DANMARKS NATIONALBANK

SPEECH

BY MEMBER OF THE BOARD OF GOVERNORS PER CALLESEN, DANMARKS NATIONALBANK AT FINANCE DENMARK'S EXECUTIVE CONFERENCE, 3 SEPTEMBER 2018

The European banking union in perspective – is there risk sharing and joint liability?

3 September 2018

CHECK AGAINST DELIVERY

Thank you for inviting me to speak.

Many of us who are present today had an opportunity to focus on the economy at the annual meeting of the Association of Local Banks a few months ago. So I will provide only a brief summary – without any figures. Instead, my presentation will be about international cooperation and specifically the European banking sector and the reinforced banking cooperation, also known as the banking union. I will not cover all aspects of this topic, but will focus on the issue of risk sharing, i.e. whether some institutions will be liable for the debts of others.

The main conclusions will be: (1) The economy and financial stability are still on a steady course. (2) International rule-based cooperation is under pressure. That gives cause for concern and emphasises the need to protect the cooperation that exists and that we are able to participate in. (3) As regards the banking union and the euro area, a clear picture is emerging – so far and looking ahead – of very limited money transfers between member states. In other words, there is limited risk sharing and joint liability. Some Europeans lament this, and there are arguments both for and against risk sharing, but there are good reasons why the institutions have been designed as they have.

The economic and financial situation

Four short remarks about the economic and financial situation:

Firstly: The economic recovery has been successful until now. It has been carefully nurtured with reforms and what we might call macroprudential nudging. We have avoided a situation where government and parliament have lost patience. Consumers and investors are spending money earned rather than borrowed on consumption and investment. And this time around, banks have been more hesitant to grant risky credits. In short, we have not seen a fiscal or credit expansion with a resultant boom and bust cycle this time. We must ensure that this continues.

So, *secondly*, our imbalances are small. We also have a large current account surplus. When the economy reverses – as it will, although we do not know how and when – domestic factors need not trigger a deep recession. But there are major external risks linked to the procyclical fiscal boost in the USA, something as old-fashioned as trade restrictions, as well as weaknesses and, perhaps, experiments in several European countries and emerging markets.

Thirdly, we have capacity pressures, but so far without inflation. This can lead to loss of market shares, but we cannot produce more than our labour resources permit. There are signs that this pressure is affecting productivity. We must take care, but the situation is not as bad as it was during the upswings in the mid-1980s and mid-2000s.

Fourthly, times are also good in the financial sector, although risks are increasing. Far into the upswing, interest rates remain very low, there are a number of international risks, and there is fierce competition to provide loans in a low-demand market. It is time for a larger countercyclical capital buffer. We have a sound real economy with buffers, but there is limited scope for reducing interest rates and providing fiscal stimuli next time the economy goes into recession. When that happens, the financial sector cannot and should not be part of the problem.

International cooperation under pressure

Now I will turn my attention to international cooperation. We are fortunate to live in an age of rule-based international organisations set up by a few forward-looking generations that came just before ours.

In the field of economics, the IMF, the World Bank, the WTO, the OECD, the EU and the euro project should be highlighted. These institutions have treaties and statutes, governing bodies representing all member states, voting rules, tools for further development and settlement of disputes, and courts of law and rulings with equal treatment.

It ought to be self-evident why rule-based cooperation is a good idea for everyone, and especially for small and medium-sized countries. Unless they choose isolation, they would otherwise have to approach the largest and strongest countries one by one, on a case-by-case basis, and then adhere to the standards set by the largest and strongest countries. Settlement of disputes would be dependent on the goodwill of the various large countries.

It requires vision, outlook and a long time horizon for large countries to commit to rule-based cooperation, as they will have to give up some actual decision-making power. They have to argue their cases, they may find themselves in a minority in concrete voting situations, and in legal dispute resolution the rules apply, not the sizes and short-term interests of the parties. So why did the large countries choose not only to participate, but also to lead the way when setting up these institutions? Presumably it helped a little that binding cooperation is fair and intellectually satisfactory. But a much more decisive factor has probably been that, in economic terms, it is far more efficient for everyone, and the alternative is political chaos, with anarchy, shifting and random alliances and eternal conflicts, not least between large countries.

