NEWS

DANMARKS NATIONALBANK 200 YEARS 2018

DANMARKS NATIONALBANK

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Three new capital requirements have attracted attention

Increasing equity by one krone does not cost one krone

The banks should have larger buffers so that they are more resilient in an economic crisis, which typically leads to losses on lending. That is why the banks have been met by stricter capital requirements since the financial crisis.

The crisis that erupted 10 years ago had a devastating effect on Denmark. Subsequently it was assessed that the cost for the Danish society was around kr. 200 billion in loss of output.

From time to time it has been indicated that higher capital requirements will cost the banks an equivalent sum. That is not correct, Danmarks Nationalbank points out in an analysis of the impact of such requirements on the banks' funding costs.

The capital requirements increase the banks' equity, but the cost of increasing equity by one krone does not amount to one krone. Instead, the cost amounts to a percentage of the the extra krone which reflects the shareholders' required rate of return. At the same time the increase in equity capital replaces an equivalent volume of debt, meaning that the banks will no longer have to service that part of the debt. Instead, they must remunerate the increased equity capital.

Three measures strengthen requirements for banks

Activation of the countercyclical capital buffer

New requirement for own funds and eligible liabilities, MREL

Completion of Basel III

But with more equity the banks will be able to absorb correspondingly larger losses. In other words, the risk for both creditors and shareholders decreases when the equity capital increases. The lower risk is normally reflected in lower interest rates on the bank's debt and a lower required rate of return on its equity capital. This means that the additional costs of holding more equity cannot be calculated as the simple difference between the required rate of return on equity and the rate of interest on the debt.

The analysis shows that the equity capital of a bank can be increased by retaining a larger share of profits rather than e.g. distributing dividend to shareholders. This will not leave shareholders worse off than if dividend had been distributed. Distribution of dividend gives shareholders an immediate liquidity benefit, but at the same time the price of the bank's equities falls. If part of the profit remains in the bank, the need for debt financing is reduced.

It could be a concern that lending by banks would decline as a result of higher capital requirements, but Danish experience from the transition to Basel III shows that lending has not fallen.

The new capital requirements have been introduced to ensure that banks can handle the losses incurred during a financial crisis. That will increase the robustness of the entire banking system.

Three new measures have attracted particular attention. Firstly, the countercyclical capital buffer has been activated for the first time in Denmark. This means that the banks are required to increase the level of capital "cushion" in good times. In addition, banks must meet a requirement for own funds and eligible liabilities which reduces the risk that the government will have to step in with financial aid if a failing bank is to be resolved. And finally, the completion of Basel III means that large banks and mortgage banks must fund a larger share of their loans with equity.

See the full capital requirements analysis at Danmarks Nationalbank's website (*link*).

ABOUT NEWS

News are news articles based on analyses, working papers or other longer texts from Danmarks Nationalbank. News primarily address journalists, politicians, government officials, specialists and others who want to be updated on current topics.

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SECRETARIAT AND
COMMUNICATIONS

DANMARKS NATIONALBANK
200 YEARS
2018

In 2018, Danmarks Nationalbank celebrates its 200th anniversary. Danmarks Nationalbank's overall objective has been more or less unchanged during its 200-year life – to "maintain a safe and secure currency system" and "facilitate and regulate the traffic in money and the extension of credit", as the Danmarks Nationalbank Act says.

One of Danmarks Nationalbank's objectives is thus to contribute to the stability of the financial system. Increasing the banks' buffers and capitalisation so that they are resilient to crises is a key prerequisite of financial stability.

Banking and financial crises – history tends to repeat itself

The last 150 years have seen multiple banking and financial crises. The monetary crisis of 1857-58 was the first one. Since then, we have had seven banking and financial crises in Denmark.

The crises have often called for an overhaul of the regulation of the financial sector to make it more robust. A case in point is the savings bank crisis of 1876-78, which led to the first Danish savings bank act, while the construction and banking crisis in 1907-09 resulted in the first commercial bank act.

The most recent crisis was triggered by turmoil in the US financial markets in the summer of 2007 following a dive in the US housing market. The crisis spread to Europe and a number of Danish banks became distressed and were unable to continue as independent institutions. From the beginning of 2008 until August 2013, a total 62 of Danish banks ceased to exist.

The central government had to introduce a number of bank rescue packages during the crisis. Bank Rescue Package 1, which was adopted in October 2008, included a guarantee scheme ensuring full coverage of all depositors' and other unsecured creditors' claims on banks.

After the crisis, multiple initiatives were launched, in Denmark and internationally, to make the financial system more resilient and to seek to prevent similar serious crises from arising in the future. For example, the requirements for banks' capital and liquidity were tightened.

Furthermore, arrangements have been made to ensure orderly resolution of even large banks if they become distressed again. The purpose is to ensure that the key functions of a failing bank can be continued so that customers are not compelled to find new bankers at short notice. Another objective is to ensure that the owners of and investors in a failing bank – not the taxpayers – bear the losses in connection with resolution.

Loan impairment charges 1875-2016

Per cent of loans and guarantees