SPEECH

SPEECH BY GOVERNOR LARS ROHDE AT THE ANNUAL MEETING OF FINANCE DENMARK 2017

DANMARKS NATIONALBANK

CHECK AGAINST DELIVERY

4 December 2017

Thank you for inviting me to speak here today.

I will be delivering three key messages:

- Optimism and large lending capacity are boosting the banks' risk appetite.
- Danmarks Nationalbank is not planning to issue central bank digital currency to the public.
- And last but not least: the risky ties between the government and the financial sector should be broken.

Slide 2: Full steam ahead for the financial sector

First, I would like to talk about developments in the financial sector. We have put the financial crisis behind us. The sector is now better capitalised than before the crisis. Danmarks Nationalbank's most recent stress test shows that all SIFIs are able to meet the minimum capital requirements in a severe recession.

There is a sentiment of optimism in the financial sector, both in Denmark and abroad. The banks and their customers have regained their risk appetite and at the same time there is plenty of liquidity in the global financial markets.

In other words – there is a basis for a general increase in risk-taking. And indeed, we are seeing signs of this.

Fortunately, the economy is picking up steam again. That is clearly visible from the bottom lines of the banks and mortgage banks.

These institutions now have considerable capacity to increase lending, and many have stated that they are easing their credit standards.

Lending fluctuates with the business cycle, so it is only natural that lending grows in an economic upswing.

In some respects, current developments are similar to the period leading up to the financial crisis in 2008. But there is one major difference, and that relates to credit growth, which is still well below the strong level seen in the pre-crisis period.

All the same, it is worth noting that total lending remains at a very high level and that it did not fall at any time in the years of economic downturn.

Slide 3: Financial risks
If we zoom in on the trend in lending, there are signs of risks building up. Banks and mortgage banks are increasing lending to vulnerable households with high debt ratios and the medium-sized banks have increased lending to cyclical industries.

So ***no***, credit growth is not soaring at the moment. But ***yes***, risks are building up. The level of interest rates is low and risk appetite is high. Combined with the economic upswing, rising asset prices and potentially strong credit growth, this is a toxic cocktail that could cause a hangover if we are not careful.

That is why Danmarks Nationalbank assesses that the conditions for activating the countercyclical capital buffer are in place.

The purpose of this buffer is to reduce the economic downturn in the event that households' and firms' access to credit is tightened disproportionally in periods of stress in the financial system. When the buffer is released, the institutions gain access to capital which they can use to keep up their lending capacity.

To increase the probability that the buffer has been built up before a period of financial stress occurs, it must be built up in good times like the present – while it is easy to do so.

The Systemic Risk Council can submit a recommendation to change the buffer rate to the Minister for Industry, Business and Financial Affairs. At its December meeting, the Council will consider whether to activate the buffer.

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Exactly one year ago, we launched the shared vision that the Danish financial sector is to be "best in class" in Europe in terms of combating cybercrime.

That work is now well underway, and I would like to express my appreciation of the good cooperation we have had the first year. A couple of weeks ago, Danmarks Nationalbank held the first Nordic cyber conference in Copenhagen. There was widespread agreement that Denmark is among the most digitised countries, but also that Denmark may not be in the top league when it comes to the degree of cybersecurity.

We must continue our journey towards increased cybersecurity. So in 2018 Danmarks Nationalbank will conduct a survey similar to that carried out in 2016 to see whether cyber resilience has increased, and we will also establish an "intelligence-led red-team testing programme" for the financial sector. I think this programme will be useful for the individual actors and for the sector overall. I also see it as a necessary step towards realising our vision of being best in class.

Slide 4: CBDC

Denmark is one of the most digitised countries in the world. Does that mean that we should also have central bank digital currency as a supplement to cash and deposits in commercial banks?

In the near future we will publish an analysis of this topic, but I can already today disclose some of the conclusions. The short answer is no, Danmarks Nationalbank should not offer retail banking services to all Danes.

An important thing to keep in mind when discussing central bank digital currency is that it has very little to do with the so-called crypto currencies, of which bitcoin is probably the best known one.

