pandemic.

When it comes to pressures on the Danish labour market, the surge in employment following the reopening of the economy has made it difficult for businesses to recruit labour. Recruitment difficulties have been exacerbated by the need for many businesses to re-employ staff, and also some labour has been retained in the health care sector as covid-19 testing and vaccination staff. The recruitment challenges could increase wage pressures. This could sound worrying – but we should remember that wage pressures are at the core of a market economy. This is the mechanism that helps ensure that unproductive businesses fail, while productive businesses survive.

However, we do expect pressures to begin to ease as vacant positions are filled, but pressures will remain high. This is compatible with the Danish economy progressing further into the boom. But as I mentioned earlier, uncertainty is high. We are again increasing our covid-19 testing capacity, which could prolong pressures on the labour market.

I have outlined some of the assumptions underlying our projections for the Danish economy. We assess that some of the pressures we are seeing right now will ease, which will produce a balanced growth pattern. The Danish economy is fundamentally sound, and Danish competitiveness is strong. We can withstand a period of capacity pressures.

But we are venturing into uncharted territory. So, there is a higher-than-usual risk that the economy could behave differently from our projection. Growth could be substantially stronger.

A particular focus area for us is that households have accumulated large savings, so a lot of "pent-up" household spending could potentially be unleashed in a short time. And such an exceptional increase in consumption could cause the economy to overheat.

With this risk in mind, we have recommended that the Danish government should be prepared to tighten fiscal policy more than currently envisaged.

PHASING-OUT OF LOCKDOWN RELIEF PACKAGES

--- Slide 4: Danish banks also benefited from government relief packages ---

As already mentioned, the Folketing (Danish Parliament) adopted extensive relief schemes for the Danish corporate sector when the Danish economy was locked down because of the pandemic.

Several of these measures were in the form of direct compensation to businesses. For instance, the wage compensation scheme reduced the number of redundancies and helped businesses retain key employee competencies. Moreover, a number of deferred tax and VAT payments provided access to significant liquidity. Since the pandemic struck, the Danish tax authorities have exceptionally deferred payments of a total of kr. 330 billion.

As the deferred payments fell due, businesses were given access to government loans of the same amount. The authorities have also given some businesses access to government-backed bank loans.

Throughout the pandemic, the banking sector has been pointing out that in this crisis, the sector was *not* part of the problem, but part of the solution. I do understand the wish to bring good news. But then again, it is the least that you could expect. Still, it has been in stark contrast to the situation during and after the financial crisis.

Danish banks have not used the government compensation schemes. By and large, they have been prepared to provide liquidity and loans to private and viable businesses in need of liquidity and loans. So far so good.

But, as we all know, there is always a limit. It is worth remembering that without the government relief packages, the situation would have been much more serious – also for Danish banks. Indirectly, Danish banks also benefited from the relief schemes. Banks and mortgage credit institutions would have been facing higher losses if the central government had not kept customers afloat.

--- Slide 5: Support for weak businesses hampers business dynamics ---

As mentioned, the pandemic is not over. This autumn, the covid-19 virus has again taken hold of our society. But hopefully, the worst is behind us.

The government relief packages are being phased out. Compensation payments have almost ceased. Temporary liquidity schemes are due to expire over the coming years. Most of the tax and VAT loans fall due for payment next April.

It is positive that we can now see the end of the relief schemes. Receiving government relief is not healthy – although it may temporarily be necessary.

As the economy has recovered, supporting the corporate sector has become increasingly problematic. Obviously, it is expensive for the central government, but also for the economy in general, because market forces have been weakened.

The terms of tax loans have been attractive. Tax loans are interest-free and have been extended regardless of borrower creditworthiness. Not surprisingly, this has attracted many businesses that were already weak. They may already have had difficulties obtaining credit approval.

Even before the pandemic struck, banks assessed many of the corporate customers that subsequently raised tax loans as being weak. A large portion of these businesses had loans which, according to their own banks, were either subject to a significant increase in credit risk or were credit-impaired. Some of these businesses have been kept artificially alive by the government tax loans.

Market forces usually contribute to effective resource allocation. The Danish economy is characterised by flexibility and adaptability. So, in the pre-pandemic years, there were few unproductive businesses – the so-called zombies. In Denmark, unproductive businesses are ousted by productive businesses and default.

Restoring business dynamics is important. To do so, the banking sector must be put back in charge of credit allocation rather than the central government.

--- Slide 6: Danish banks are ready for liquidity support to be phased out ---

What will be the cost of phasing out the schemes? What will happen to businesses that have received liquidity support once it expires? Will they be able to operate without liquidity support? Or will we be faced with a wave of defaults?

Let me say to you up front: The phasing-out of liquidity support will result in defaults. Anything else would be unnatural. During the pandemic, the number of defaults has been lower than in the pre-pandemic years. Defaults are part of a healthy market economy, and we have a backlog in that respect.

Restoring the market forces is also in your best interests. In contrast to government relief schemes, the banking sector must grant credit based on thorough credit assessments. That is your core competency. You need to stick to your credit policies, and if a business cannot survive, it should not be kept artificially alive. Otherwise, you will be sowing the seeds of your next crisis.

But I would also like to say a few reassuring words. As mentioned earlier, the Danish economy is performing well. We are seeing labour shortages – for instance labour that may have been locked in unproductive businesses during the pandemic. And Danish banks have made it through the pandemic relatively unscathed. I will get back to that.

Banks have the capacity to take over tax loans when they expire. The sector is well equipped to lend to viable businesses, and the worst affected segments of the economy account for a limited portion of bank lending portfolios.

And do not forget: You have emphasised that this time around, the banking sector is not part of the problem, but part of the solution. Hopefully, this will also be the case when the tax loans start to fall due next April.

Incidentally, the phasing-out of relief schemes could still be expensive for the central government. The government recognises this, and kr. 2 billion has been allocated for losses under the schemes.

RECENT FINANCIAL SECTOR DEVELOPMENTS

--- Slide 7: Currently, Danish banks are as resilient as they were in the run-up to the pandemic ---

And now back to the situation in the banking sector. Fortunately, the pandemic did not affect the banking sector as severely as had been feared. The earnings expectations of the large Danish banks have now returned to pre-pandemic levels – and in some cases they are even higher than before the pandemic.

