SPEECH

SPEECH BY GOVERNOR PER CALLESEN AT CBS' 100 YEARS CELEBRATION EVENT

DANMARKS NATIONALBANK

CHECK AGAINST DELIVERY

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CAN BANKING BE SUSTAINABLE IN THE FUTURE? A PERSPECTIVE FROM DANMARKS NATIONALBANK

Key messages

Thank you for the invitation. Congratulations with the 100 years!

I will focus on three issues and set of conclusions:

First, banks will likely face stronger future competition from several sources. This is to be welcomed from the perspective of consumers and business. Such competition will drive further innovation and productivity in both the financial and non-financial sectors. Some banks will cope well with stronger competition. Others will fail. The most important regulatory challenge in this respect is to enable orderly resolution of failing banks.

Second, digitisation of financial services will likely continue to grow. Payments and other financial services are already highly digitised in Denmark and other countries. Sound digital currencies exist in the form of private bank deposits. A couple of side issues are under debate and need clarification. Crypto-currencies are unhealthy for consumers and business, and potentially, down the line, for financial stability. At the other end of the spectrum central banks – which are the banks of the banks – should not offer digital currencies to the general public.

Third, digitisation poses new risks, not *only* in financial services, but *also* in financial services. Risks include vulnerable or unstable equipment, human error and outright crime, such as cyberattacks. Coping with such risk is costly, and a continuous struggle or arms race, but is indispensable for financial stability and the credibility of financial institutions.

Diversity and competition
Stronger competition in financial services is in part driven by technology and new private business models. It is also being facilitated by regulatory developments. We should welcome all these sources of competition. Regulation should strive to underpin innovation and competition, not seek to put a brake on them. Three potential driving forces are cross-border competition, stronger market financing – or non-bank financing – and the appearance of Fintech, typically start-ups, as well as Techfin companies, typically major IT companies broadening their scope of business.

Cross-border competition certainly prevails, but many financial activities are still, even within the EU, predominantly national. There are historical and cultural reasons behind. But also regulation and crisis management has typically contributed to limiting competition across borders, not least due to the adverse loop between banks and their sovereigns – very visibly so during the 2008 financial crisis.

The Single Supervisory Mechanism, anchored in the ECB, and the Single Resolution Mechanism represent major progress. These institutions enable effective supervision of cross-border banks, they reduce barriers to competition, such as unwarranted differences in regulatory standards and practices, they reduce the risk of regulatory capture by local banks and not least, they are a precondition for a competition-friendly resolution of failing institutions.

Like all institution-building this work is not complete (and probably never will be), but Banking Union is about the single market, competition and innovation. These are not currency issues, and Denmark would benefit from joining the Banking Union. In the meantime we should build our own regulation on the same principles – we are in any case all committed to joint EU regulation – seeking close cooperation and avoiding national peculiarities where they may unnecessarily block cross-border competition.

Market-financing and non-bank lending is rather limited in Europe compared to other advanced countries. Banks have many virtues, but we miss out in terms of diversification and competition if they are too dominant. This is acknowledged by the EU Capital Market Union initiative. A major change from bank-driven financing to market financing is likely to occur slowly and gradually, but it should be encouraged. By its nature, market financing circumvents the vulnerability of bank intermediaries. But of course regulators should be vigilant towards bank-like risk occurring in other forms.

New technologies may lead to shrinking or the disappearance of some of the financial intermediary activities we have been used to expect from banks only. Currently this is particularly the case in the market for payments. Some of this is driven by Fintech start-ups. Some is driven by competition-enhancing regulation such as the new payment services directive, which allows for third party access to bank accounts – of course based on explicit acceptance by the account holder. Yet another source is large, well established world-wide IT or network institutions expanding their range of activities based on their vast existing customer base.

Also the technology-driven competition is to be welcomed, but it comes with challenges as well. If new institutions go beyond payment activities, if they start taking deposits and provide lending – in other words if they become banks, they will need to be regulated as banks. If they become too dominant, competition may eventually suffer and any systemic importance for financial activities will need to be managed carefully by regulators.

What does this innovative and competitive environment imply for the banks? They will continue to exist, they will all have to adjust business models over time, some will thrive and expand in both domestic and foreign markets, others will shrink or disappear. This is what market economics is about – to the benefit of society, consumers and business. The objective is to enable the best provision of services to the market, not to preserve specific companies.

Banks should continue to strive to be well capitalised, and we know from history that they need a helping hand from regulators to pursue this at all times.

But one needs to stress one particular horizontal conclusion in the context of competition and increasing competition, irrespective of the driving forces. That is the need for a fully functioning and comprehensive resolution framework, which enables market exit or restructuring of unviable banks without triggering financial crises and without bail-outs by taxpayers.

We are in Europe much closer to achieving this than we were in the past. But we are not where we should be or wish to be yet. A lot needs to be done in terms of recovery and resolution-planning by banks and regulators. Commitment needs to be stronger, avoiding exceptions which undermine the credibility of the resolution framework. Communication needs to be clear and transparent: losses and recapitalisation are to be fully borne by shareholders and creditors, not taxpayers.

