SPEECH

BY GOVERNOR LARS ROHDE AT THE ANNUAL MEETING OF DANISH AUDITORS

DANMARKS NATIONALBANK

CHECK AGAINST DELIVERY

10 September 2019

Thank you for inviting me to speak here today.

My topic is trust and transparency in the financial system.

This topic is always current, but it became particularly relevant in connection with the financial crisis. It was a substantial breach of trust when central governments in large parts of the western world had to use taxpayer funds to save the financial sector.

In recent years, the topic has surfaced again following a number of unfortunate issues that have accumulated since the financial crisis. For a long time we may have thought that this was primarily a problem that existed outside Denmark's borders. But then cases emerged in Denmark too. There have been money laundering cases, there have been deliveries of very large banknotes to bureaux de change, and incorrect advice has been provided in connection with investment products. The financial sector has been involved in transactions that have drained the government coffers of many billions of kroner in dividend tax. And I am sure we could find more examples.

What these examples have in common is that they contributed to undermining trust in the financial system. Trust is low at the global level. That has been documented by the Edelman Trust Barometer. In fact, one of the key messages in the Edelman analysis is that the financial sector is the sector that people trust the least. Danish surveys also point to low trust in the financial sector.

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How can we learn more about the present and about how to shape the future? One way is to look back and learn from history. So I would like to start with two examples from the past.

I will begin in the 18th century. More specifically with the Rothschild family dynasty. It was founded by Mayer Amschel Rothschild. He was the head of a poor family comprising his wife and 10 children. The family lived in Frankfurt in the late 18th century. Good ideas combined with unusual willpower gave Mayer Rothschild a point of departure for forging business relationships with powerful men in the area. He also dispersed his sons across Europe. The sons established their separate trading firms and were successful. Especially the son in London was doing well. He soon became so rich that he could lend money to the Duke of Wellington. In 1814, this son became the British government's secret banker for funding the Napoleonic wars.

The family established a close network throughout Europe, with links to ship owners, transport companies and financers, among others. News spread very fast through this network. After Napoleon's defeat at Waterloo, the Rothschild family received the news – before the British government! They purchased British government bonds, and when news of the victory arrived, prices rose, making the Rothschild family even wealthier.

At the core of the family's success was the foresight of Mayer Rothschild, which led him to conclude a partnership agreement with his sons at an early date. This agreement was aimed at ensuring a strong family-owned business based on the father's solid reputation as a businessman. The family was to benefit from the reputation that Mayer Rothschild had built up.

Furthermore, Mayer and his sons were to share the profits from the business empire, which meant that they took an interest in each other's affairs and the partnership as such. In other words, the business empire was based on the principle of everyone having something at stake.

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My other retrospective example relates to a period of around 30 years in mid-19th century USA. Before this period, every single bank in the USA had to have a charter through special legislation for that specific bank. However, this changed when many states began to introduce state charters describing the general requirements to be met by banks that wanted a licence to operate. This period has been called the "free banking" era because anyone meeting the relevant state's banking requirements could establish a bank.

A bank was typically established by selling shares – "subscriptions" – and by using the funds received to purchase government bonds. If you wanted to operate a bank, you had to deposit government bonds to back the banknotes issued by the bank. The banknotes were used by traders, and there were "banknote reporters" who prepared lists of counterfeits and listed the prices of the various banknotes.

Later generations have interpreted this period in different ways. A number of banks failed, so initially it was investigated whether they misused their special position, e.g. by having insufficient backing for the banknotes issued. In the literature, these banks were referred to as "wildcat banks". Later, the view of the period changed, and focus is now on market discipline during this period. This was reflected in the market's ability to price the risk on the banknotes from the individual banks, which was of paramount importance to the bank's reputation. There were banks that failed, but they did so because the market was able to price the risk. People voted with their feet. So there was a high degree of market discipline.