The outlook was bleaker last year. Right after the pandemic struck, banks recognised substantial impairment charges. A considerable portion of these impairment charges reflected either a downward revision of expectations regarding economic growth or discretionary management decisions. Many of the expected losses have yet to be realised.

The current situation is that the large banks are as resilient as they were before the pandemic struck.

Overall, their capitalisation has improved during the pandemic. However, it should be noted that their additional buffers did not materialise out of the blue. But during the pandemic, I noticed a sudden responsiveness to outside advice. I was pleased that our advice was heeded this time.

In that context, it is however thought-provoking that, in the aftermath of the pandemic, we are still seeing a number of large banks with limited excess capital adequacy.

--- Slide 8: There are indications that risks are building up, so the countercyclical capital buffer must be rebuilt ---

Now that the banking sector is back to pre-pandemic levels, the sector framework should be restored as well.

Just as before the pandemic, we are now seeing signs of risk build-up in the financial system. The pace of economic recovery was rapid, and asset prices in the equity and housing markets, among others, have increased considerably. Also, financial conditions remain accommodative.

In the years leading up to the pandemic, the Minister for Industry, Business and Financial Affairs decided, on the recommendation of the Systemic Risk Council, to start building up the countercyclical capital buffer. The buffer is to ensure that institutions build up capital during periods in which risks are rising in the financial system. This will make them more resilient when risks subsequently materialise.

Back then, each buffer rate increase would spur a heated debate. Subsequently, when the pandemic struck, the buffer proved to be an indication of timely response.

This time, the buffer must be built up faster. It is important that we do not drag our feet. In June, the Systemic Risk Council recommended that the Minister for Industry, Business and Financial Affairs increase the buffer rate to 1 per cent from September 2022. The Minister followed the recommendation, and I have noted that the sector received the decision, if not joyfully, then with understanding.

The Systemic Risk Council has already announced that at its December meeting, it expects to recommend a further increase to 2 per cent. The Council also expects that the building of the buffer rate will continue up to 2.5 per cent.

--- Slide 9: High prevalence of deferred amortisation contributes to risk build-up in the housing market ---

One of the risks mentioned has attracted by my particular attention. It deserves some elaboration.

Recently, there has been a lot of debate about the housing market. During the pandemic, we saw high levels of activity in the housing market and substantial price increases.

However, I have spoken long and hard about the housing market and have been advocating for healthier housing market structures. A resilient housing market is key to a resilient Danish economy. That is important to you as bankers, to homeowners across the country and to the Danish economy. If you are not convinced about the importance of a resilient housing market, let me remind you that many of the major economic downturns we have seen in the past have followed in the wake of problems in the housing market.

Now that the Danish economy has overcome the crisis, this is a good time to implement measures to improve the resilience of the economy.

When house prices go up, indebtedness tends to increase too. Homeowners increase their debt by buying more expensive homes or by borrowing against their home equity.

So far, overall credit growth has remained moderate. But credit growth is picking up, especially in areas that have seen strong house price rises. The Copenhagen housing market has seen a marked increase not only in house prices, but also in lending. Diverse developments across areas and groups of homeowners could generate pockets of high risk.

Add to this the fact that more homebuyers have opted for deferred amortisation in the last few years – despite a number of lending requirements introduced by the authorities. The greatest cause of concern is that a large portion of mortgage credit institutions' new lending to highly indebted homeowners is still with deferred amortisation.

In June, the Systemic Risk Council recommended that the government further restrict access to housing loans with deferred amortisation. But regrettably, the government has chosen to disregard this recommendation.

Apparently, it is never the right time to do the right thing.

BASEL III AND THE OUTPUT FLOOR
--- Slide 10: Array of capital requirements might be mutually counterproductive ---

As already mentioned, the banking sector is performing well. Against that backdrop, it may be tempting for boards of directors in Denmark to start offering "treats" to shareholders.

But banks should carefully consider the level of dividends and share buybacks. Although shareholder funds remain in the bank, the funds are still theirs. At the same time, more equity means lower risk for both shareholders and creditors – and so a more resilient banking system.

In general, bank equity is a topic surrounded by myths. Let me be clear: Equity is not an expense. If a bank increases its equity, its expenses do not rise. Equity is part of the financing base of any business. Obviously, equity should be rewarded like other sources of financing – but, as already mentioned, the required rate of return will decrease as equity increases.

Myths or not, banks will be required to be better capitalised in the coming years.

In October, the European Commission published its proposal for the implementation of the final elements of the Basel Committee on Banking Supervision's global capital requirements package – known as Basel III. The Committee introduced the first elements of the package in the wake of the financial crisis, and the Committee's proposal puts a preliminary stop to well over a decade of new capital requirements.

General capital requirements have been tightened. This is positive. Both more and better bank capital was needed. But the framework, which started out as a solo act with one capital requirement, has evolved into an orchestra with many instruments. That makes it more difficult to ensure that all instruments keep time.

With the array of new requirements, some large institutions actually cannot use their capital buffers in stress situations. If they did, they would come into conflict with the new leverage ratio requirement. In other words, we are talking about a lack of *buffer usability*.

The leverage ratio is an add-on capital requirement which – unlike the other requirements – does not reflect a specific assessment of an institution's risk. This requirement first appeared in the international debate in the years following the financial crisis. Those years were marked by deep global distrust of banks and their risk assessments. On the one hand, large institutions that had been permitted to use internal models-based approaches for credit risk assessment were accused of taking the task too lightly. On the other, the standardised approach used by small banks was accused of insufficient risk sensitivity.

These are some of the new and old challenges the Basel Committee and now the European Commission want to address. The question is: Will the new rules bring more harmony?

--- Slide 11: Positive notes in the European Commission's proposal for the implementation of Basel III ----

In my opinion, the European Commission has proposed a reform with many positive aspects.

First and foremost, the proposed reform tightens the rules of large institutions' use of internal models-based approaches. This has been necessary to ensure high credibility of their risk assessments and will and must lead to higher capital requirements.

My view is basically that capital requirements and the actual risk involved must go hand in hand. Use of internal models-based approaches may help to ensure that an institution's capital requirements better reflect the institution's specific risk. But achieving that requires great insight and vast amounts of high-quality data. Those conditions have not always been met. Therefore, it is sensible, for instance, to reduce the use of internal models-based approaches in areas that are difficult to model.