Seen from our perspective, as a small country, rule-based cooperation has to some extent been challenged by institutions with the major powers as members – such as the G7, G20, FSB (Financial Stability Board) and Basel Committee – for they do not operate with treaty rules and equal treatment, and furthermore we are not invited to join them. On the other hand, they are more concerned with coordination and advice rather than direct decision-making. The EU and the ECB sit at the table and serve as buffers in relation to implementation. And perhaps it is just as well that the largest countries meet up in smaller forums and have an opportunity to avoid frustrations they may have in the rule-based institutions where they need to negotiate with many other large and small countries.

It is more serious if large countries withdraw from existing agreements, prevent the rule-based institutions from working efficiently or go solo and test the limits of or act in direct contravention of the written or unwritten rules of the institutions. Or if medium-sized and small countries individually get the notion that they will be able to decide more themselves by withdrawing from the institutions. In this case they face a difficult choice. Either they must follow the rules laid down by others – without having any influence on them. Or they must accept the loss of prosperity and the hassle imposed on the government, businesses and citizens from opting for isolation and their own rules, plus harvest possible windfalls that may come in the form of bilateral agreements. Unfortunately, there are topical examples of both situations, and in some countries there is pressure to follow suit. This also poses a risk to Danish prosperity and influence. It is important to keep the value of broad international cooperation in mind, also when focusing (more narrowly) on issues such as the banking union, and the implications if Denmark at some point decides to join it.

The development of the banking union

The banking union is not fully developed and is not likely ever to be. There will always be new issues and proposals to consider. But the largest and most important pieces have fallen into place with the Single Supervisory Mechanism and the Single Resolution Board, both of which are functioning.

The participants are currently discussing the collaboration under the heading of "risk reduction and risk sharing. The heading is not well-chosen, as it gives an impression of a "quid pro quo" mindset. In reality, the "discussion" comprises a number of elements that are all well-founded, also when viewed separately.

The discussion has been organised, e.g. via the development of a set of indicators for the soundness of the banking sector. These may be of separate interest, but will also be used as criteria for the development of the potential European Deposit Insurance Scheme, EDIS – which I will return to later.

Risk reduction

As in this country, banks in the rest of Europe are also benefiting from the stronger economy and the efforts to clear up the mess left by the crisis.

Return on equity has risen despite a slightly depressed interest margin, but with considerable variation between member states. The German banks stand out with relatively low earnings. There has been consolidation within the sector, as also seen in Denmark.

The European banks are better capitalised. This is because they hold more capital, but also because their risk weights have fallen. (This reflects an improved cyclical position and better credit management, but also the discontinuation of weak banks and divestment of non-performing loans.) Liabilities are also being issued to meet the MREL (Minimum Requirement for own funds and Eligible Liabilities). Observance of the MREL is to ensure that eligible liabilities can be written down or converted into equity in a reasonably orderly manner if the institution is failing and is systemically important. In that case, it must be recapitalised and continued in a new form. It will take some years before the MREL is fully built up. In

Denmark we have also begun to build up MREL funds, although no MREL requirement yet applies to mortgage banks, as you will know.

As regards liquidity, it has been agreed to apply the two liquidity ratios, LCR and NSFR[1], as indicators.

The LCR has, on average, increased considerably in most member states, and the distance to the 100 per cent requirement is increasing. The NSFR requirements are also generally met.

The spread in the share of non-performing loans has been a significant barrier in relation to encouraging the economically strong member states to engage in more risk sharing. In terms of legislation and practise, the ability and willingness of member states to realise the underlying assets and collateral pledged for non-performing loans, e.g. in the form of enforced sale, also differ. This is to a considerable extent politically or culturally motivated. The volume of non-performing loans has fallen in most member states, and they have to a larger extent been taken into account in the banks' financial statements, e.g. in the form of impairment charges.

All in all, the indicators show a clear improvement in the banks' soundness. As regards capital adequacy and liquidity, the EU requirements are generally met. The situation in relation to non-performing loans is improving, but further improvements are required in some member states.

