Hugo Frey Jensen: Creating relations in a digital new (banking) world

Speech by Mr Hugo Frey Jensen, Governor of the National Bank of Denmark, at the Director's Conference of the Danish Bankers Association, Copenhagen, 8 September 2014.

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Thank you for inviting me to speak here today.

The heading of today's conference – "Creating relations in a digital new (banking) world" – shows that the banks now have the strength and resources to look forward after a few years in the shadow of the financial crisis. This is positive and on the whole tallies with Danmarks Nationalbank's assessment of the economic situation and the general condition of the banking sector.

The Danish economy is recovering after some difficult years. Admittedly, the most recent figures show a small decline in GDP in the 2nd quarter, but viewed in a larger context, activity has grown since the end of 2012. It is important to stay focused on the underlying trend and not to become hypnotised by quarter-on-quarter fluctuations.

Decreasing North Sea oil output is reducing overall production these years. If this factor is disregarded, value added in the Danish economy is now 2 per cent higher than in 2012 – and rising.

The increase in activity has also been reflected in the labour market, where employment has been picking up over the last year or so. Employment is developing at a steadier pace than production. As a result, productivity development is a little jerky, which is quite normal for the Danish economy.

As the economy has improved, pressures on the Danish banks have gradually eased. But a few banks are suffering from the repercussions of the crisis and several banks are still struggling with low return on equity.

The sector has ample excess liquidity cover, and for this reason Danmarks Nationalbank has phased out the temporary measures introduced to boost the banks' liquidity. These included the option to raise 6-month loans from Danmarks Nationalbank and to pledge sector company shares and credit claims as collateral.

The financial crisis is over, but it has left its mark. Above all, the crisis has reduced the number of banks in Denmark. As the chart shows, it has amplified a trend that has been evident for many years.

In our Monetary Review from the 4th quarter of 2013, we examined productivity and cost efficiency in the financial sector. In terms of the cost-to-income ratio, Denmark seems to differ from comparable countries. The figures indicate that resource consumption within the sector has not yet been fully adjusted.

In addition, the future slope of the graph showing the number of banks in Denmark could well depend on how the banks manage to tackle the challenges posed by today's theme – increased digitalisation.

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Competition and cooperation in the new world of banking that awaits you and us will also affect the role of Danmarks Nationalbank. A case in point is the future participation by Danmarks Nationalbank in jointly owned infrastructure companies.

I could also mention the issue of Danmarks Nationalbank's oversight of the financial infrastructure – including in an area that is at the heart of today's conference: competition from non-banks in the field of payments.

In Denmark, we have a long tradition of shared solutions for leveraging economies of scale and network effects. This is reflected in e.g. joint ownership of core companies within the financial sector, often with Danmarks Nationalbank as a co- owner. This means that the users – or customers – have also been owners, and the general operation of the company has been placed in the hands of a board of directors representing the owners – typically people like you and me.

When these companies were set up, this was a natural way of doing things. It ensured that the various stakeholders had a say, which was a precondition for their full support. In addition, the companies were focused primarily on servicing their Danish owners, which meant that business and competition issues were limited in scope.

But over time this form of ownership has come under mounting pressure. The reasons differ from company to company, but frequent explanations include increased competition as a result of international regulation, technological advances, undesirable tying-up of capital and a need to achieve economies of scale. On balance, there can be no doubt that it has become more complex to operate such companies. This has increased the need for strong managerial skills, including the ability to secure the commercial interests of the company.

An early example of a jointly owned company where it was necessary to change the ownership structure many years ago is the Copenhagen Stock Exchange. Some of you have been part of the process right back from Stock Exchange Reform II, when the CSE was converted into a limited liability company, to the merger with OMX and later with NASDAQ.

I will not go into detail, but simply conclude that no-one has questioned the need for a modern, efficient stock exchange, even at a time when the possible existence of a credit crunch has been discussed. Foreign ownership without the participation of all customers and stakeholders has not prevented the Stock Exchange from raising capital – on the contrary.

More recently and amid much media attention, Danish and Norwegian banks and Danmarks Nationalbank have sold their shares in Nets. This has done away with a structure in which banks were both owners and customers of and in some cases also competitors to Nets. It has eliminated a number of rather obvious opposing interests among the company's owners and provided a more suitable framework for operating Nets on commercial terms – which will ultimately benefit the end users of payment services: citizens and firms.