I would like to add that Europe is actually already unifying, harmonising and tightening requirements concerning internal models-based approaches. Within the banking union, the ECB has been conducting a targeted review of internal models (TRIM) for institutions under their supervision over a number of years. Unfortunately, Danish institutions have escaped such review. But soon Danish institutions will also be required to meet new European guidelines.

Second, the rules under the standardised credit risk approach are being revisited. The keyword in this respect is more risk sensitivity. I especially note that, in future, it will require relatively more capital to provide housing loans with high LTV ratios than with low LTV ratios.

And then there is the much debated output floor. I have mentioned this on a previous occasion: That is not our idea. Such general and rigid floor requirement is contradictory to the notion that capital requirements and actual risk must go hand in hand. And although much effort has been put into introducing more risk sensitivity into the underlying standardised approach, it will never beat well-functioning internal models-based approaches.

I am not the only one taking a position on the output floor requirement. The prospect of higher capital requirements on mortgage lending, in particular, has made the Danish financial sector sit up and take notice, prepared to advocate alternative solutions.

But we also need to relate to reality. The output floor has been long in the making. It replaces an old and even more incomprehensible floor requirement which you may already have forgotten. And the European Commission's proposal of European discounts on housing loans secured by mortgages and loans to unrated corporate customers addresses two of the issues highlighted by the Minister for Industry, Business and Financial Affairs' group of experts back in 2018.

The Commission's proposal for the technical implementation of the floor requirement – the so-called *single-stack approach* – has the advantage of being simple. We do not need to add to the complexity of the capital requirement rules. Concentrated efforts are already needed to ensure that the instruments keep time with each other.

And now that we are back to keeping time, we must not forget the other new instrument: the leverage ratio requirement – which is a floor requirement that is not risk-based. In that constellation, even a binding output floor – with some risk sensitivity – may be preferable? If nothing else, it has the potential to improve *buffer usability* – and that is music to my ears.

Thank you for your attention.