Risk sharing in perspective

What is more important than current indicators of banks' soundness – which may change – is the ability to understand and interpret the institutions that are already or may at some point be involved in risk sharing between banks and government finances across member states. An insurance element of this kind may be useful when handling specific crises as it may reduce spillover effects between banks in crisis-ridden member states. And it can reduce interdependence between banks and the governments of their home countries. On the other hand, it may seem unfair and may even increase institutions' risk appetite if taxpayers or banks in other member states are liable for the consequences of decisions and risk-taking beyond their control.

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[1] The Liquidity Coverage Ratio (cf. the EU Capital Requirements Regulation) and the Net Stable Funding Ratio (cf. the current proposal to amend the EU Capital Requirements Regulation, which has not yet been adopted).

Both views can be justified. But it is a fact that the decisions made within the union show a strong aversion to risk-sharing and to some participants – banks or sovereign states – being liable for incidents or decisions made in other member states. This can be illustrated from four different angles.

My first example is the loan programmes for crisis-ridden member states from the IMF[2] and the ESM[3]. Especially the Greek programme has been in focus in recent years. These loans are intergovernmental and extend far beyond the banks, but they are, in principle, interesting in relation to understanding the dominant European mindset that applies, also in the banking union. That is why I will elaborate a little on this issue. My point is that the programmes consist of loans and liquidity support, subject to specific terms and conditions. They have involved neither direct nor indirect fiscal transfers. Today these programmes are seen as a success, although the picture of a Greek recovery is still somewhat blurred, which is hardly surprising. After all, it took several decades before Denmark had fully recovered from the situation in the early 1980s, when the economic challenges in some respects resembled those faced by Greece today.

The debts of Greece have been written down, but only for private-sector creditors. The interest terms have been very accommodative and Greece annually saves several per cent of GDP on its government interest payments. For example, Portugal's interest expenses are higher, even though its debt is lower. But the interest rate has not been lower than that at which the IMF and ESM have been able to borrow in the market. The principals of the loans have not been reduced. Instalments and interest payments have been postponed considerably, but have not been written down. There has been a reduction in the margin lenders add to their financing costs, and there is a possibility that the ECB will waive its profit on market purchases of Greek government bonds, but again there have not been any fiscal transfers from other member states.

In the international press, increased write-down of debt, also to other governments, has been called for. But write-down of government lending is a fiscal transfer, and there are good reasons why this has not taken place. In that situation, taxpayers in the lender states would feel that they were bearing the costs of decisions made in borrower states – decisions

[2] The IMF, International Monetary Fund, established in 1944. The IMF today has 189 member countries and a lending capacity of around 1,000 billion dollars.
[3] The ESM, European Stability Mechanism, established by the euro area member states in 2012 as an intergovernmental institution. The ESM has a lending capacity of 500 billion euro.

that they could not influence. This would provide a basis for political conflicts in and between member states. Taxpayers and the government of the borrower state would have a joint incentive to ease fiscal plans if others were ultimately to foot the bill. And it may be difficult to raise government loans for other crisis-ridden member states in future if they can subsequently be converted into income transfers.

Fiscal transfers can be perceived as "taxation without representation". And there is a legitimate need for member states to be allowed to test their own policies and hence also to bear the consequences. A balance is struck because there is a common fiscal framework which is discussed on an ongoing basis. The rules are politically rather than legally binding. Can it be simplified? It is doubtful. Does it work? Yes, when member states use it as support for sound policies rather than making it a scapegoat. So it solves some, but not all, problems. Nor can the banking union be expected to solve all problems.

Backstoppers are the assistance programmes that impose strict conditions on the borrowers. This will always be controversial, but the requirements are milder than the conditions and interest rates that a crisis-ridden member state may obtain on market terms.

Another example is the crisis management of individual banks in recent years, e.g. in Italy and Spain. It should be remembered that although the BRRD/SRMR[4] rules apply, the build-up of MREL funds has by no means been completed yet. In the most controversial cases, the EU institutions assessed that the banks concerned were not systemically important in a Community context, and the further management of these banks was left to the national authorities. Those authorities then insisted that the banks had regional systemic importance and obtained the approval of the European Commission for measures with an element of state aid that does, to some extent, distort competition. If this indicates a flaw in the system, it lies not in the banking union but in the general EU rules on state aid, which might be criticised for not having been brought in line with the BRRD. However, there has not been any talk about using shared funds in connection with crisis management by e.g. the SRF. The measures taken have been at the expense of the relevant member state itself.