Whereas central bank digital currency would represent a claim on Danmarks Nationalbank – like cash – a crypto currency does not represent a claim on anybody, so it has no underlying value. Another significant difference is that money issued by Danmarks Nationalbank is stable in value. In contrast, the value of crypto currencies can fluctuate strongly, which makes them very poorly suited as means of payment or stores of value.

One argument used in favour of central bank digital currency is that it promotes a more secure and efficient payment system. In my opinion, that argument is not particularly relevant in a Danish context. In Denmark we already *have* a secure and efficient payment system in which payments are settled fast, smoothly and securely. It is possible to transfer funds from an account to any other account, and instant payments allow funds to be transferred in seconds.

Another argument used is that households and firms should be entitled to a secure asset. I can only say that it is already possible today to invest assets securely by holding cash, buying Danish government bonds or making deposits in commercial banks up to the guaranteed limit of approximately kr. 750,000. Full coverage of larger deposits can be obtained by spreading deposits on several banks so that the limit of kr. 750,000 is not exceeded in any one bank.

A third argument is to establish a back-up system that can take over if the current payments infrastructure is disrupted. Establishing a payment system that is completely independent of the existing system would require considerable resources. And a new system would still be subject to some of the same dependencies as the current system, such as the electricity grid. In my view, it makes more sense to spend that money on enhancing the robustness of the existing systems, e.g. in relation to cyber risks.

I acknowledge that the above arguments may be valid in other countries where e.g. the payment systems are more fragmented. But in a Danish context I find it difficult to see what central bank digital currency would contribute with that our existing payment solutions do not already offer. We already have digital money in the form of bank deposits.

In our assessment, the potential gains from introducing central bank digital currency do not match the considerable challenges that its introduction might create.

If Danmarks Nationalbank were to issue central bank digital currency, our role in the financial system would change. Danmarks Nationalbank would go from being banker to the banks to being banker to the general public. In that way we would be competing directly with the commercial banks, e.g. by offering deposit accounts and payment services, a role not traditionally assumed by central banks.

The introduction of central bank digital currency would also create a risk of financial instability by increasing the risk of systemic bank runs. Today it is difficult to carry out a run on the Danish banking system overall unless deposits are moved to abroad. But in practice it is not possible to exchange all bank deposits for cash. But with central bank digital currency, bank runs can take place rapidly and become systemic. In periods of loss of confidence in the Danish banking sector, this is possible despite the deposit guarantee scheme and any higher interest on bank deposits.

So I can set your minds at ease: Danmarks Nationalbank has no plans to compete directly with the banks. As you know, Danmarks Nationalbank's objectives are to contribute to ensuring financial stability, stable prices and safe payments.

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I will now turn to the issue of how to resolve large banks and mortgage banks in a crisis situation.

A precondition for preparing credible resolution plans for the largest Danish financial institutions – the SIFIs – is that a group can be resolved as a single corporation.

The resolution authorities should apply a single point of entry resolution strategy aimed at recapitalising and continuing the whole group. This is because the SIFIs are deeply integrated, both commercially and operationally.

Since the plan is to recapitalise the whole group, own funds and eligible liabilities must, of course, be issued for recapitalisation of all parts of the group. To ensure the necessary credibility of the resolution plans, the minimum requirement for own funds and eligible liabilities, MREL, must observe three principles.

Slide 5: 3 Key principles
Firstly, the MREL must reflect the current risks of the specific SIFI. The requirement cannot be capped as is the case for the current debt buffer.

For high-risk institutions, a cap on the MREL would mean insufficient liabilities eligible for writing-down and hence for covering the losses that may occur. For currently low-risk institutions, the requirement will be too low if the risks increase. As a result, the MREL will be too low precisely at the time when own funds and eligible liabilities are required for absorbing losses. That may have implications for financial stability and for the government finances.

It is a sound principle that the requirements for financial institutions are risk-based. I suppose we all agree on that. This helps to ensure sound incentives. So the Basel output floors that remove sensitivity to risk is not an idea that we have nurtured. The MREL should be risk-based like the capital requirements.

Secondly, the MREL should be the same, no matter how risk is distributed across the group. This means that there is no incentive to move risks to the entity subject to the least stringent requirements.