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PwC Banking seminar 2021

Governor Lars Rohde, 22 November 2021

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Today's programme

From pandemic to recovery

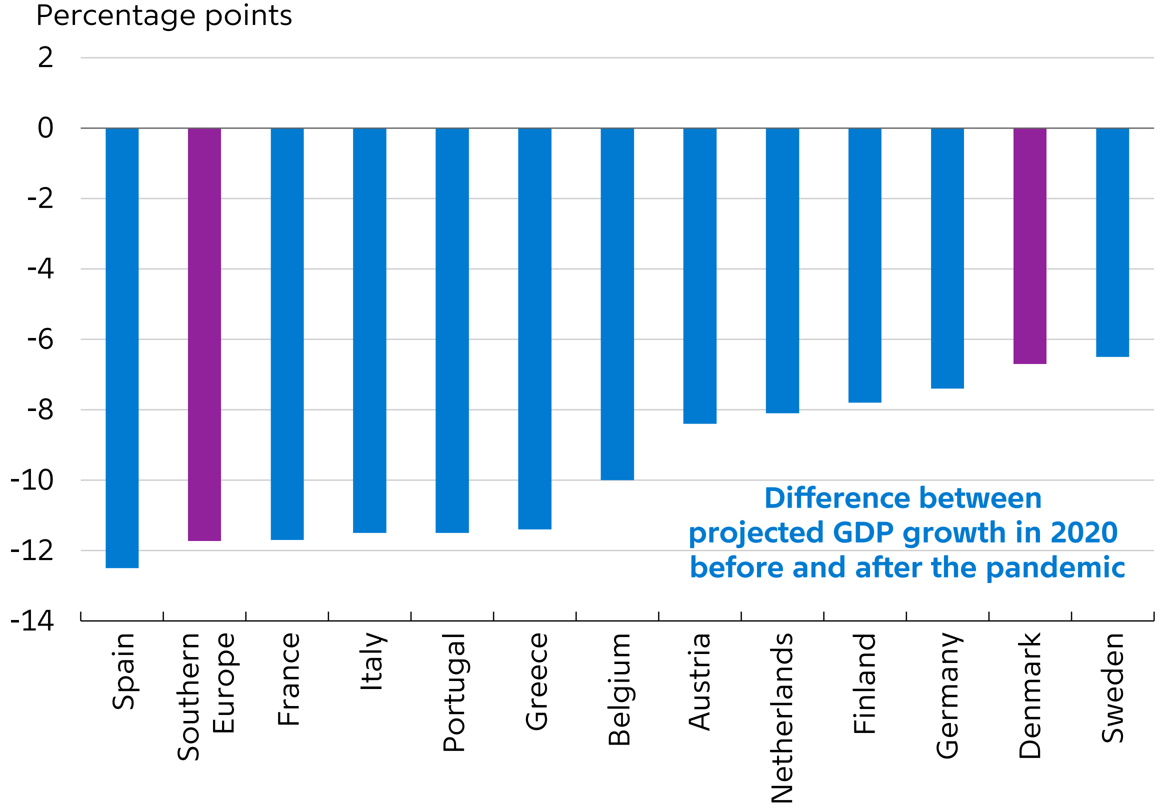
Phasing-out of relief packages

The state of the financial sector

Basel III and the output floor

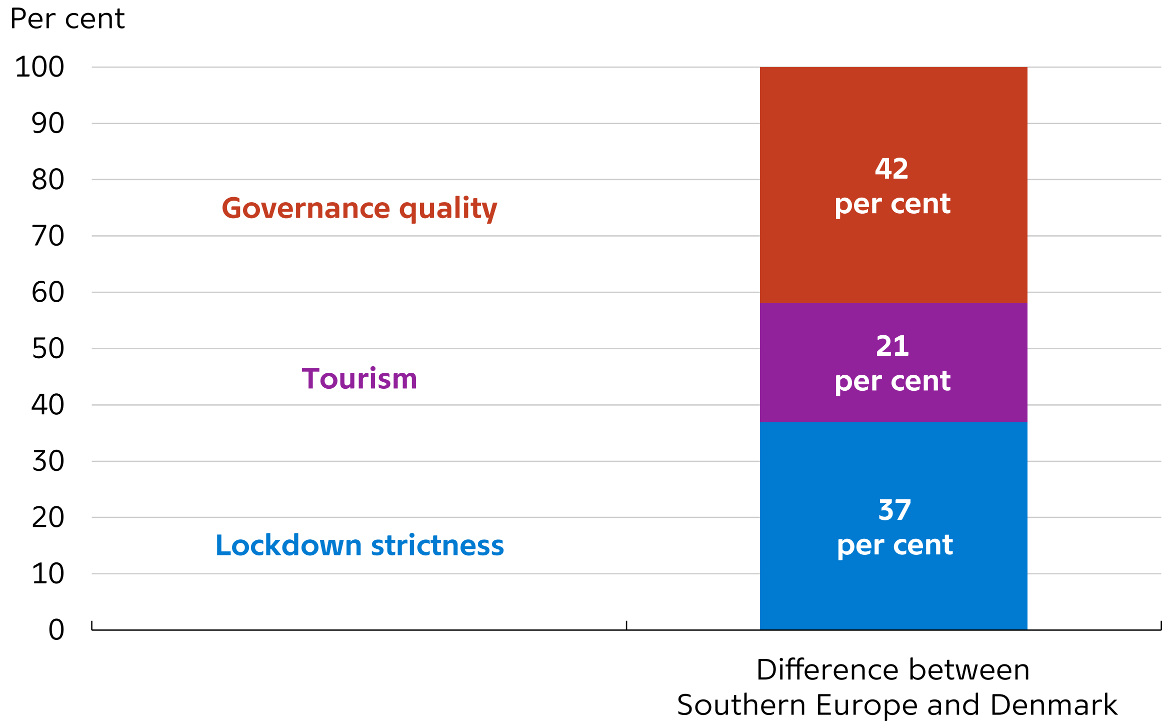
The pandemic produced a sharp global slowdown – but impacted different countries very differently

Coronavirus outbreaks have affected Southern Europe more severely than Denmark



Note: The chart illustrates the difference between the European Commission's February and July forecasts. Southern Europe is Spain, Italy, Greece and Portugal.
Source: Bruegel.

Three factors can explain close to 60 per cent of the differences in the downturn



Source: Bruegel and own calculations.

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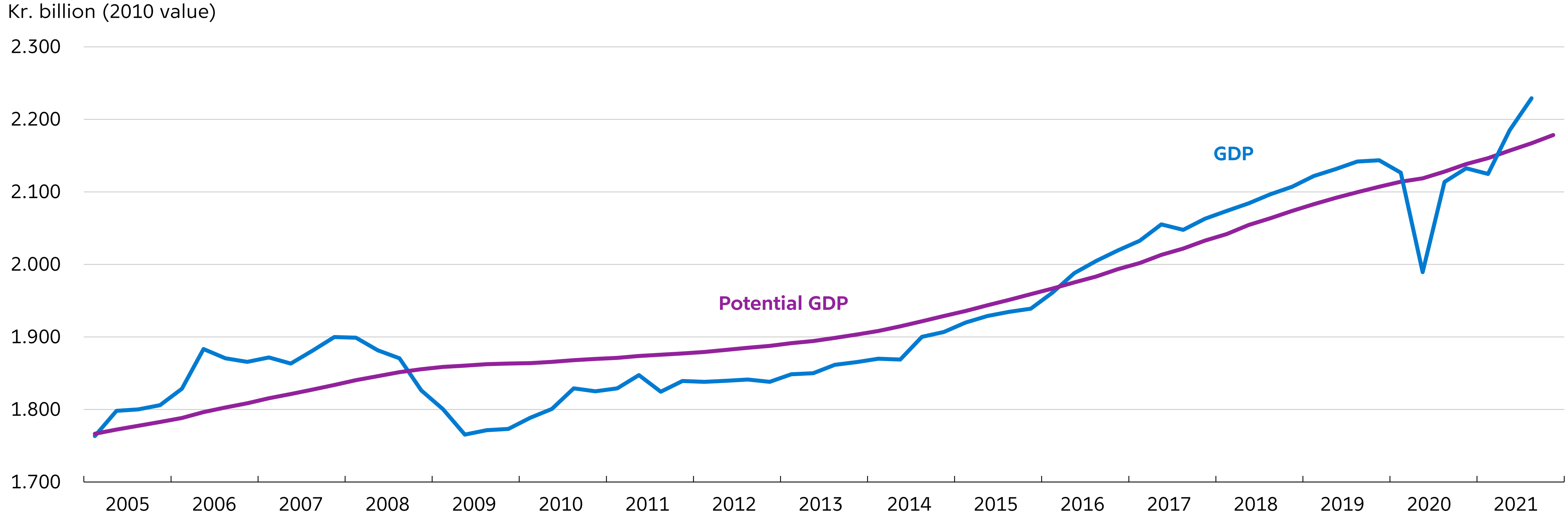
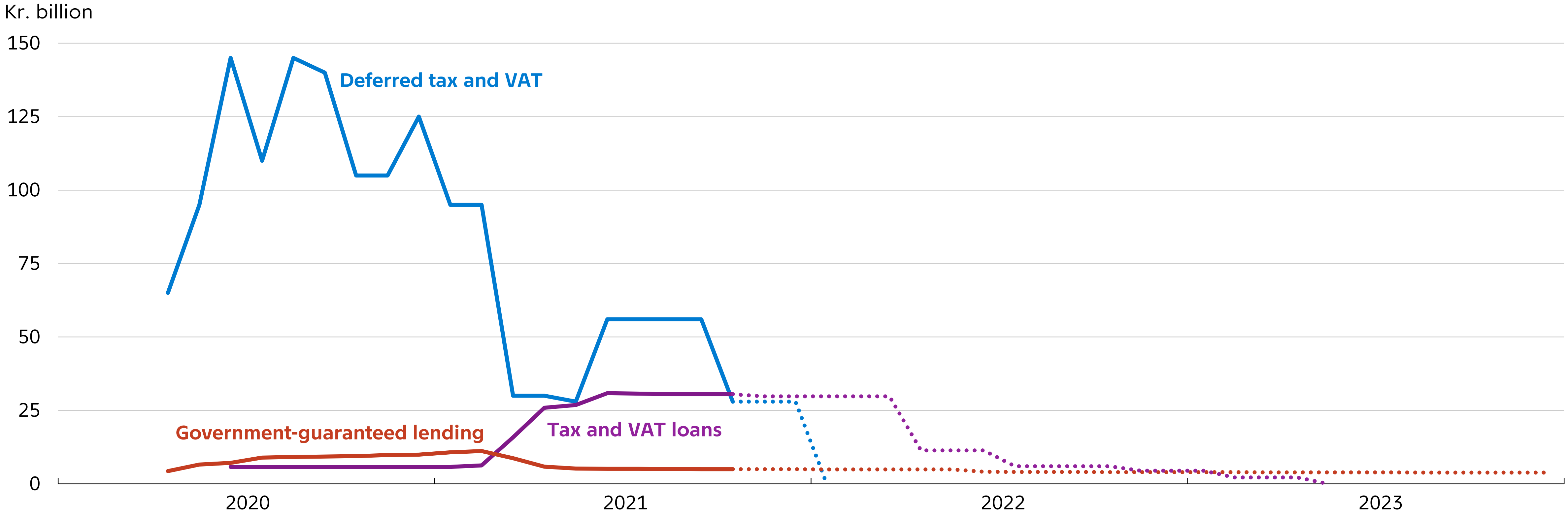
The Danish economy is already now operating above its potential



