DANMARKS NATIONALBANK

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CHECK AGAINST DELIVERY

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FROM NATIONAL REGULATION TO AN INTERNATIONAL LEVEL PLAYING FIELD

Thank you for inviting me to speak today. I have been looking forward to this.

What are the characteristics of banking?

In the words of the historian Søren Mørch – loosely quoted – banking belongs in the department where rabbits are pulled out of top hats and ladies are sawn in half. This only works if the audience – the banks' customers – behave as expected and do what they usually do.

If the customers do not trust the bank, there will be a run on the bank. The trick will fall flat, and the money will vanish.

We can try to regulate our way out of the risk that the trick will fall flat. But whatever we do, we can never guarantee that the banks will not experience problems. So does that mean that we should avoid regulation? The answer is "no". Regulation is a must.

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Historically, the financial sector has been characterised by being regulated. The reason is that a breakdown would have major implications for society.

Typically, regulation has been introduced in response to financial crises – this applied to, for example, the first Danish Savings Bank Act from 1880 and the first Danish Commercial Banking Act from 1919.

The purpose of the 1919 Act was to prevent bank managements from losing people's money and then applying to the government for help so that innocent depositors would not be ruined. With the Commercial Banking Act, the banking inspector was also introduced; this was the first supervision of *commercial banks*. Savings banks had been supervised since 1880. Today's banking supervision is undertaken by the Danish Financial Supervisory Authority – and I would like to congratulate you on achieving the centenary that we are celebrating today.

When supervision of savings banks was introduced, it was not believed that it was necessary to subject commercial banks to supervision. Their customers were, to a large extent, commercial enterprises that would be capable of assessing the creditworthiness of their bankers themselves! Well – what can I say?

The Commercial Banking Act could not save the financial sector in the 1920s. The Act came too late. Over a period of 13 years, numerous banks in Denmark experienced difficulties. The failure of Landmandsbanken is the best known episode from that period. This is because Landmandsbanken was Scandinavia'slargest bank, and Denmark's first banking inspector – Mr Green – wrote a diary from his inspections of the bank.

Several of the banks' problems were attributable to management. As Professor Per H. Hansen writes in his book on the 13-year banking crisis from 1920 to 1933: "It is the individual bank management that, through day-to-day operations and the strategy laid down for the bank, determines the structural conditions that are of significance to its risk exposure".

That sounds familiar in relation to the most recent financial crisis. And – regrettably – it is topical in relation to the headings which the financial sector is attracting in the media.

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At the time when the first commercial banking act was introduced, the banks' solvency ratio declined. Their solvency ratio in the original meaning of the word – net worth as a fraction of total assets – was 11.8 per cent in 1919, only half the 1908 ratio. This development may challenge the conventional wisdom that regulation limits the banks' scope to operate.

In the current age of open economies, financial business is transacted across borders. That was not always the case. In fact, foreign banks were not able to set up business in Denmark until the 1970s. At first, their effect was very modest. After 11 years, foreign banks had a share of just 1 per cent of the aggregate banking balance sheet. It was simply too cumbersome to enter the Danish market, partly because the banks would be subject to Danish supervision.

The amendments to the Danish banking legislation were part of the harmonisation of the financial sector in the European Community. The aim was to create a single market for financial services by ensuring a level playing field and uniform framework conditions. The single market for financial services was a means of reaching the actual goal – to enhance competition to the benefit of consumers and firms.

The next phase of harmonisation followed in the 1980s, when it became easier to set up business in other EC member states. With a banking licence from the home country, it was possible to conduct banking activities in all member states: the bank was subject to supervision by the home authorities only. At the same time, a European framework for equity and solvency was introduced.

As a result, the Danish rules were amended so that the required solvency ratio for banks was calculated as a percentage of risk-weighted assets. Until then, the solvency ratio had been calculated relative to total debt and guarantee exposures. The view on solvency was changed from a buffer against a run on the bank to a cushion related to the quality of the loans. This amendment was part of the introduction of BIS solvency rules in the EC. The aim was to improve the solvency of the global banking system. But the aim was also to ensure that the banks competed under more equal conditions. These rules were known as Basel I.

The introduction of new capital adequacy rules led to substantial easing of the capital requirement for Danish banks. Denmark was less severely hit by the banking sector crisis in the early 1990s than the other Nordic countries. This was partly attributable to the high Danish capital requirements that applied before Basel I.

From a current-day perspective, the first EC capital rules were very simple and comprised credit risk only.

Since then, European regulation of the financial sector has evolved considerably. Basel I was replaced by Basel II, which to a larger extent took modern risk management techniques into account. Another wave of regulation followed in the wake of the financial crisis. This was based on the acknowledgement that one of the reasons for the depth of the financial crisis was that capital requirements had been eased too much under Basel II.

To illustrate how much regulation has evolved, I would like to quote former Governor of Danmarks Nationalbank Richard Mikkelsen, who in *Dansk Pengehistorie* (Monetary history of Denmark) wrote as follows about Denmark's implementation of Basel I:

"Actually, the Act and the resultant executive orders, etc. became so complex that it defied ordinary human perception. Whether the Act is complied with is for computers to determine." If only he had known what was to come!

The EU rules regulating the financial sector *are* complex. The three large sets of rules alone run into more than 1,100 pages in Danish. The rules are so extensive because they need to regulate firms with very complex activities. Moreover, if something goes wrong, the costs to society are considerable. The legislation is also extensive because it must take into account the structures and traditions of many countries. The Danish mortgage credit sector, for one, has benefited from that.