Thirdly, the MREL should be neutral from a competition perspective. The MREL to cover loans of the same nature which are to be treated equally in a resolution solution must be the same, irrespective of whether the loan has been granted by a bank or a mortgage bank.

If these principles are to be observed, a consolidated MREL must be set, comprising all entities of a SIFI. This will also bring us in line with European standards.

We suggest that the MREL is, as a main rule, set at twice the capital requirement plus the combined buffer requirement for all SIFIs. We also suggest that a reduction is granted for, inter alia, the Basel floors if they are introduced so that the requirement does not become unreasonably severe in relation to the actual risks of the groups.

However, 8 per cent of the total balance sheet assets is a relevant minimum requirement so that it is possible to top up with funds from the Resolution Fund if necessary.

Legislation says that mortgage banks must be resolved without use of bail-in. That is why mortgage banks are exempt from the MREL. Since this legislation was adopted, we have been putting much effort into finding out how to resolve SIFIs.

Slid 6: It was a mistake

We made a mistake when we exempted mortgage banks from bail-in and MREL and introduced the debt buffer. The work on SIFI resolution plans has now reached a point where it is necessary for us to correct this error so that we can proceed.

Consequently, Danmarks Nationalbank has recommended that the legislator should repeal the exemption of mortgage banks from bail-in and MREL. The potential gains are large, while the costs are very limited.

This will make it possible to adapt resolution plans to the SIFIs' business models and not vice versa.

The alternative – to operate with plans to discontinue mortgage banks by winding them up –is not credible. The mortgage banks are closely interwoven with the rest of the financial system due to the role of mortgage bonds in liquidity management. So the discontinuation of a mortgage bank would have a knock-on effect on the rest of the financial system. At the same time, the sector concentration is so high that much of its lending capacity would vanish if any one institution ceases to exist.

If an acceptable resolution scheme for failing SIFIs is not put into place, everyone will expect the government to save them. Mortgage banks operate under an implied government guarantee as long as they are exempt from bail-in and MREL.

When owners and creditors believe that an institution will be saved by the government, they will assume greater risks than otherwise. After all, the taxpayers will foot the bill if things go wrong. The absence of credible resolution plans for SIFI groups and mortgage banks distorts incentives and competition within the sector.

Indeed, the Competition Council's conclusion is that credible resolution plans must be prepared for the large mortgage banks and that they must be supported by MREL or perhaps by additional capital.

If the exemption is repealed, this will increase competition to the benefit of borrowers.

Slide 7: Should the government pay?
The purpose of the Bank Recovery and Resolution Directive was to ensure that banking crises do not jeopardise whole economies. With the exemption applying to mortgage banks in Denmark, we have chosen to keep up the risky ties between the government and the financial sector. We should know better than that.

A competition-neutral and credible MREL ensures that all credit institutions – irrespective of size and systemic importance – can be resolved without the use of taxpayer funds and without devastating effects on the economy. Once that is in place, credit institutions can be treated like all other private sector corporations:

Shareholders and creditors risk losing their money and management their jobs.