Source: Statistics Denmark and own calculations.

Danish banks also benefited from government relief packages

Government liquidity schemes are due to expire over the coming years



Note: Dotted lines show the expiry forecast. Estimated amount for total volume of deferred payments of withholding tax (A-tax), tax not collected at source (B-tax), labour market contributions and VAT. The actual amount will depend on the level of activity and employment. Outstanding amounts for loan schemes for VAT and payroll tax, A-tax and labour market contributions for non-financial corporations (excluding sole proprietorships).

Source: Danish Ministry of Taxation, Danish Tax Agency, Danmarks Nationalbank and own calculations.

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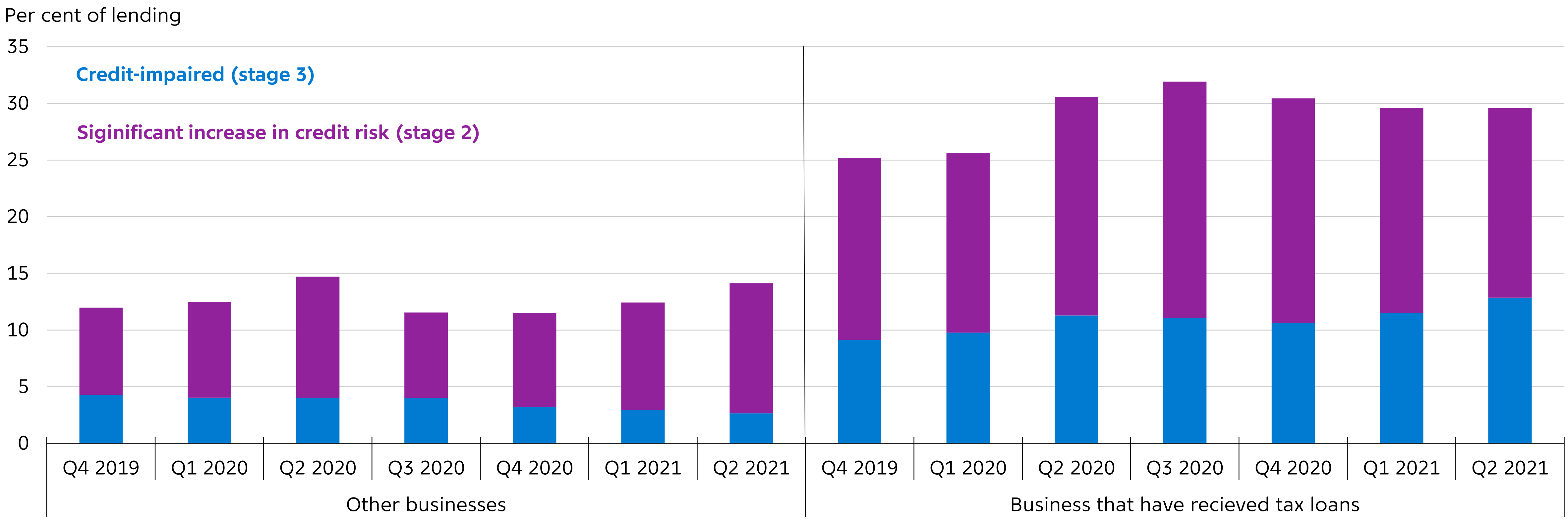
Support for weak businesses hampers business dynamics

Poorer credit quality for customers who have raised tax and VAT loans



Note: Corporate lending excluding sole proprietorships broken down by impairment stages. The remaining lending is in impairment stage 1 without any significant increase in credit risk.
Source: Danish Tax Agency, Danmarks Nationalbank and own calculations.

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Danish banks are ready for liquidity support to be phased out

A credit assessment should be performed when loans are granted

It is a sound principle for loans to be credit-assessed, and that is a core banking task.

Banks have the capacity to take over tax loans

Danish banks are well equipped to make loans to viable businesses when the deferred payment deadlines and loans fall due.