If you wish to be part of an international market, it is a huge advantage to operate under a single set of rules. This applies globally within trade, and it applies within the EU in the form of regulation of the financial sector. It is a particular advantage for a small country with a very international economy, such as Denmark's. If we were outside, we would, for competitive reasons, still have to operate under the same rules – but without having any influence on their design.

Common rules lead to closer cooperation and facilitate the exchange of goods and services. Developments in the last 40 years illustrate that. They create a level playing field and reduce the opportunities for rule arbitrage.

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In the wake of the financial crisis, the EU adopted the Bank Recovery and Resolution Directive, BRRD. Again, we have made considerable progress since the first savings bank act from 1880, which in very simple terms describes how to close a savings bank.

The BRRD requires institutions to draw up and maintain recovery plans, and the authorities must draw up resolution plans. In addition, a framework has been laid down for the authorities' resolution of a failing financial institution. This could be, for example, the resolution tools to be used and who is to bear the losses.

The strategy for resolution of systemically important financial institutions in Denmark is to restructure them and return them to the market with sufficient capitalisation to ensure market confidence. They perform functions that are critical to society and essential to financial stability. If this is to be possible, the institutions must observe a minimum requirement for own funds and eligible liabilities. In other words, MREL. These funds are used to absorb losses and for recapitalisation if the institution is failing. So the taxpayers will no longer have to bear the costs of resolving a failing credit institution.

The BRRD is the most significant regulatory initiative in the financial area in Europe in recent times. The days when banks were rescued by the central government are over.

However, we still have an important outstanding issue in Denmark – whether or not we join the strengthened banking cooperation – and that is how we resolve the mortgage credit institutions. They are exempt from the MREL. As a result, we cannot be sure that there are sufficient funds to resolve failing mortgage credit institutions. And we cannot use the Resolution Fund for loss absorption in the mortgage credit institutions, should this be necessary. We need to do away with this exemption in order to ensure credible resolution of mortgage credit institutions. At the same time, I would like to emphasise that mortgage bonds should not absorb losses. Instead, as I have already said a couple of times, there must be sufficient MREL funds.

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The BRRD is a large step in the right direction.

But, looking ahead, what is the main challenge for a financial supervisory authority and for financial stability?

Seen from a Danish supervisory perspective, it must be the ever-increasing complexity of the very large banking groups and the internationalisation of banking activities. Large banking groups are complex to operate. And they are complex to supervise. There is nothing new in that, but it is becoming increasingly evident.

Supervision of the largest banks means supervision of major international players with customers and a presence in multiple countries. That in itself is a challenge for the supervisory authority. In addition, risk management and the methods applied are becoming still more advanced.

Naturally, there are also many other challenges. One of them is digitalisation, which entails a gradual change in the competitive situation of the banks.

Developments require that the competences of the supervisory authorities constantly evolve so that they are a match for the banks. This is more easily achieved by working together. As I see it, that is the single most important reason why Denmark naturally belongs within the strengthened banking cooperation – or the banking union, as it is also called.

If Denmark joins the strengthened banking cooperation, the Danish Financial Supervisory Authority will continue to play a significant role in relation to supervising Danish banks. But it will be supplemented with the Single Supervisory Mechanism, SSM, which involves the ECB and all other national supervisory authorities within the banking cooperation. The SSM is headed by the Supervisory Board, of which the Danish Financial Supervisory Authority will be a member. The single supervisory authority of the ECB leads the supervision of the largest and most complex banks within the cooperation.

Danish participation in this cooperation will boost the competences of the authority which is to scrutinise the largest Danish credit institutions. The single supervisory authority in Frankfurt can attract experts from all over Europe. And it is currently building up considerable experience via its supervision of a number of very large banks.

It is of paramount importance to financial stability that our supervisory authority has the competences to match the large banks. And it is equally important that we have a resolution authority with the necessary insight and resources to resolve the largest Danish banks.

It is considerably easier to build up and maintain such supervisory powers if you have many "customers". The quality of the resolution also increases if you gradually accumulate experience in resolving large banks.

The strengthened banking cooperation is a further development of the single market for financial services, which Denmark is part of. It strengthens the overall European supervisory powers and creates a more level playing field for credit institutions in Europe. We ought to be able to agree on opting in.

Joining the strengthened banking cooperation will be a natural step on the journey that financial regulation has taken over the past many years. By joining the banking cooperation, we will become part of a supervisory structure that will be a match for the large banks. And it is necessary to match them – in the interests of society and of the banks themselves.

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I started by talking about pulling rabbits out of top hats and sawing ladies in half. But don't get me wrong. Banking is no joking matter. Regulation of the banks is necessary as they play a special role in society.

Financial regulation and the financial supervisory function, which has now existed in Denmark for 100 years, are primarily there for the citizens and firms – not for the banks.

Banking and rules undergo continuous change. Take for example payment services, where costs to society are almost halfed since 2009. Increased competition and innovation is something we should welcome.

Future financial services and functions will perhaps be delivered by new actors. They may claim they are not banks and therefore should not be subject to supervision. However, the guiding principle should always be that it is the function which is regulated.

The new challenges for the supervisory authority are best solved in close and binding cross-border cooperation, which is precisely what the strengthened banking cooperation is about.

None of us know what tomorrow brings. But it is our duty to do our best to protect the fundamental financial functions of our society.

Thank you.