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What can we learn from these two historical examples? Firstly, I note that the people involved also took on the risk – they all had something at stake. It was their own money – or their close business partners' money – that was lent. That gave them an incentive for sound risk management. They were focused on behaving in such a way that their good names and reputations and their wealth were not jeopardised. That is no longer the case. Today's banks are so large that no individual or small group of people can own and operate a big bank. This means that there is no longer a close link between those bearing the risk, the owners, and the day-to-day management. When shares are as widely dispersed as they are in most Danish banks, everyone is responsible, which ultimately means that no-one takes on the responsibility. Being owned by everyone is the same as being owned by no-one.

Secondly, I note that the market plays an important role. It is good if clients vote with their feet.

You might ask whether things had been different today if we had learnt more from history.

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Now I will turn my attention to something more recent – the financial crisis. It is already more than 10 years since the financial crisis erupted.

The financial crisis made it very clear that we had created a system in which the banks reaped the gains in good times, while society and the taxpayers had to foot the bill when things went wrong. Distressed western banks were saved by means of government funds. That was also the case in Denmark. There was simply no other option. It was necessary to intervene to support financial stability. That was important in order to be able to continue the functions within the financial system that are critical to the real economy. Households, firms and authorities all depend on services provided by the institutions. Default within the financial system would interrupt these critical functions, which would have considerable negative consequences for the financial system and the real economy.

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After the crisis, crisis management regimes were introduced for banks worldwide. In the USA, Dodd-Frank was passed. And at the EU level the Bank Recovery and Resolution Directive, BRRD, was adopted to prevent a similar situation in the future.

The BRRD requires all banks and mortgage banks to prepare and update recovery plans and also requires the authorities to prepare resolution plans. These plans are the point of departure for the crisis management in the institutions and authorities.

Besides these two requirements, the BRRD includes another key element: it lays down a framework for the authorities' management of a failing institution or an institution that is likely to fail. There are rules stating who is to bear the losses. Institutions must observe a minimum requirement for own funds and eligible liabilities. This requirement is referred to as the MREL. The purpose of the MREL is to ensure that it is possible to resolve the individual firm in a crisis. The bail-in tool is of particular significance in this respect. I will get back to that.

The MREL has two components: a loss-absorption amount and a recapitalisation amount. The loss-absorption amount corresponds to the losses the institution can be expected to have to absorb. The recapitalisation amount is to ensure that the chosen resolution strategy can be implemented. If the group is to continue as a viable business after having been distressed, it must be possible to recapitalise it at a level whereby it meets the capital requirements and enjoys sufficient trust in the market. By the way, that is the resolution strategy for the systemically important financial institutions in Denmark. So we are no longer in a situation where we either save them all or do not save any.

The BRRD has introduced a new layer in the creditor hierarchy. This is non-preferred senior debt, which can be used for loss absorption and covers losses before senior unsecured creditors are affected. The price of this new type of debt is a sensitive indicator of the soundness of a bank.

In that way, there is no risk that taxpayers, rather than investors and creditors, will bear the costs of handling a failing institution. The idea is that losses should be borne by those who incurred the risks and those who get the prospect of profit. That is known as bail-in. Bail-in helps to ensure that the institutions have an incentive to run their businesses prudently and that investors and creditors monitor the activities of the institutions in order to prevent excessive risk-taking.

The BRRD is the most significant regulatory initiative in the financial area in Europe in recent times. We now have a set of rules that reduces the risk that institutions will suffer serious financial problems, while also ensuring that the authorities have the tools required to handle the situation, should the institutions nevertheless become distressed. Like other firms, banks can fail without passing the bill to society and its citizens.

But the BRRD cannot stand alone. There is a need for regulation of financial companies. For example, capital and liquidity requirements must apply. The requirements as to how much capital banks and mortgage banks must hold have evolved considerably over the last 30-40 years. Seen from today's perspective, starting with Basel I, it included very simple rules regarding the capital required if a bank was to lend money. There was a fairly rough breakdown by loan risk, which meant that loans were weighted according to their riskiness.

The belief that it was possible to estimate the loss profiles of various customer and loan types, and hence to calculate the capital requirements for unexpected losses on loans, led to Basel II.

As we all know, it did not stop there. We now have Basel III, and complexity has increased. Fortunately, the capital requirements have also increased.

