DANISH PARTICIPATION IN THE BANKING UNION

On 4 November 2014, as part of the establishment of the banking union, the European Central Bank, ECB, assumed responsibility for the supervision of the largest euro area credit institutions.[1] This was preceded by a thorough review of the balance sheets of the credit institutions concerned. The review has contributed to a substantial strengthening of the capitalisation and, hence, robustness of the European banking sector.

In Danmarks Nationalbank's opinion, in 2015 Denmark should apply to participate in the banking union. No uncertainties or outstanding issues justify a postponement of this decision.

Overall, Danish participation in the banking union is expected to make a positive contribution to financial stability in Denmark. Participation will entail stronger supervision of the largest Danish credit institutions compared with the situation today. At the same time, Denmark will participate in the Single Resolution Mechanism, SRM, where a central authority, the Single Resolution Board, SRB, will guarantee credible and consistent application of the rules saying that creditors must bear the losses of failing banks. In accordance with European legislation, the aim is to ensure the continuity of the credit institution's systemically important functions without relying on use of public funds. In addition, common cross-border standards and practices will provide a basis for enhanced competition in the market for financial services in Denmark – to the benefit of households and firms. This effect is expected to increase over time.

Furthermore, Danmarks Nationalbank believes that there is room within the banking union for the Danish mortgage credit sector as we know it. At the same time, Denmark will have a better opportunity to influence the development of European rules, standards and practices, thereby increasing the probability that future EU regulation adequately takes special national circumstances into account.

In some respects, participation in the banking union may have drawbacks relative to the current regime. For instance, publication of inspection reports and individual solvency requirements is not expected to become standard practice in the Single Supervisory Mechanism, SSM, and the supervision of various financial industries will be divided.

Here and now there will not be any substantial negative implications if Denmark opts for non-participation in the banking union. However, Denmark will have less influence on the future European rules, standards and practices developed within the areas of supervision and crisis management. At the same time, Danish credit institutions may find that their funding conditions deteriorate. They are likely to increasingly be compared with institutions in other European countries outside the banking union. In several of these countries the authorities are already planning to introduce stricter capital requirements for large credit institutions than those coming into force in Denmark.

1 Overall descriptions of the two pillars of the banking union, the Single Supervisory Mechanism, SSM, and the Single Resolution Mechanism, SRM, are provided in Danmark Nationalbank, *Financial stability*, 2nd Half 2013, Chapter 6, and Danmarks Nationalbank, *Financial stability*, 1st Half 2014, Chapter 6, respectively.

In Danmarks Nationalbank's overall assessment, the interests of Danish households and firms are best served by participating in the banking union.

A SAFER FINANCIAL SYSTEM

Cyclical downturns triggered by a financial crisis tend to be deeper and more prolonged than other cyclical downturns, and subsequent upswings tend to be weaker. Whether or not the government has intervened directly to ensure financial stability, this may put public finances under severe negative pressure due to declining revenue and rising expenditure. If future financial sector regulation and frameworks can reduce the risk of financial crisis without impeding lending, substantial socio-economic gains may thus be achieved. Therefore, the degree to which Danish participation in the banking union is assessed to promote financial stability is a key element in the analysis of the pros and cons of joining the banking union.

STRENGTHENED FINANCIAL SUPERVISION

In countries opting into the banking union, the responsibility for the most important supervisory tasks in relation to the largest credit institutions will be transferred to the ECB. Strong, credible supervision of credit institutions is as important to financial stability as appropriate rules on excess capital and liquidity. The Danish Financial Supervisory Authority is a fully competent supervisor, but in Danmarks Nationalbank's assessment, increased and external supervision of the Danish financial sector provides obvious benefits.

If Denmark opts to participate in the banking union, more resources and more expert experience will be devoted to the supervision of the largest Danish credit institutions. The system is based on close cooperation between the ECB and national supervisors, facilitating the development of specialist skills. The ECB will also bring extensive expertise in macroeconomics and financial stability. Moreover, the broader scope of the single supervisory mechanism will provide a better basis for comparison. That way, it will be possible to track trends across many large credit institutions, enabling early identification of build-up of risks. At the same time, transfer of the decision-making power to a central authority will reduce the risk of politicisation of supervisory activities and the risk of supervisors giving in to pressure from national interest groups.