Bail-out was something authorities had to do, when that was the only way to avoid standard bankruptcies of failing financial institutions. Standard bankruptcies do not work for large financial institutions. Therefore we now have the principle of bail-in, which will at the same time allow the vital activities to continue while letting shareholders and creditors cover those losses they would have had to cover in case of bankruptcy – just like in any other failing private company.

So yes, banking can be sustainable, but it would be hazardous to predict their future market share and business models.

Digitisation and currencies

Coming back to digitisation and payment systems, one may start from acknowledging what a payment is. A payment is basically a transfer of ownership for an asset from one person or entity to another person or entity. In barter economies that could work through exchanges of physical goods or services. Cash issued by central banks made some progress in the payment system. Modern payment systems are so much more efficient. In addition, people like to be able to store financial assets.

Such virtues are combined by exchanging deposits between bank accounts, and it became convenient to think about bank deposits as "money". Bank deposits are one out of many other components of financial assets. And bank deposits take many different forms. One should not forget that any financial asset is the debt of somebody else. In the case of bank deposits they are a liability, or debt, of the banks.

The point here is that the possibly ongoing wave of new payment technologies is just one of a long historical series of innovations preventing any perfect definition of monetary aggregates, not to mention observing any stable correlation between such monetary (stock) aggregates and real economic (flow) variables such as GDP and inflation.

If, say, a bond can be exchanged for another liquid asset, say a bank deposit, within a very short time span, why should it matter for the real economic decisions of a person or a company if their financial assets are held as a bond or a bank deposit? In other words, we are not able to control what people think of as money supply at a given point in time. And this should not worry us. As central banks we have not even controlled the supply of notes and coins, they are issued according to demand from the public.

What matters for the real economy is rather the entire spectrum of financial assets and liabilities and the interest rates, which offer incentives to build up more or less of these assets.

Of course the vital factors from a central-bank perspective include financial stability, efficient payment systems and preserving the purchasing power. We should care for the health of banks and we should vigilantly monitor and sometimes control the development of credit, not least credit provided by banks.

When it comes to payments based on bank deposits they serve the necessary characteristics for efficient digital currencies. They can be exchanged instantly (admittedly in most countries it will still take some hours or days), they are sufficiently safe as enough of them are covered by the deposit guarantee, and they retain their value because central banks ensure price stability. Challenges still remain with respect to international payments.

Privately initiated so-called crypto-currencies do not meet these criteria. In particular, nobody and nothing stands behind their value, which may therefore fluctuate a lot and disappear entirely. Their existence is for a start a consumer-protection issue. Arguably, some people fully understand the products and volunteer to take upon them such risk. Other users may not understand the risk. More importantly, should the general public and financial institutions engage in holding such risk to a very large extent, this may pose financial stability risks. Regulators need to be alert to such developments and act accordingly.

For very different reasons it is neither to be recommended that central banks change their entire business model from being the banks of banks to issuing digital currency to the general public, say by opening an account for every citizen and company (including foreigners?). For a start it would not create something which is not already offered by private banks. It would not be a substitute to notes and coins but to private bank accounts. It would therefore rather open a highway to bank runs, challenging financial stability, unless the amount allowed would be limited to an extent where it could not serve useful transactions purposes. It would add competitive distortions at the expense of private institutions and very substantial costs in terms of IT, staff and regulatory compliance. In addition, piling up large deposits from the general public in central banks would raise the question if central banks should also engage in centralised and perhaps politically motivated lending activities.

New sources of risk

Finally, unfortunately, all the virtues of digital financial services do not come for free. The system is exposed to vulnerable or unstable equipment, human error and outright crime, such as cyberattacks. These are serious operational risks, which need to be managed by financial institutions one by one, by authorities and in cooperation.

Of course we passed the point of no return quite a while ago. The use of cash in this country is rapidly declining and digital payments accounted for around 80 per cent of retail turnover last year.

Danmarks Nationalbank has initiated a forum for collaboration among the critical companies in the Danish financial sector – the Financial Sector Forum for Operational Resilience, FSOR. FSOR has three primary goals:

1. to create an overview of cyberthreats to financial stability,
2. to implement joint measures to ensure financial sector resilience and
3. to set up a framework for collaboration and knowledge-sharing.

Testing is one measure that has proven to be excellent at uncovering cybersecurity weaknesses. We regularly test cross-sector crisis response plans to manage serious operational incidents, including cyberattacks. But we also seek to test the cyberresilience of individual institutions through so-called Red Team Testing. In a Red Team Test, an external team is hired to perform a series of coordinated attacks. The target institution's internal IT security then has to defend the systems to the best of their abilities.

Once the test is over, the institution's vulnerabilities and its capability to detect and respond to the attacks are evaluated. A remediation plan is then put in place to eliminate weaknesses before cybercriminals are able to take advantage of them.

Thank you for your attention. Enjoy the conference!