Not only capital has been regulated. There are also rules on liquidity, fit and proper rules for management and rules on investor protection now.

And many more. All these rules and measures address important issues. And they have been necessary because there were insufficient incentives to ensure that the financial sector behaved.

We cannot and should not regulate all aspects of the financial sector in detail to prevent things from going wrong. It would simply not be possible to formulate such rules and it would also be virtually impossible to observe them. The banks' managements must have a certain degree of freedom to run their businesses.

I am not in favour of further detailed regulation. And perhaps we should consider whether the fence poles are in the right place or whether we have fenced in some areas too much. So I am on the side of simplifying and streamlining rules and regulations if possible. And as I have said, that is possible now because the BRRD ensures that irrespective of the size of a bank, we can manage it in a crisis situation. The critical functions will be continued, and investors and creditors will foot the bill – not the taxpayers. In other words, the BRRD is a *prerequisite* to do away with some of the detailed regulation. If we do so, it may give managements and boards more space to actively consider the business model and ethical principles on which their business is to be based. It is a task for management to create a culture based on responsibility and decency and to ensure that employees contribute actively to that agenda.

In Denmark, we basically trust our institutions and firms and each other. But when this trust is broken, we cannot simply lean back and wait for it to be restored. That requires an effort. Trust is something we earn. And in this respect the financial sector has its task cut out. It is by no means all banks that misbehave, presumably it is only a few and perhaps only in certain respects. But a breach of trust rubs off on the whole sector.

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Lenin said, "trust is good, control is better". I prefer to say that trust is good – in fact it is a precondition – but control is necessary. That is why the quality of such control matters. And you, the auditors, play a special role as the trusted representatives of society in general. That role must be undertaken with credibility and integrity as the whole purpose of conducting audits is to support trust in the information published. So you have a very important role.

There is a price to be paid if the quality of an auditor's work is not good enough. And we all know that that is sometimes the case. We have seen cases where the Disciplinary Board on Auditors (Revisornævnet) has imposed fines on auditors for having acted contrary to good auditing practices.

Sometimes there may be a discrepancy between, on the one hand, general expectations regarding an auditor's work and, on the other hand, legislative requirements. In a court of law it can be difficult to prove that an auditor has not observed good auditing practices. It can only be hoped that the scope and quality of audits in the vast majority of cases go well beyond the legislative requirements. In this respect self-checks and quality controls by the authorities are both important tools for ensuring trust in auditors. It is also important that you, the auditors, stay focused on your core task – audit – and do not give lower priority to audit quality in favour of consultancy services – although they may appear to be more profitable in the short term.

The relationship between a firm and its auditor is a client relationship. This involves an inherent conflict between the auditor's wish to meet the customer's expectations and the role as the trusted representative of society in general. Your task is to take a critical view of what you see in firms. You must challenge management and point out practices that are not in accordance with the rules. And you must communicate clearly if they are not brought in order. That is your task. If you do not do that, you are doing your clients a disservice in the long term. If you lose clients on that account, you should see it as a necessary cost of maintaining integrity and the respect of society – your other clients.

Your organisation, FSR – Danish Auditors, has prepared an action plan to strengthen the quality of the sector in Denmark. I note that it includes strengthened public sector control of auditors, new tools for measuring the quality of the work performed and enhanced self-checks. Might I suggest that you also consider the role of auditors in relation to the ethical foundations and culture of a firm? I would like to see auditors play a role in relation to reviewing whether the targets for ethical behaviour set by the board are also implemented in practice.

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We must learn from history and consider whether we have the right incentives. The task is to keep your own houses in order. That applies in the financial sector and among auditors. I can say for certain: once the crisis hits, there is no-one you can call! At least I can say; We do not pick up the phone. The financial institutions – their creditors and investors – must suffer the consequences. Just as the BRRD envisages. So when you audit financial enterprises, I hope you keep in mind that it is an honour to be the trusted representatives of society in general. And I hope that the trust placed in the employees and managers of the financial enterprises is rewarded with responsible and decent performance of their tasks.

Thank you.