Danish participation in the banking union ensures that the supervision of and requirements for Danish credit institutions are fully in line with European standards, and that Denmark is able to influence these standards directly. Given its size and central position, the ECB is expected to become Europe's leading supervisor and to be a symbol of quality and credibility. The ECB's standards and methodology of supervision must be expected to be the yardstick for credit rating agencies, analysts and investors. It should be noted that the ECB applies a risk-based approach to supervision, based on extensive qualitative and quantitative analysis, as is the case for the current Danish approach.

However, the harmonisation of standards and practices of participating member states could result in the phasing out of some existing national rules and standards. For instance, the existing Danish requirements in terms of publication of inspection reports and individual solvency requirements are not expected to become standard practice in the SSM. Danmarks Nationalbank finds that this would be inexpedient.

MORE EFFICIENT AND CREDIBLE CRISIS MANAGEMENT

Sensible rules and frameworks for the recovery and resolution of credit institutions play a key role in the work to ensure financial stability. The structure of these rules and frameworks primarily affects the practical resolution or recovery of a failing institution. At the same time, the crisis management framework is an important determinant in the organisational choice of credit institutions, the price at which they are able to obtain funding on an ongoing basis and thus also in the amount of risk they are able to assume.

As from 2016, the fundamental principle of crisis management in the EU will be that the owners and creditors of a failing institution must bear losses.[2] This will be effected to such an extent that

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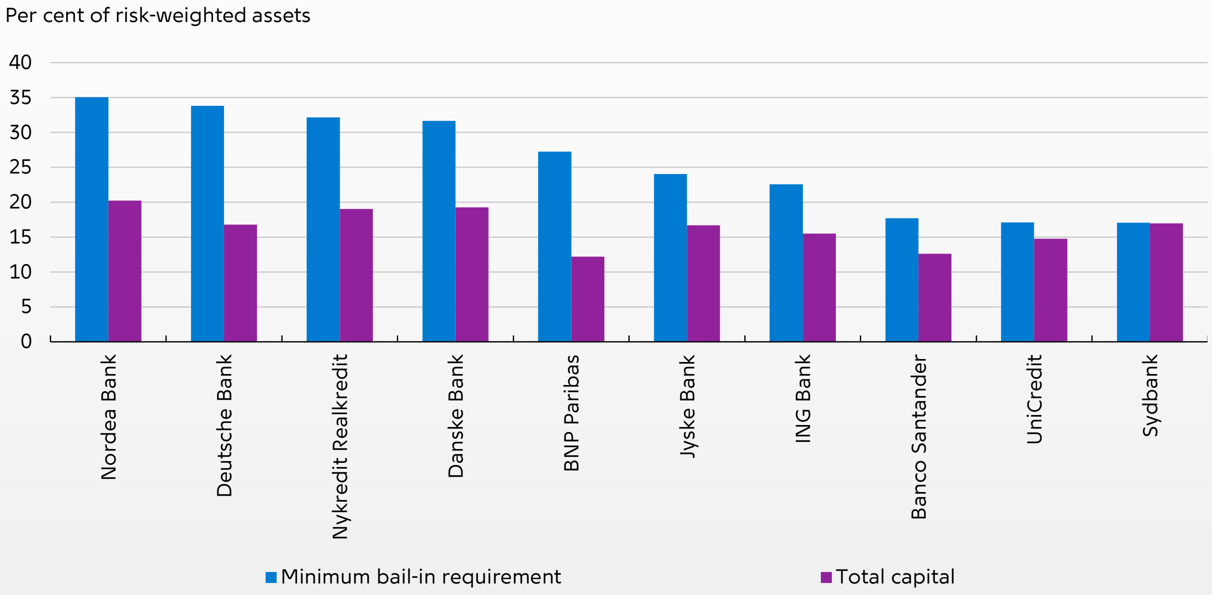
2 This description refers to Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, the "Bank Recovery and Resolution Directive". For an overall description of this directive, see Danmarks Nationalbank, *Financial stability*, 1st Half 2014, Appendix 3.