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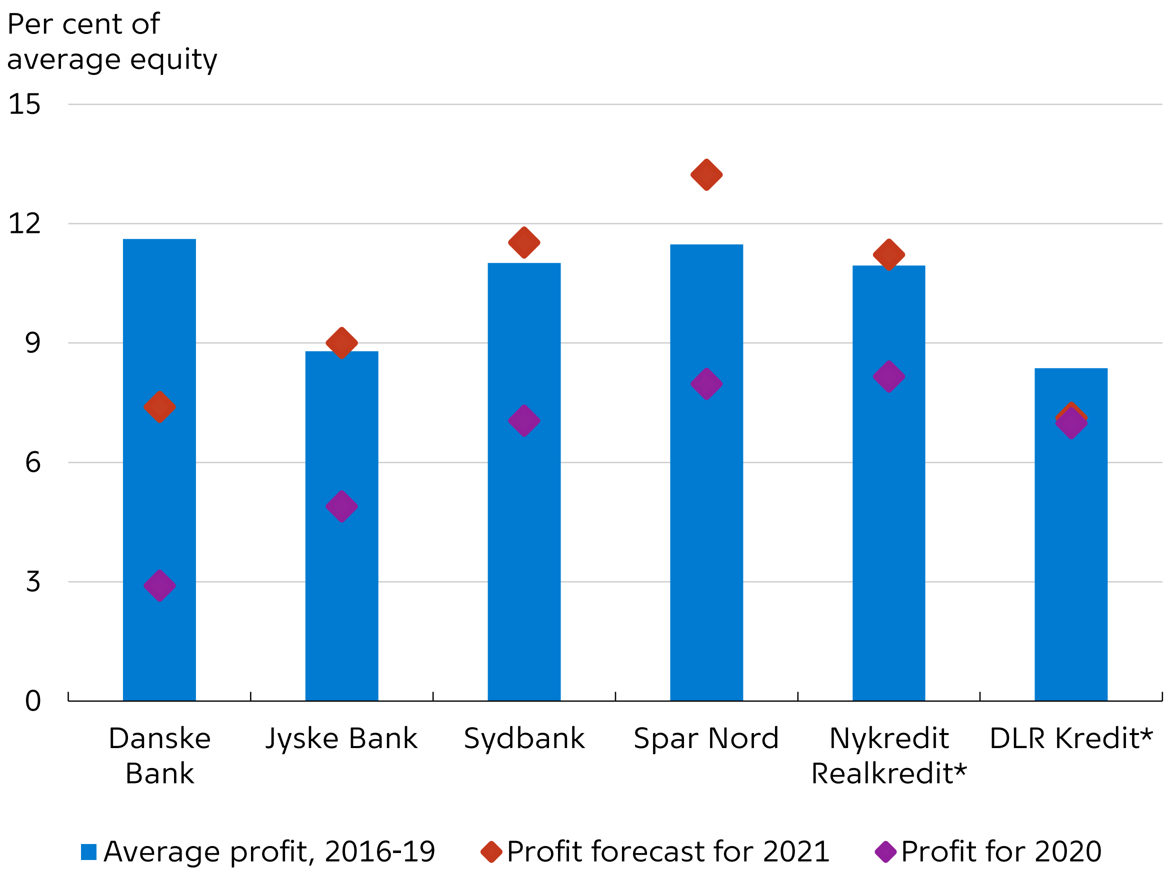
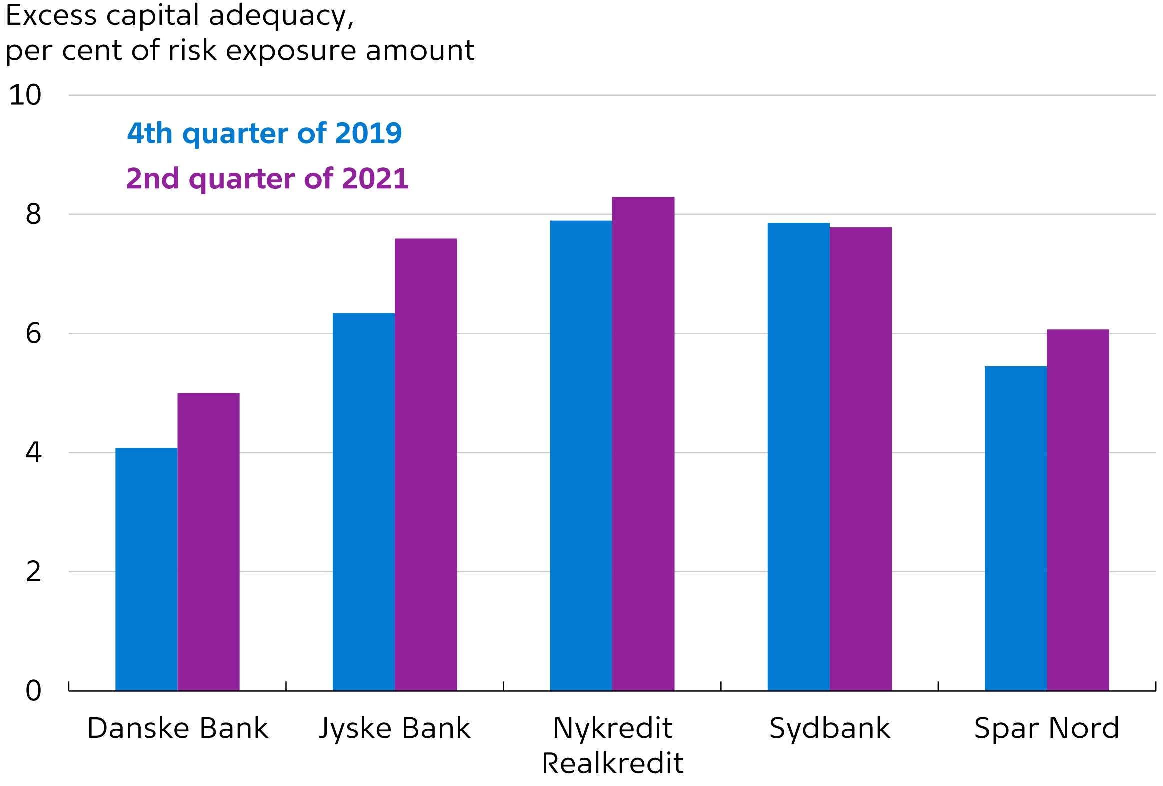
Currently, Danish banks are as resilient as they were in the run-up to the pandemic

Credit institutions expect higher earnings in 2021



Note: Net profit for the year and average of the latest announced profit forecast for 2021 as a percentage of the shareholders' average equity for 2016-19. Credit institutions marked with * are calculated before tax.
Source: Financial statements and own calculations.

Excess capital adequacy has increased during the pandemic



Note: Excess capital adequacy relative to binding minimum capital requirements including buffers. The countercyclical capital buffer released in the 1st half of 2020 has been disregarded.
Source: Danish Financial Supervisory Authority and own calculations.

