Bodil Nyboe Andersen: The significance of Basel II for Danish banks

Speech by Mrs Bodil Nyboe Andersen, Governor of the National Bank of Denmark, at the Annual Meeting of the Danish Bankers' Association, Copenhagen, 1 December 2004.

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At all recent annual meetings of the Danish Bankers' Association the various speakers have commented on the Basel framework. This framework sets the international standards for the capital adequacy of the banking organisations.

In the 1970s the G-10 countries set up the Basel Committee, whose secretariat is at the Bank for International Settlements (BIS). Located in Basel, BIS is often called the central bank to central banks.

In the 1980s the Basel Committee started its work of formulating international standards for the capital adequacy of banking institutions. In 1988 this resulted in the Basel framework - now called the Basel I framework. This is still the basis for the requirements of the size and structure of the capital of banking organisations in more than 100 countries all over the world.

The strong expansion and increasing complexity of the financial markets and banking organisations since the Basel I framework was drawn up have made it necessary to formulate a more sophisticated framework. The Basel Committee therefore took on the drafting of new international standards, and the first proposal was put forward in 1999.

This work has proved to be more complex than expected. The Committee has on several occasions issued consultative papers inviting the financial world, authorities and other stakeholders to comment on the drafts put forward.

This process has been quite comprehensive, but also highly valuable, since it has given all countries and parties the opportunity to table suggestions and constructive criticism. In this way, a number of special circumstances could be taken into consideration.

The consultations have by no means made the process less protracted, nor have they simplified the proposal. Nonetheless, on 26 June 2004, the Basel Committee closed the file and reached a decision on the new international standards. The framework now fills more than 200 pages, while Basel I comprised 30 pages.

On the basis of these standards the European Commission has put forward a draft directive for a new capital adequacy framework. The directive is expected to be adopted in 2006, and to come into force in 2007-2008.

The new standards are of course considerably more complicated than the 1988 framework. A noteworthy departure from the current framework is that individual banks will be able to choose between two different principles for compiling the capital required to cover credit risks. Larger banks may base their capital requirement on an internal risk model, while others may opt for a simpler standard method closer to the current principles.

The purpose is to allow for the differences between small local banks and large international institutions that apply sophisticated risk management tools.

As always, the bank's board and management are responsible for capital adequacy, including a necessary buffer to ensure sound operations. Basel II sets out firmly and clearly the principle that the supervisory authorities must perform an overall evaluation of each individual bank's need for capital. The board and management's assessment of the need for capital must be discussed with the supervisory authority, which in the end may require the bank to hold more capital than the equivalent of the minimum requirement of 8 per cent.

Finally, the Basel II framework also includes standards for the disclosure of information relating to risk and capital adequacy.

The idea behind the disclosure requirement in the set of standards is that the soundness of banking institutions is evaluated not only by the supervisory authorities, but also by market participants. Monitoring by the authorities and the market in combination enhances the certainty that signs of weakness will be spotted in time, avoiding potential crises. Avoiding financial crises is, of course, the whole purpose of the exercise.

The banks play an exceptional, central role in society. This is the background to the extensive regulation of banking activities.

One sometimes hears the remark that regulation by the authorities is a special burden imposed on the banks. This leads to the argument for uniform international regulations, to ensure a level playing field. This is the purpose of the Basel framework.

Often the banks also point out that the authorities should remember that banks are business enterprises that need some scope for manoeuvre in order to be competitive.

One could pose the theoretical question of how the banks would behave in the absence of regulation by the authorities.

In our time, this question is so hypothetical that there is no clear answer. However, it is thought-provoking that back in the days when the banks were not subject to any regulation - before the first Danish banking act in 1919 - capital adequacy was generally far higher than today. Around the mid-19th century capital and reserves were approximately 40 per cent of the balance-sheet total, and by around 1900 a good 20 per cent. In the 1920s this had fallen to around 12 per cent. Today, the banks' net capital is an average of approximately 6 per cent of the balance-sheet total.

A comparison of this nature should naturally not be taken too literally, although it may lead to the realisation that regulation should not be perceived as a burden, but perhaps a valuable asset!

On 1 January 2005 the EU's new accounting regulation comes into force. It introduces the international accounting standards (IAS) and will also affect the banks' financial statements. The fact that - in the special EU version - it also poses some particular problems for mortgage-credit institutes should also be mentioned here.