Current levels of capitalisation and the minimum bail-in requirements for selected large Danish and European credit institutions

Chart 1



Note: The blue bars have been calculated as 8 per cent of the institution's total liabilities divided by total risk-weighted assets at end of the 3rd quarter of 2014. The purple bars represent the institutions' total capital divided by total risk-weighted assets at the end of the 3rd quarter of 2014.

Source: SNL Financial and own calculations.

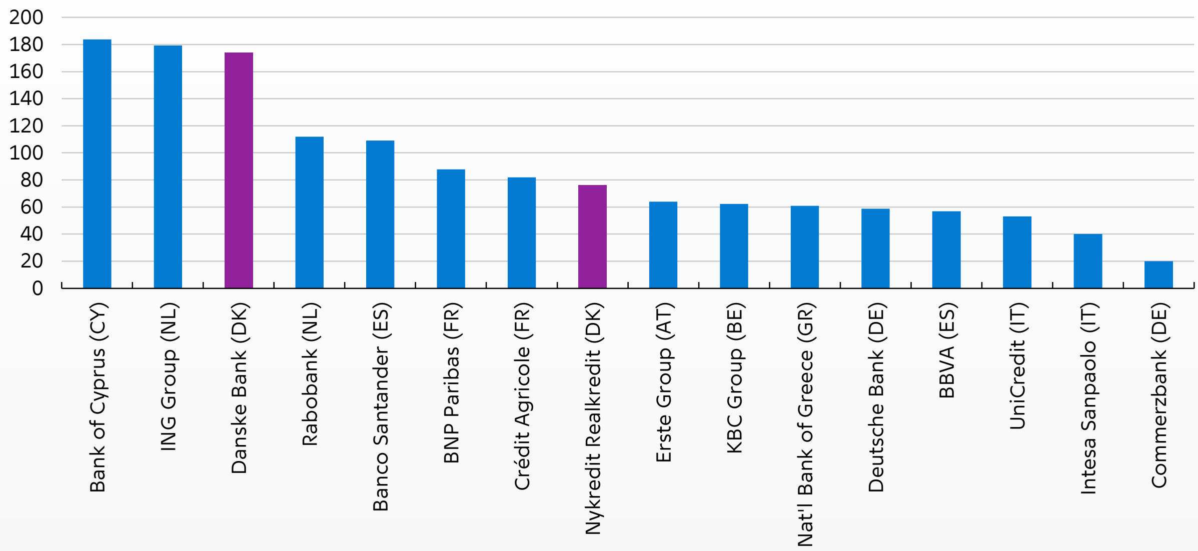
it will be possible to restructure the institution with a view to ensuring the continuation of systemically critical functions. This is key to ensuring financial stability. In such instances, the authorities must be able to write down capital instruments and the claims of unsecured creditors (or convert these claims to new equity), using the bail-in tool. Ultimately, it will also be possible to draw on a national resolution fund funded by contributions from the credit institutions. Nevertheless, in order to draw on the fund for a capital injection into the failing institution, at least 8 per cent of the institution's total liabilities must have been written down or converted. For several large Danish and Northern European credit institutions, this is equivalent to between 20 and 35 per cent of their risk-weighted assets, cf. Chart 1. Historically, accumulated losses of that magnitude have been very unusual. In other words, this is a stringent requirement, ensuring that EU resolution funds can be used for this purpose only in exceptional circumstances with high loss levels.

The same legal basis of crisis management will apply in the banking union and the rest of the EU. However, in Danmarks Nationalbank's view, substantial practice differences may occur between participating and non-participating member states – the reason being that responsibility for recovery and resolution in the banking union is transferred to the Single Resolution Board and that national resolution funds are merged into a Single Resolution Fund.

