27 March 2015

Observation

Low interest rates and build-up of systemic risks

The Systemic Risk Council observes that the conditions for a rapid build-up of systemic financial risks are in place due to the extraordinarily low interest rates, especially if these are embedded into the expectations of borrowers and credit institutions. The banks and mortgage banks are urged to exercise suitable caution when granting loans on the basis of real property, in particular when granting loans with variable interest rate and deferred amortisation.

Background to the observation

Following its meeting in September 2014, the Council issued an observation stating that a prolonged period of low interest rates, especially in combination with an economic upswing, could entail a risk of systemic financial risks building up.

Recent months' monetary policy developments in Europe and Denmark have led to a continued fall in interest rates to a historically low level. Together with the fall in oil prices and a weaker effective krone rate this provides the foundation for growth in the Danish economy, which has been positive for some time, to pick up further.

There is currently an unusual combination, not previously seen, of extraordinarily low interest rates, rising house prices and an expanding economy. This combination could lead to inappropriate behaviour in the form of excessive risk-taking and risk illusion among borrowers and credit institutions, and systemic risks may build up in the form of e.g. excessive credit growth and excessive price increases in the residential and commercial property markets.

In the absence of automatic stabilisers, a key condition for sustainable economic development is that the extraordinarily low interest rates do not cause the housing market to derail.

The pass-through to credit growth and the property market is not yet reflected in official statistics but the conditions for a build-up of systemic risks are in place. The Council finds that there is reason to exercise due caution.

Recent years' house price increases, particularly in the housing market in Copenhagen, have brought real prices close to the 2005 level. The development in house prices should, among other things, be viewed in the light of the current level of interest rates which is approximately 2.5 percentage points lower than in 2005. Indicators of price expectations for the country as a whole are at a relatively high level, i.e. many people expect house prices to rise. Widespread expectations of house price increases may lead to more risky behaviour among borrowers and credit institutions and may have a self-reinforcing effect.

It is important for credit institutions to be attentive to the risks that may build up during a prolonged period of very low interest rates. It is particularly important that the banks and mortgage banks exercise suitable caution when granting loans on the basis of real property, especially when granting loans with variable interest rate and deferred amortisation.[1]

Lars Rohde, Chairman of the Systemic Risk Council

[1] In Denmark, a mortgage loan typically has a maturity of 30 years. A fixed-rate mortgage loan has a fixed interest rate until maturity. Variable interest rate mortgage loans comprise loans where interest rates are automatically reset typically in intervals of 6 months, 1, 3 or 5 years.