VP Securities is another jointly owned company that has undergone a transition from its establishment as an independent institution in 1980 over its conversion into a limited liability company in 2000 to now operating in a market where the framework conditions are changing radically. The single most important change in this area is the establishment of TARGET2 Securities – T2S – the future trans- European securities settlement platform.

At the same time, the securities sector is being thoroughly harmonised. So these years European central securities depositories are changing from being national monopolies to operating on competitive terms. VP has decided to join T2S and will soon have to make a number of strategic choices as regards its position in a competitive environment.

As I mentioned earlier, Danmarks Nationalbank is or has been a co-owner of several jointly owned companies. Each shareholding has its own history. However, I would like to take this opportunity to emphasise that Danmarks Nationalbank's role is that of an authority, including in relation to oversight of the financial infrastructure. Our role is not to be a co-owner of competitive companies operating on commercial terms. For this reason we have gradually begun to withdraw from such companies.

The first step was taken when we sold our shares in Nets. Since Danmarks Nationalbank had acquired those shares, PBS/Nets had developed into an international enterprise competing with other companies offering advanced payment solutions in multiple countries. It was clearly no longer a company in which a central bank should have a stake. Furthermore, we wanted to be beyond reproach in relation to performance of our oversight tasks, which also comprise Nets.

Another jointly owned company in which Danmarks Nationalbank should at some point divest its shares is BKS Cash Service. Danmarks Nationalbank and the banks established BKS in order to support a secure supply of cash. We did so in response to several serious robberies which had disclosed a need to raise the level of security in relation to cash handling. At the same time, a number of security standards were laid down, which must be observed by all cash-in-transit companies.

Together we have come a long way in terms of meeting the new standards – and we will get there. When we do that, the main objective of Danmarks Nationalbank's co-ownership of BKS will have been fulfilled. We will still consider security aspects and lay down requirements, but Danmarks Nationalbank will no longer be a natural co-owner of a company like BKS. But as with the other jointly owned companies we will not simply abandon BKS. There is still plenty of work to be done. In due course, Danmarks Nationalbank will retire from the group of owners in an orderly manner.

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Now let me turn to the potentially increased role of non- banks in the field of payments in the coming years.

There is a clear trend. Danmarks Nationalbank's payment instrument – cash – is becoming less and less important. Cash as a share of retail turnover has dived sharply over the years, and this trend is set to continue.

Banks still account for the vast majority of payments, and when it comes to new payment solutions, the banks' products – such as MobilePay and Swipp – get all the attention. But the widespread popularity of these solutions shows that this is a dynamic area which could rapidly undergo significant changes.

A recent report from the Danish Payments Council makes a broad distinction between two categories of non-banks that could become significant players in the field of payments. One is firms receiving payments, who see an advantage in offering customers their own solutions. There can be several reasons why a firm chooses to launch its own payment solution, but in most cases it is a desire to provide optimum customer service, thereby boosting turnover.

The other category comprises a wide range of non-bank providers of payment services. Their payment services vary considerably, but a common feature is that these services do not include deposit accounts. The providers often rely on existing account structures or payment solutions, are not in possession of the customers' funds at any point during the payment process and primarily want to collect data – not to make a profit from the actual payment transactions.

Non-banks offering payment services are currently regulated by the E-Money and Payment Services Directives. These two Directives lay down rules for e-money and payment institutions, respectively. A major objective for both types of institution is to increase competition in this area. Some years after the Directives came into force we can conclude that there are still very few payment and e-money institutions in Denmark – so you are still strongly positioned in the field of payments.

Another – potentially more extensive – legislative initiative is a proposal from the European Commission to allow third- party access to execute payments via bank accounts with the approval of the customers. This proposal was presented last year and has been analysed by the Payments Council. The analysis resulted in a number of recommendations for Danish views, especially in relation to security aspects of giving third parties access to bank accounts.

Precisely the issue of security and hence of user trust may be a decisive factor in determining the success of non-bank solutions. And we should not underestimate the competitive value of trust for the banks. Users typically have strong trust in the banks and their solutions – believing that their funds are secure and protected, that the solutions work and that data will not be misused.