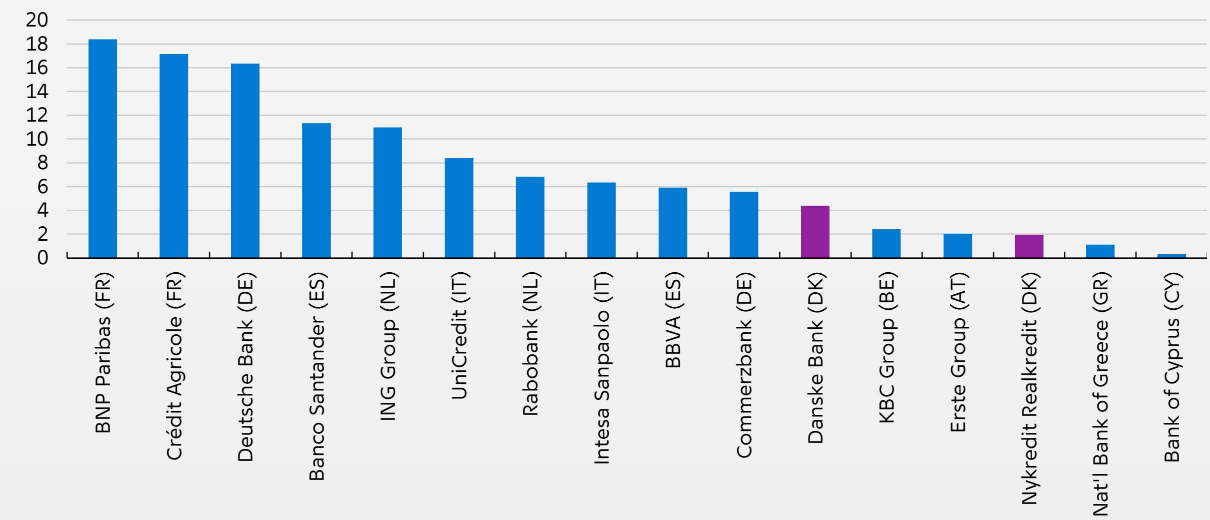
In the longer term, the Single Resolution Board is expected to evolve into the European institution with the best specialist skills and the most extensive experience in resolution work related to large credit institutions. This applies both to the development of credible resolution plans and to specific experience in how to separate and continue systemically critical functions in a resolution situation. Danmarks Nationalbank also expects the central decision-making process to facilitate swift and smooth recovery and resolution of cross-border banking groups. As for the latter advantage, it is expected to be relatively small in the short term due to the current limited exposure of Danish credit institutions to the euro area. In the longer term, greater economic and financial integration with the euro area member states could increase the importance of this aspect.

Chart 2

Balance sheet total of selected credit institutions relative to home country GDP, 2013



Balance sheet total of selected credit institutions relative to the euro area and Denmark's total GDP, 2013



Note: Please note that the y axis values differ in the two charts. Data are presented at group level. Selected credit institutions are the two largest groups with Denmark, Germany, France, the Netherlands, Italy and Spain as home country, and the largest groups with Belgium, Austria, Greece and Cyprus as home country.

Source: ECB, SNL Financial and own calculations.

The fact that all resolution decisions regarding the largest credit institutions are made by a single, central authority will also make it more likely, and therefore credible, that owners and creditors will actually bear losses in a crisis situation. A contributing factor will be the fact that individual credit institutions which account for a very large share of the home country's economy will have a considerably smaller weight in the economies of all participating member states, cf. Chart 2. Thus, no one credit institution will be so large that the system will not be able to handle a resolution respecting the principle that owners and creditors must bear losses.

The largest credit institutions may currently have a funding advantage due to the assumption of financial support from the government or bail-out of unsecured creditors in a crisis. In Danmarks Nationalbank's view, this advantage will be smaller in the banking union, which will strengthen the incentive for the largest credit institutions and their creditors to have sound risk management programmes in place.

Moreover, the single, much larger resolution fund will be able to better ensure that the financial sector, and not the public sector, will cover losses and costs of recapitalisation in the few extraordinary cases where this may be needed. Access to the Single Resolution Fund, which, when fully built-up, will be about 45 times larger than the national Danish fund, will also increase the likelihood that the fund has sufficient funds for purposes other than capital injections.[3] The fund may e.g. provide guarantees, grant loans and purchase assets from a failing institution in order to promote an orderly resolution process. The fund must cover the needs of all participating member states, but it is an obvious advantage that the Single Resolution Fund must be restored to its target size by all credit institutions in the participating member states – not just the remaining institutions in a single member state.

The Single Resolution Board will start operations in January 2015 and will assume responsibility for and have access to all crisis management tools in the participating member states from 2016. Consequently, it will be a while before a clear pan-European practice of crisis management of large credit institutions will emerge. If Denmark opts for non-participation in the banking union, the same uncertainty will apply in Denmark. A new Danish resolution act will enter into force in 2015, and there is no direct experience with resolution of a large institution.