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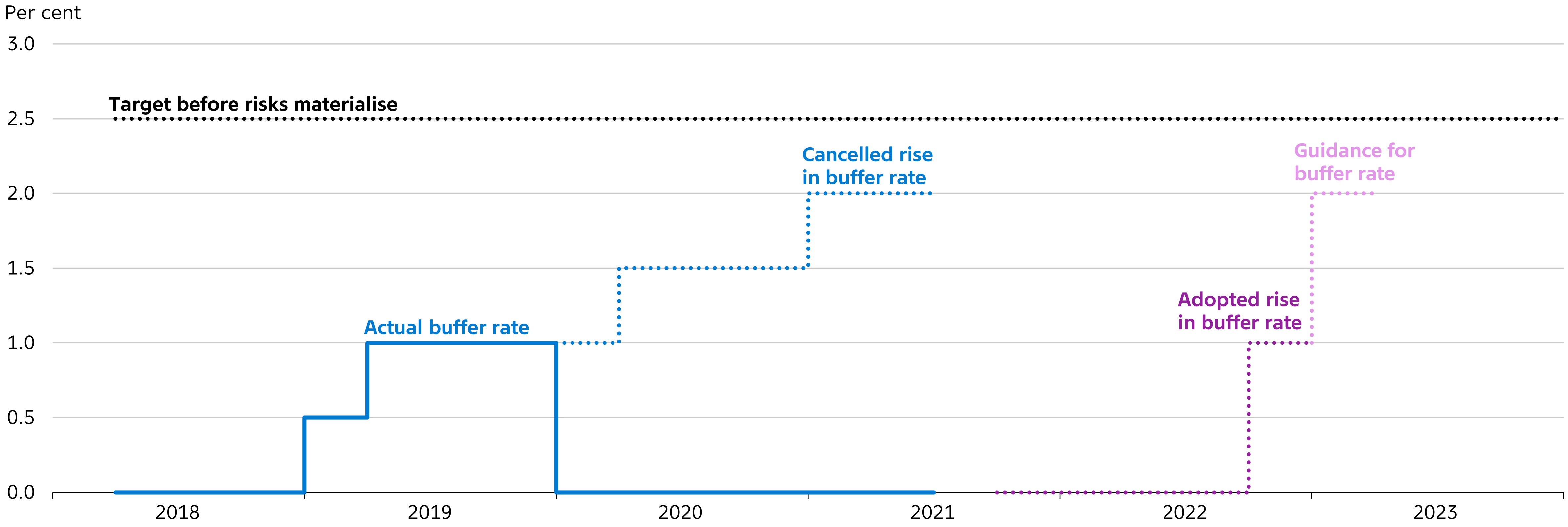
There are indications that systemic risks are building up – so the countercyclical capital buffer must be rebuilt



Note: *Cancelled rise in buffer rate* shows adopted increases of the countercyclical capital buffer that were cancelled when the buffer was released in March 2020.
Source: Danmarks Nationalbank.

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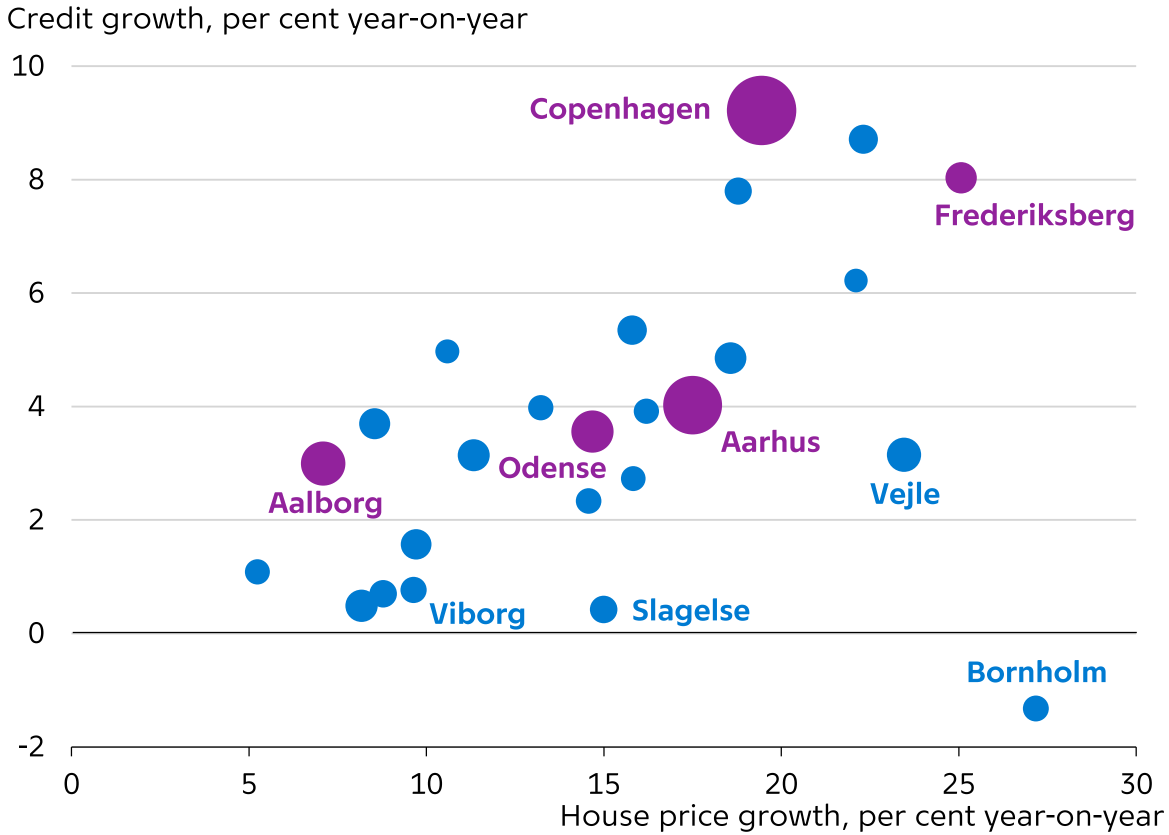
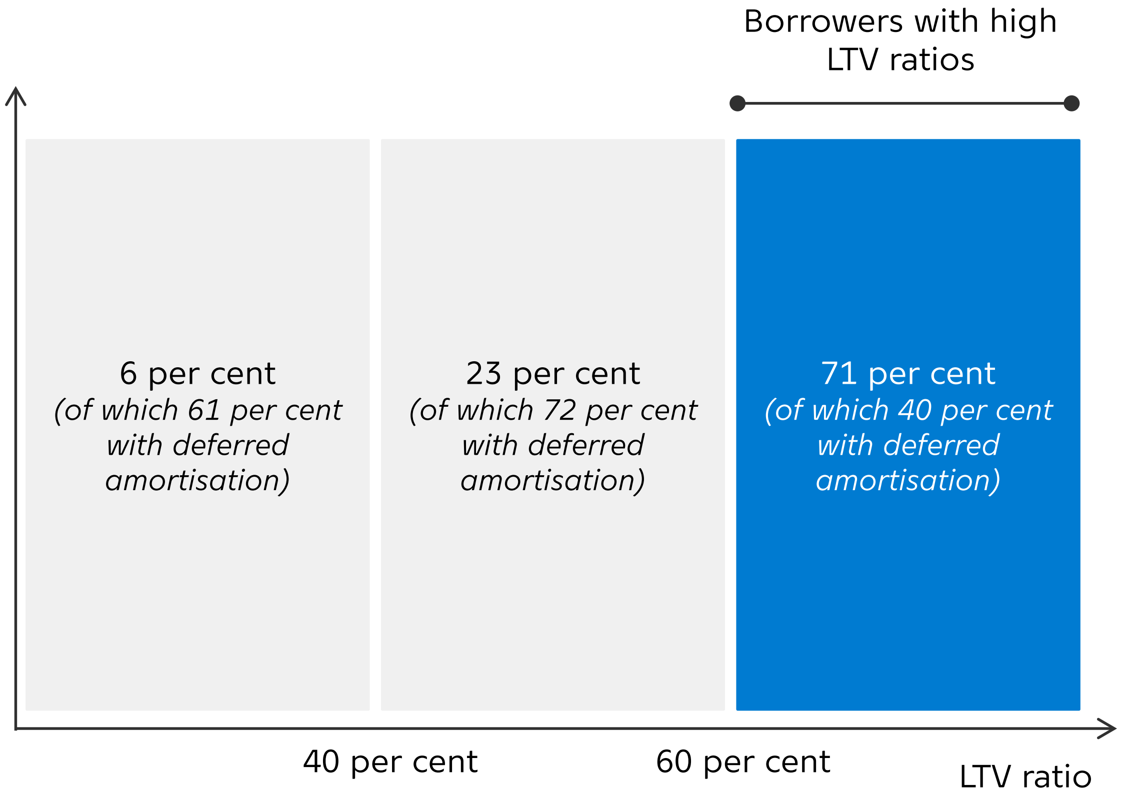
High prevalence of deferred amortisation contributes to risk build-up in the housing market

