Nils Bernstein: Central banking at a crossroads – Europe and beyond

Introduction by Mr Nils Bernstein, Governor of the National Bank of Denmark, to the DIIS (Danish Institute for International Studies) conference "Central banking at a crossroads – Europe and beyond", Copenhagen, 29 January 2013.

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I have been given the privilege by DIIS to open this conference, and I would like to welcome You all to the conference of "Central Banking at a Crossroads: Europe and beyond". A special welcome to our foreign guests.

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Central banking has undergone major changes over the last half decade. The financial crisis, which began in 2007 and escalated into a worldwide financial and macroeconomic crisis in the autumn of 2008, has in many ways been a game changer. Not least in terms of the way in which central banks operate. Old paradigms and truths have fallen, and new, in many cases untested, monetary-policy measures have been introduced. With monetary-policy interest rates close to zero – and in Denmark's case even below zero – "quantitative easing" has become, well perhaps not exactly a household term, but at any rate part of the vocabulary of educated citizens. With the latest unconventional measure in the form of the ECB's Outright Monetary Transactions, and soon also a single European supervisory mechanism for banks, under the auspices of the ECB, the division between central banking and other policy measures has become less clear-cut. How this will work out in practice remains to be seen.

After years of crisis fighting – with low growth, stubborn unemployment figures and increasing government debt levels, it is being discussed if central banks have come to the limits of their capacities and governments left to design and implement political difficult structural reforms? One observation is that it is remarkable what the ECB has achieved in recent six months, fighting the European debt crisis by declaring what it intends to do under certain circumstances without actively having done it yet.

The first workshop is about "bank resolution in a comparative perspective". This is a very topical issue. In Denmark – as in many other countries – we had been used to handling distressed banks on a case-by-case basis. No two cases were identical, and the approach differed each time.

Just before the collapse of Lehman Brothers in September 2008, Denmark's 9th largest bank – Roskilde Bank – became distressed. It had already been attracting the attention of the authorities for some time. As in previous cases where banks failed, the action to be taken had not been laid down on beforehand, and Denmark clearly lacked the tools to manage the situation.

Although the size of Roskilde Bank was not in itself sufficient to make it systemic, the turmoil in the financial markets meant that there was, in Danmarks Nationalbank's assessment, a considerable risk of a knock-on effect on other banks. In the end, Danmarks Nationalbank and the rest of the banking sector purchased Roskilde Bank for zero kroner. In other words, the subordinated capital had been lost, and the private banks provided a guarantee of kr. 750 million to cover further losses. But as it turned out the losses were in fact far greater.

A large number of Danish banks became distressed in the period around the autumn of 2008. From the beginning of 2008 to the beginning of 2009, 18 Danish banks were wound up, acquired or merged with other banks. All of these were small banks.

With Bank Rescue Package 3 of September 2010, a bank resolution scheme was established in Denmark. The government-owned Financial Stability Company was put in charge of the resolution of distressed banks, thereby assuming the role that Danmarks Nationalbank had had in connection with Roskilde Bank. Under Bank Rescue Package 3, not only shareholders, but also unsecured and subordinated creditors could lose their money if a bank failed. This was in accordance with international recommendations, but nevertheless caused a bit of a stir internationally, and led to a general downgrading of Danish banks.

The first bank to be wound up under Bank Rescue Package 3 was Amagerbanken – a regional bank based in the Copenhagen area. I will not go into detail, but merely note that we now have a mechanism for handling distressed banks which works and which ensures, that taxpayers will not ultimately pay for a distressed bank.

Denmark was among the first countries to introduce a bank resolution scheme under which those who had lent money to the distressed bank could also lose their investment. This has made headlines, and I am surprised to note that even very small Danish banks in distress still find their way to the pages of the Financial Times. Recently it was a very small bank in the south of Jutland, Tønder Bank. In my opinion that is out of proportion. Over the weekend another local bank, Sparekassen Lolland, has been taken over by the larger Jyske Bank along the same lines, i.e. a private solution.

It has been a general principle in Denmark throughout the financial crisis that the banking sector itself should fund the process of "tidying up" the sector. In fact, so far the Danish government has made a profit of around kr. 10 billion, or 0.6 per cent of GDP, from the Bank Rescue Packages implemented. The final result cannot be calculated yet.

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Tomorrow's theme is "Central Banking in an Age of Collateral-based Finance". The financial crisis has enhanced focus on bank liquidity, and the securities that are seen as liquid. This is reflected in the Basel III rules to be implemented in the coming years. Collateral is required when borrowing from central banks. It has been necessary to expand the collateral basis during the financial crisis.

Uncollateralised lending in the money market, which was common prior to the crisis, has all but vanished in favour of collateralised lending. The banks also need to pledge collateral when borrowing from central banks. All this has increased the need for collateral in banks.

In many countries, collateral is restricted to government bonds. Denmark is unique in the sense that we have a very large and well-developed mortgage- credit sector and hence a large volume of outstanding mortgage bonds. These bonds may be pledged as collateral for loans from Danmarks Nationalbank in the same way as government bonds. But it is still uncertain to which extent they may be included in the liquidity reserves of the banks in future. Throughout the financial crisis, Danish mortgage bonds remained liquid and new issuance took place. In general, lack of collateral is not a problem in Denmark, but naturally it may be so for a few banks, especially those under pressure.

Danmarks Nationalbank has on several occasions expanded the collateral basis for borrowing by banks. Some of the measures were temporary and applied only at the peak of the crisis. For example, Danmarks Nationalbank has expanded the collateral basis to include banks' lending of good quality. This has also improved the liquidity of the banks' balance sheets.

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The theme of this conference, "Central Banking at a Crossroads – Europe and beyond", is highly topical and those present here today include many outstanding scholars within this field. I think we have a couple of very interesting days ahead of us. With these words, I declare the conference open.

Thank you for your attention.