3 The Single Resolution Fund's target size has been set at 1 per cent of the covered deposits of all credit institutions in the participating member states. According to calculations by the Commission, this is an estimated 55 billion euro, based on institutions in the euro area. Initially, the target size of a Danish national fund will be 1 per cent of the covered deposits of all Danish credit institutions, i.e. approximately kr. 8.5 billion or 1.1 billion euro (based on deposits as at 30 September 2014).

A MORE EFFICIENT MARKET TO THE BENEFIT OF CUSTOMERS

Over the last five years, great strides have been made in establishing stricter and more uniform rules for EU credit institutions. A main objective has been to restore the soundness of the financial sector and thus its ability to contribute efficiently to funding solutions. Another main objective has been to ensure a uniform framework for credit institutions across the EU, thereby creating the conditions for a more efficient single market for financial services.

Much of the legal basis for financial enterprises in the EU is now the same, for instance in terms of capital and liquidity requirements and requirements of deposit guarantee schemes and resolution regimes. As a result, national options have been reduced, but not eliminated. National supervisors and resolution authorities still have extensive options as regards a number of elements. Various EU member states also continue to have special national rules and legislation for the financial sector. There are obvious advantages to the possibility of having and using national options and special rules, but also drawbacks. In some cases, it is expedient to adjust the common regulatory framework to special national rules; this may promote financial stability and provide for a wide range of services in demand. On the other hand, special national rules increase the risk of creating an unlevel playing field, especially across national borders.

The banking union will provide one interpretation of how the supervisory and resolution rules are to be implemented. Within the Single Supervisory Mechanism, SSM, and the Single Resolution Mechanism, SRM, clear standards of methodology, reporting requirements, etc. will be established. More uniform standards and enforcement of such standards ensure a more level playing field. This, in combination with e.g. authorisation (and withdrawal of authorisations) by a single, central authority, will make it much easier to conduct cross-border financial activities in the banking union. Regulatory costs will be reduced, facilitating economies of scale, which may lead to stronger price pressure and a wider supply of services.

Moreover, the banking union is expected to help even out differences in the funding costs of large and small credit institutions, cf. the section above on more efficient and credible crisis management. Some of these differences are rooted in expectations among the owners and investors of the largest credit institutions that the government will intervene in a crisis ('too big to fail'). Elimination of these distorting expectations will be a clear advantage to small, national credit institutions.

For large credit institutions with cross-border activities, it will be an advantage that the supervisory dialogue regarding the full scope of their activities in all participating member states is conducted with a single supervisory counterpart.

The coverage of the Single Supervisory and Resolution Mechanisms only comprises a subset of the financial markets and not, for example, investment funds, stock exchange trading, insurance and pension. This could constitute a drawback for participation in the banking union, since Denmark currently has fully consolidated financial market supervision under the auspices of the Danish Financial Supervisory Authority. Further, rules and responsibilities in a number of key areas regarding credit institutions remain at the national level, e.g. regarding consumer supervision, accounting and bankruptcy. During a transitional period, the banking union's separation of responsibilities between the central and the national levels in the single market for financial services could pose some challenges.

Overall, Danmarks Nationalbank finds that Danish participation in the banking union will strengthen competition in the market for financial services in Denmark. This may lead to more favourable composition of price, services, advice and product ranges for banking customers, both households and firms. While the immediate impact is expected to be limited, it will grow over time.

FURTHER CONSIDERATIONS

DANISH MORTGAGE CREDIT

Danmarks Nationalbank finds that, overall, the interaction between the rules governing the SSM and existing Danish mortgage credit legislation provides a sensible framework for the ECB, in partnership with the Danish Financial Supervisory Authority, to supervise Danish mortgage banks, taking their special business model into account. Thus, the ECB must apply national legislation, transposing EU directives into national law and implementing options under EU regulations. Moreover, the ECB is required to design its supervision in a way that respects the diversity of credit institutions, including size and different business models. The point of departure is that diversity is to the benefit of the entire European financial sector.