[4] The BRRD, Bank Recovery and Resolution Directive, and the corresponding rules for euro area member states, the SRMR, Single Resolution Mechanism Regulation, both adopted in 2014.

A third example is contributions from the SRF, the Single Resolution Fund financed by the banks. They are incredibly well protected. SRF funds can be used only after bail-in of the equivalent of 8 per cent of the liabilities of a failing bank. This typically corresponds to 25 per cent of the risk-weighted assets. Calculations show that during the crisis period after 2008 only one systemically important European bank had losses exceeding this threshold. Furthermore, contributions from the SRF may not exceed 5 per cent of the bank's liabilities, and it is a receivable claim, not an income transfer.

This structure is a result of a more fundamental shift (with the BRRD) in the approach to financial regulation after the financial crisis, to the effect that crisis resolution of failing banks should take place using owner and creditor funds. This shift may initially have been aimed at preventing the use of government funds, but it has also significantly reduced the opportunity to use funds collected from other banks. In other words, the cross-border insurance element has been overtaken by a healthier crisis resolution model.

The fourth example is the EDIS, in relation to which negotiations have been slow. In objective terms, there is a good case for a single deposit insurance scheme in a banking union. The risks of national banks are continuously affected by national conditions, but with single supervisory and resolution mechanisms it is natural also to have a single deposit insurance scheme. But supporters and opponents seem to exaggerate the respective pros and cons of such a scheme.

Possibly a single deposit insurance scheme will have a stabilising psychological effect on the depositors of potentially failing banks. But people tend to overlook the fact that creditor legislation has been amended so that deposits in general and covered deposits in particular rank first in the creditor hierarchy. So the Deposit Guarantee Fund can be invoked only after extremely large losses in a bank, including loss of all senior debt and uninsured deposits. Hence, the relevance of EDIS is linked to banks funded almost exclusively by deposits covered by a deposit guarantee. We should also note that the ECB in the spring published an interesting analysis[5] showing that even far deeper crises than the one in 2008-09 would not be able to deplete a fully phased-in deposit insurance fund of 0.8 per cent of covered deposits. Underlying reasons include the credi-

[5] ECB Occasional Paper 208, April 2018: Completing the Banking Union with a European Deposit Insurance Scheme: Who is afraid of cross-subsidisation?

tor preference for deposits and the build-up of MREL funds. Overall, the system has now been structured in such a way that deposit insurance schemes – be they national or European – will in practice play a very limited role in the resolution of failing banks.

Concluding remarks about the banking union

There are a number of other, strong, arguments in favour of participating in the banking union, including: further development of the single market with more competition, for the benefit of consumers and firms at home and the ability of banks to operate in other member states. Stronger supervisory powers in terms of capacity, depth, methods and the opportunity to take a broader perspective. Better management of cross-border financial activities. Greater credibility in relation to the bail-in rules, and greater certainty that failing banks will be treated in the same way. And like all other international cooperation for a small country: influence on rules and practices that must, in effect, be observed in any case – including having a spokesperson in institutions such as Basel and the FSB, where we are not invited to sit at the table ourselves. And after all, the vast majority of Danish banks are of a size which would place them under direct Danish supervision, also in a banking union. But based on the single supervisory practice – which has its advantages.

As you will have understood, the insurance element is not at the core of the banking union. An insurance element does exist for use in extreme situations with failing banks, but otherwise its role will be very limited. So the insurance element and its counterpart – fear of liability for problems incurred by banks in other member states – are neither key arguments for participating in nor remaining outside the banking union.

I am not claiming that transfers between the EU member states do not and should not exist. Transfers have taken place for many years, via the EU budget, and the amounts are considerable. Several member states receive up to 3 per cent of their GDP on the basis of a number of objective and structural criteria. So it would not be new or exceptional if other elements of the cooperation were also to include such transfers. But neither the euro project nor the banking union have involved or envisage transfers between member states to any substantial degree. And in practice, the institutions are systematically designed to minimise the likelihood of such transfers. That will probably characterise also future developments within this area.