A survey conducted by Danmarks Nationalbank last year, in which 1,300 Danes were asked about their views on various payment methods, etc., confirms this. One question was the extent to which respondents trusted public authorities, banks and others to treat their personal data with discretion. As you can see, the Danes seem to have greater faith in the data security of banks than of other firms.

Other surveys that we and others have performed show that trust – along with price and convenience – actually determines customers' choice of payment solution and provider of payment services. Experience also shows that trust can rapidly evaporate.

One unfortunate experience – funds that are lost, a solution that does not work, or a breach of data security – could undermine it. Trust is one of the banks' major assets and it must be cultivated – also when it comes to payments. This should be a key element of your efforts to provide competitive payment solutions that generate value for firms and consumers.

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Undoubtedly, the higher trust in banks is to some extent due to regulation and oversight of the sector by public authorities. Danmarks Nationalbank's role in relation to oversight of the financial infrastructure is enshrined in the Danmarks Nationalbank Act, which states that its objectives are to "maintain a safe and secure currency system and to facilitate and regulate the traffic in money and the extension of credit". Although the Act dates back to 1936 it is actually future-proof: it does not distinguish between cash payments and electronic payments, and the objective of today's oversight is clearly defined.

The objective of Danmarks Nationalbank oversight is to ensure safe and efficient settlement of payments in Denmark. In terms of audit and supervision, oversight may seem to be somewhat elastic, but that is because yesterday's safe and efficient solutions are not necessarily safe and efficient today. It is important that the infrastructure – the "tracks" – is always prepared for the needs of citizens and firms for convenient, fast and safe payments.

Examples of this are the Intradagclearing and the forthcoming Straksclearing. In my opinion, the banks and Danmarks Nationalbank have shown due diligence by "straightening the tracks" so that the trains can run faster. On top of that, the new, automated liquidity tools provide enhanced security. This supports new payment options, such as Swipp and MobilePay. Without the new systems, I think it would have been increasingly difficult to explain to users why it may take several days to settle payments.

For retailers, the Straksclearing offers settlement finality for credit transfers, unlike e.g. Dankort payments, for which retailers only have a guarantee that they will receive the first 4,000 kr. So the Straksclearing paves the way for digital development in the field of payments.

For the economy it is extremely important that electronic payments can be effected in a safe and efficient manner, and that people have faith in them. Like other central banks, including the ECB, Danmarks Nationalbank intends to strengthen its oversight of payment solutions. Oversight will be targeted at systemically important payment solutions in Denmark, currently the Dankort, Betalingsservice and credit transfers. This will support safe and efficient payments – in shops, online and when transferring funds between accounts. Since Nets and the Danish Bankers Association are responsible for the payment solutions, you will be receiving a letter about the enhanced oversight. As usual, it will be based on good and close cooperation.

Although oversight is resource-intensive for all parties, including Danmarks Nationalbank, I am convinced that Danmarks Nationalbank's oversight of the payments infrastructure boosts one of your key assets when it comes to payments – trust.

But how about the “third parties”? Can they fly below Danmarks Nationalbank’s radar and simply get a free ride on the safe and efficient payments infrastructure? No. If these payment services acquire a certain size, they will be subject to oversight by Danmarks Nationalbank. That also applies if the services are offered from other countries, as central banks have a long tradition of cooperation when it comes to oversight.

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Danmarks Nationalbank has decided to set up a credit register in cooperation with the Danish Financial Supervisory Authority. A register of individual credits with information about the debtor, collateral, etc. will improve the basis for Danmarks Nationalbank’s oversight of financial stability and for the supervisory activities of the Danish Financial Supervisory Authority.

We are aware that the credit register will involve a lot of work for the sector in terms of establishing the reporting system and regularly reporting information. But not only do we see the credit register as a prerequisite for Danmarks Nationalbank’s and the Danish Financial Supervisory Authority’s work to ensure financial stability, the establishment of the register will also help to ensure that Denmark’s supervisory and oversight instruments are at least as good as those applied elsewhere in Europe. The euro area has decided to establish a similar register from the end of 2016.

Obviously, the credit register will not relieve the individual bank of its responsibility for pursuing prudent credit policies, and in a market economy banks will differ – also in terms of credit policies. However, we would like to engage in a dialogue with you about the design of the standardised reporting, so that you have a useful tool for comparing your credits with those of the financial sector as a whole. We hope you will support this work.

Thank you.