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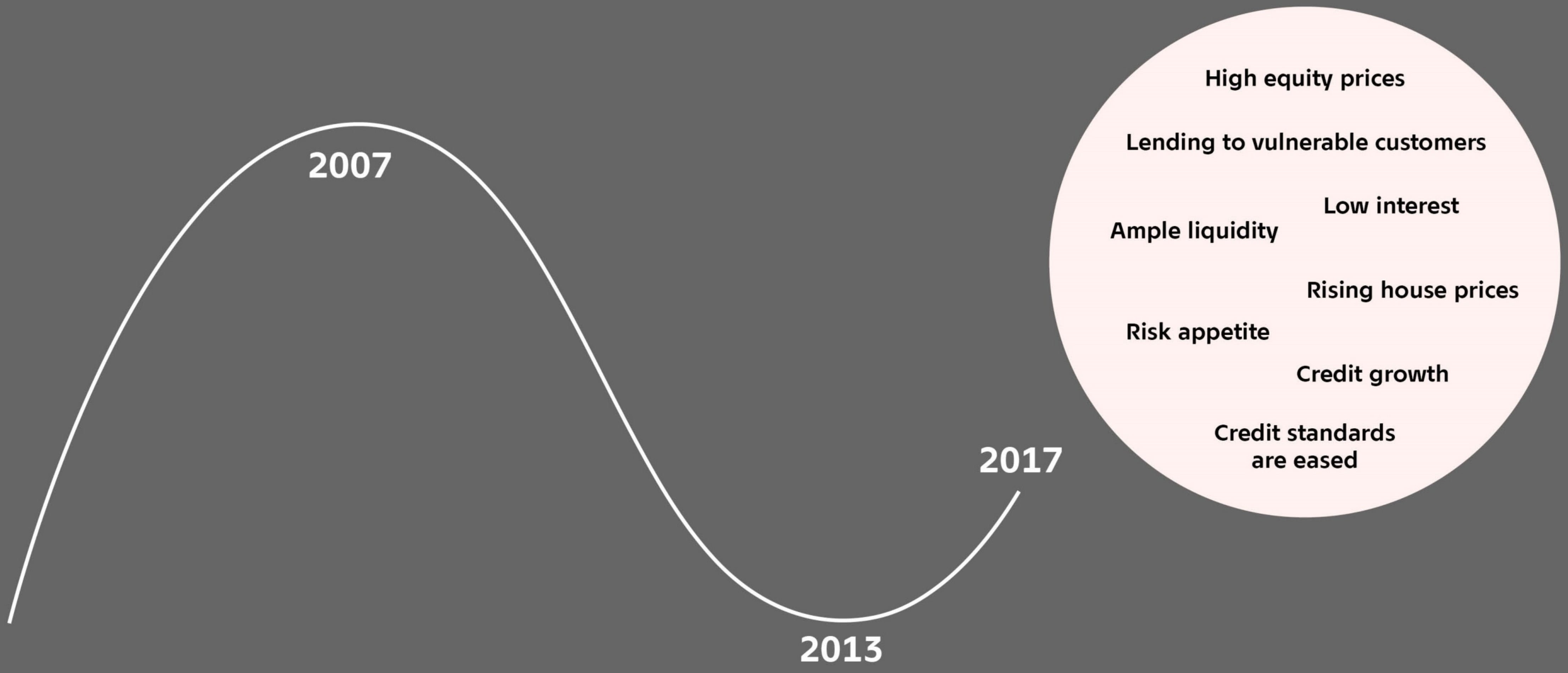
FINANCE DENMARK'S ANNUAL MEETING

Lars Rohde, Governor by Royal Appointment, 4 December 2017

The banks are stepping on the accelerator

Build-up of financial risks



Central bank digital currency

No benefit for Denmark

Three key principles for MREL

Risk sensitive

Robust

Competition-neutral

We made a mistake when we exempted Danish mortgage banks from bail-in and MREL and introduced the debt buffer.

Med det foreslåede *stk. 4* fastslås, at der ikke kan anvendes bail-in, jf. stk. 1-3 og reglerne i §§ 25-28, ved restrukturering og afvikling af et realkreditinstitut. Bestemmelsen skal ses på baggrund af den foreslåede § 266 i lov om finansiel virksomhed, hvorefter realkreditinstitutter undtages fra kravet om nedskrivningsegnede passiver. Baggrunden herfor er, at realkreditinstitutter altid vil blive afviklet ved at anvende § 19 (virksomhedssalg), §§ 21 og 22 (broinstitut), § 23 (adskillelse af aktiver) i denne lov og/eller §§ 27-33 i lov om realkreditlån og realkreditobligationer m.v. (realkreditlovens konkursmodel). Det er vurderet, at bestemmelserne sammenholdt med den foreslåede gældsbuffer i lov om finansiel virksomhed sammen eller hver for sig altid vil opfylde afviklingsmålene i § 5 i denne lov.

Dette skyldes, at afvikling af et realkreditinstitut via brugen af broinstituttet, adskillelse af aktiver, frasalg eller realkreditlovens konkursmodel, sammen eller hver for sig sikrer, at realkreditinstitutternes kreditorer vil bære tab i overensstemmelse med afviklingsmålene.