As is also the case for all other institutions concerned, in the banking union elements of the Danish Financial Supervisory Authority's current practice would likely be adjusted to the ECB's supervisory standards. This could e.g. impact the possibility of using intra-group guarantees as top-up collateral. Such moves towards standardisation affecting the mortgage credit model need to be clarified in dialogue with the ECB before Denmark's possible accession to the banking union.

If Denmark participates in the banking union, full understanding of the Danish mortgage credit system within the SSM and the SRB will be easier to achieve. Given that future EU legislation is expected to be formed by the standards and experience built up and applied in the banking union, Danmarks Nationalbank finds that participation in the banking union also increases the probability that the Danish mortgage credit model will be taken adequately into account.

INSTITUTIONAL FRAMEWORK

The institutional framework for the banking union is adjusted primarily to the euro area member states in view of the ECB's role as both central bank and supervisor, among other factors. As regards non-euro area member states, this has been accounted for by the establishment of the ECB Supervisory Board on which all participating member states are represented. Special protective measures have also been introduced to allow non-euro area member states to participate on reasonable terms.

An institution subject to direct supervision by the ECB may appeal supervisory decisions to an independent Administrative Board of Review under the ECB. The Board of Review decides on the case by issuing an opinion which the Supervisory Board must take into consideration in its proposal for a new decision to be presented to the Governing Council. The new decision is deemed adopted unless the Governing Council objects to it within 10 days. Where decisions made by the ECB are involved, this appeals procedure replaces the current access to appeal decisions made by the Danish Financial Supervisory Authority to the national Company Appeals Board. Ultimately, ECB decisions may be brought before the European Court of Justice.

DIFFERENT STARTING POINTS FOR PARTICIPATING MEMBER STATES

Danmarks Nationalbank believes that the structure of the banking union is based on the right premises and contains specific elements to limit the risk of costs associated with banking problems in one of the participating member states being passed on to the other member states. The central element to this assessment is that the authority to make major supervisory and resolution decisions is transferred to central authorities. Danmarks Nationalbank expects the new regulations on recovery and resolution to be applied in a principled and consistent manner. The key is in full respect for and use of the bail-in principle.

The Asset Quality Review (AQR) and the associated stress test of all large credit institutions in the banking union, completed by the ECB this October, have contributed to improving the capitalisation of European credit institutions.[4] The AQR has also improved transparency and comparability across member states, thereby ensuring the ECB a strong foundation as supervisor. There will be a long transition period – until 2024 – before contributions to the Single Resolution Fund from credit institutions in one member state can be fully used to address exceptional threats to financial stability in other participating member states. The ECB is also considering whether, as a supervisor, to implement restrictions on large exposures of a credit institution to its home country in the form of government bonds. This would help to weaken the link between problems of credit institutions and public finances in an individual member state.

THE IMPACT OF NON-PARTICIPATION

Denmark is well equipped to address potential problems in the financial sector. The Danish Financial Supervisory Authority is strong and credible and has hands-on experience with crisis management solutions (for small and medium-sized banks), minimising the use of public funds. In 2015, the EU Bank Recovery and Resolution Directive will be transposed into Danish law. The financial sector in Denmark is very large relative to the national economy, but the largest banks have high excess capital adequacy and are robust to macroeconomic shocks. Overall, Danish government finances are healthy.

Danmarks Nationalbank expects that, here and now, there will not be any substantial negative implications if Denmark opts not to participate in the banking union. Danish credit institutions will continue to take part in the single EU market for financial services, although without the deeper integration that the banking union represents. Danish authorities may retain a higher degree of national autonomy in terms of supervision and crisis management.

On the other hand, with or without Danish participation, the banking union will impact the broader context in which Danish credit institutions operate. For instance, the start and ongoing development of the banking union is expected to change the way in which new regulation of the EU financial sector comes about. Outside the banking union, Denmark will have less influence on European rules, standards and practices.