Credit growth is strongest in areas with the highest house price increases



Note: House price growth is a weighted average of single-family homes and owner-occupied flats. The circle sizes illustrate the number of housing transactions. Data from the 2nd quarter of 2021.
Source: Danmarks Nationalbank, the credit register and the Association of Danish Mortgage Banks.

High prevalence of deferred amortisation in new lending among highly indebted homeowners increases risks



Note: Mortgage credit institutions' total gross new lending for the 1st and 2nd quarters of 2021.
Source: Danmarks Nationalbank and own calculations.

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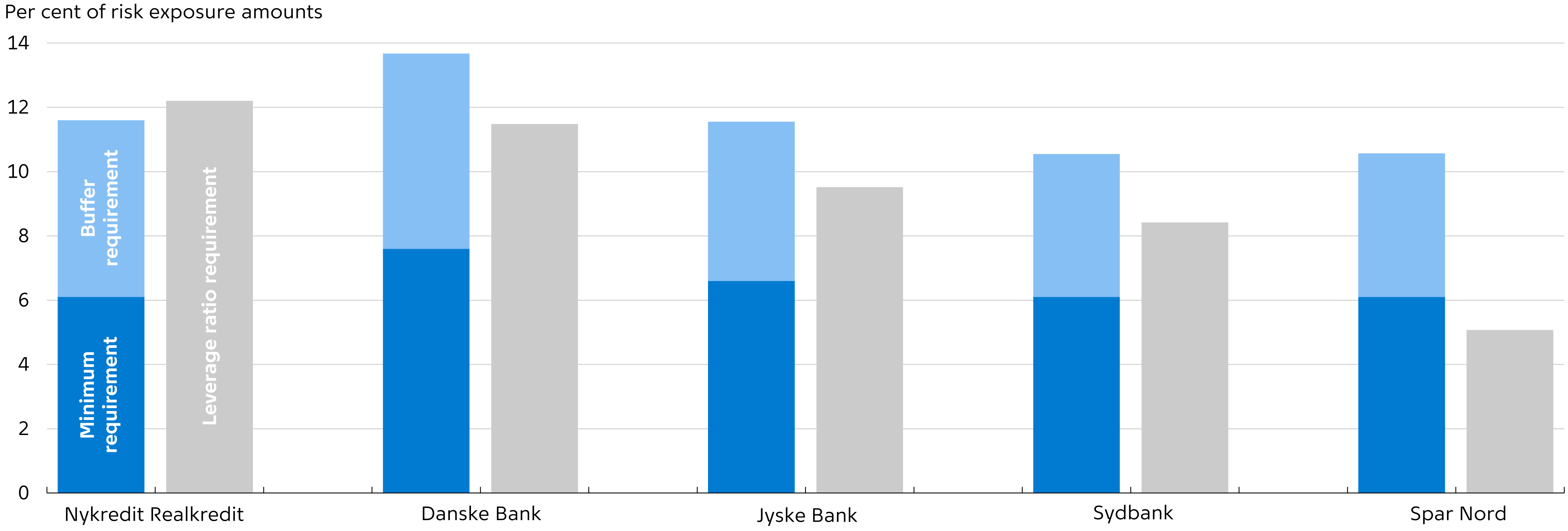
Array of capital requirements might be mutually counterproductive

Leverage ratio requirements may limit the actual usability of capital buffers



Note: Part of individual capital requirements that must be met with Common Equity Tier 1 (CET1) capital. The countercyclical capital buffer level shown is an example, corresponding to the buffer rate for Danish exposures before the buffer was released. The leverage ratio requirement has been converted into a percentage of the risk exposure amount.
Source: Consolidated financial statements and risk reports for 2020 and own calculations.

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Positive notes in the European Commission's proposal for the implementation of Basel III

	Implications of the European Commission's proposal for the implementation of Basel III
INTERNAL MODELS-BASED APPROACH	Tighter requirements to ensure high credibility
STANDARDISED APPROACH	Increased risk sensitivity
OUTPUT FLOOR	European "discounts" on housing loans secured by mortgages and loans to unrated companies
LEVERAGE RATIO REQUIREMENT	No risk sensitivity

Thank you for your attention!