With IAS, the previous Danish accounting principle for financial enterprises to state securities at market value will no longer apply in every case. Danmarks Nationalbank regrets that under the new rules some elements of a securities portfolio can be subject to cost measurement.

So far there has been agreement in Denmark that market value is the most regular principle. However, this now has to defer to the need for uniform rules within the EU, where the market valuation of securities has not been consistently applied.

The interplay between the IAS rules and Basel II is especially significant for Danish banks. So far, we have applied a prudent principle to the compilation of losses and provisions. Instead, the IAS rules introduce a neutrality principle for the assessment of the provision requirement.

The term itself states the case: the banks must no longer be quite so prudent in their evaluation of the need for provisions. This may require substantial provisions to be carried back, reducing the banks' buffer against potential losses. To put it another way, the change of principle may release substantial funds in Danish banks.

Added to this, on the introduction of the Basel II rules a reduction of the capital requirements of Danish banks can be expected, since loans to households as well as to small and medium-sized enterprises are subject to a lower risk weighting under the new framework. These loans weigh relatively heavily in Denmark.

In overall terms, this is a considerable relaxation of the capital requirements and provisions. So it is important that the boards and managements of the various banks consider carefully how much capital they need in order to ensure an appropriate buffer in case of unforeseen adverse events.

In order to promote this process, the current bill for a Financial Business Act anticipates the Basel II framework. Already in 2005 the requirement is introduced that the banks must assess their need for capital and engage in dialogue with the Danish Financial Supervisory Authority in this respect. The Bill does not require the disclosure of the results of these deliberations. Since these are provisional rules prior to the full implementation of the Basel II framework there can be arguments against disclosure. The few years involved can be perceived as a running-in period during which the previous dialogue between the banks and the Authority concerning provisions is supplemented by a dialogue on capital adequacy.

Danmarks Nationalbank would like to emphasise, however, that the assessment of the need for capital should be disclosed when the full Basel II framework is implemented.

The financial markets and the financial products are becoming more and more technically advanced and sophisticated. New products are constantly appearing to match customers' changing needs and preferences.

In overall terms this is good for both business enterprises and households. Choice is always a good thing - so that everyone's needs can be catered for. For large groups of especially households it can be very difficult, however, to pinpoint exactly what is needed, and even harder to understand the various products and the risks they entail, and make the right choice. This applies especially to life's major financial decisions, not least financing the purchase of a home and choosing the right pension scheme.

This is where advisory services come into play. Bank employees devote a lot of effort to advising households. It is, however, important that clients understand that there is no certain answer to the question of how e.g. interest rates and share prices will develop in the future. The adviser may have certain expectations, but nobody can know for sure.

Today many banks do a lot to emphasise that they are profit-driven commercial enterprises. This means that their employees must be good at selling their products. For this reason, some banks have incentive structures to reward successful salespeople.

Undoubtedly the interests of the bank and the private client may coincide, but it is hard to believe that this is always the case. This applies to many types of professional advisers - from insurance brokers to pharmacies, opticians and banks.

Denmark is now harvesting the fruits of more than 20 years' stability-oriented economic policy during which major structural reforms have been implemented.

As a result, we have favourable growth, low inflation, a large current-account surplus and a surplus on government finances. Unemployment is low in international terms. After rising for two years the curve seems to be on the way down as the unemployment level has stabilised, or is dropping slowly, depending on whether people in job creation schemes are included or not. The krone is extremely stable against the euro and both short-term and long-term interest rates are only marginally above the euro interest rates.

So what are the challenges to economic policy? Although no short-term economic measures are called for, significant structural challenges are waiting in the medium and long term. Our life expectancy is longer, which is good news, even though it is often presented as a problem. Nonetheless, the consequence is that the demand for welfare benefits will rise. Greater affluence will also make us demand more in terms of the quality of these services.

Moreover, in years to come more people will retire from than join the labour force, while many groups would like more time away from work. There is no obvious way of reconciling these aspirations. The government has therefore set up a Welfare Commission to investigate all of these issues.

Before the Commission's reports are published I would like to take this opportunity to express the hope that all groups of society: the business community, stakeholder organisations, politicians and ordinary citizens, will read the reports with an open mind towards discussing the issues raised. We need a serious debate without avoiding or skirting these issues. Pointing to other countries that face even bigger problems is not the solution either.

At a time when the economy is flourishing and no short-term measures are required it is important that we make a start on debating the long-term economic structures.