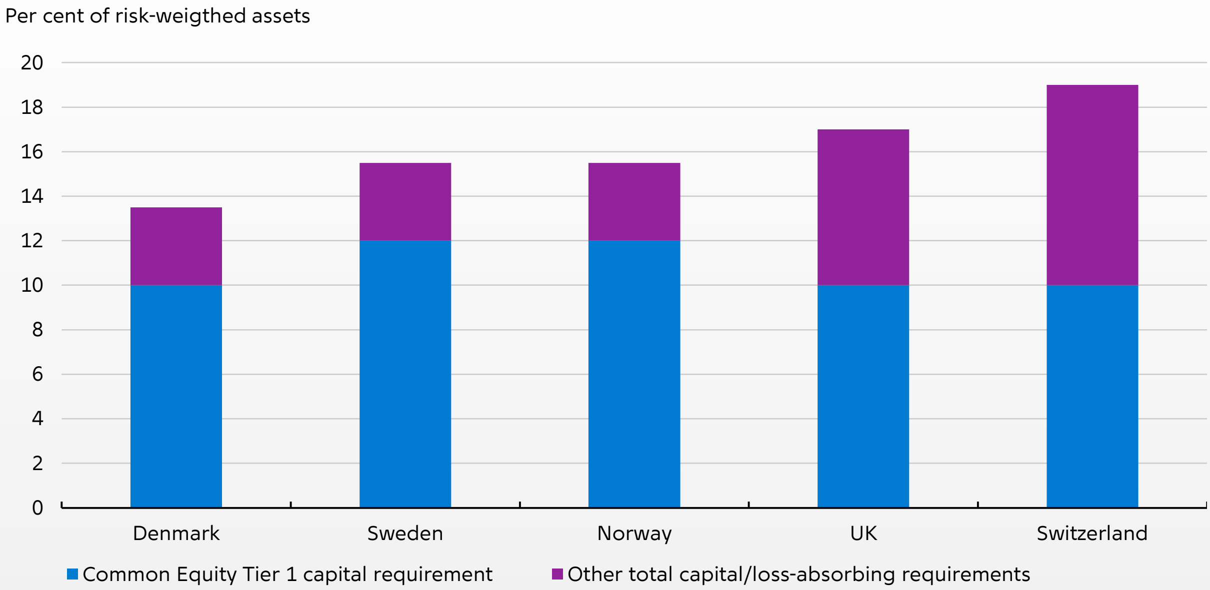
The banking union will also affect the way credit rating agencies and international investors view participating and non-participating countries. Danish credit institutions outside the banking union will not obtain the seal of approval which ECB supervision is expected to imply. A small country that deviates from the common standard – and the credit institutions of that country – will always have to use many resources to explain its different rules and standards. Understanding and following the special Danish rules and arrangements will entail extra costs for international investors. Other things being equal, these factors will have an overall negative impact on the relative funding conditions of Danish credit institutions.

Should Denmark opt for non-participation in the banking union, Denmark can to a greater extent expect to be compared with other Western European non-euro countries states with large financial sectors, i.e. the UK, Sweden, Norway and Switzerland. Capital requirements to be met by the largest credit institutions in these countries

4 Cf. Danmarks Nationalbank, *Financial stability*, 2nd Half, Chapter 2 and Box 2.3.

Fully phased-in capital requirements for the largest credit institutions in Denmark, Sweden, Norway, the UK and Switzerland

Chart 3



Note: The chart shows the expected requirement from 1 January 2019 for the most systemic credit institutions in the various countries, stated as a percentage of risk-weighted assets. The requirements include different capital and debt instruments for the various countries and hence they are not fully comparable. The chart does not include requirements for countercyclical capital buffers and Pillar 2 requirements for any country. Effects from higher risk weight floors for housing exposures in Sweden, Norway and Switzerland have not been included.

Source: Danish Ministry of Business and Growth, Financial Supervisory Authority of Sweden, Financial Supervisory Authority of Norway, HM Treasury UK, Swiss Federal Council.

are generally tougher than in Denmark, cf. Chart 3. Moreover, these countries have tightened, or are considering tightening, the rules for measuring credit risks on mortgage credit more than is currently the case in Denmark.

Danmarks Nationalbank finds that a Danish 'No' to the banking union (or postponement of the decision whether to participate) should be followed by broad reassessment of whether the existing framework of supervision, crisis management and preparatory measures is adequately adjusted to this new reality. This applies both to the resources and skills of the relevant authorities and to specific rules and requirements, especially as regards the largest credit institutions. Creating closer, more formalised partnerships with the supervisory and resolution authorities of other countries will also be important.