From: Explanatory note to Act on Restructuring and Resolution of Certain Financial Enterprises, section 24(4).

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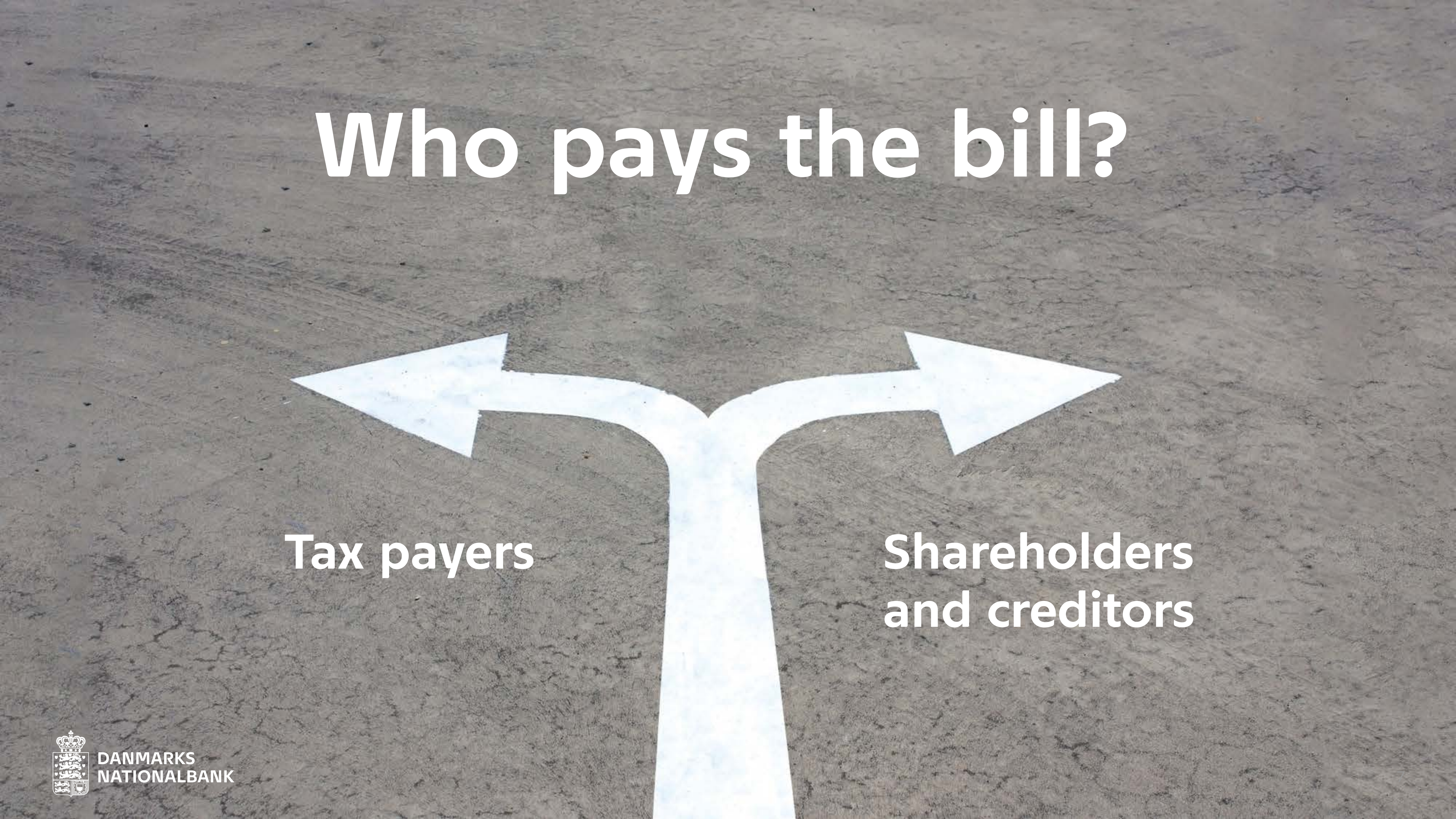
Who pays the bill?



Tax payers

Shareholders and creditors

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