*Per Callesen**

NEW MACROPRUDENTIAL AND MICROPRUDENTIAL SAFETY NETS

1. INTRODUCTION

In my presentation I will focus on macroprudential policy issues. Remarks will also be made on the treatment of government bonds in financial regulation as well as resolution regimes. I think both issues are important, also from a macroprudential perspective.

The crisis made it clear that we need a new framework and a battery of instruments for macroprudential policy. One way to define macroprudential policies would be policies targeting system-wide financial stability which are conceptually in-between macroeconomic instruments on the one hand and firm-level microprudential instruments on the other hand. A comprehensive framework for macroprudential policies has not been developed yet, but we are moving closer to it. The ESRB is an important step. International financial regulation is working at high speed. National macroprudential institutions are at a somewhat earlier stage.

In terms of the framework for national macroprudential institutions, we need to ensure focus, develop instruments and take specific actions. One of several challenges is that a variety of institutions such as legislators/governments, central banks and supervisors are in charge of the instruments.

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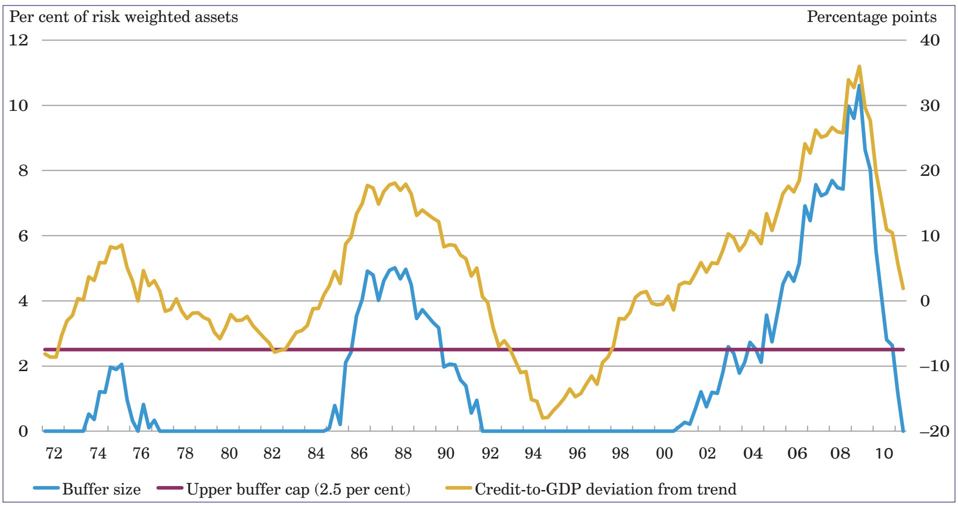
A national macroprudential council is a good idea. It can preferably be anchored at a central bank level, where it can rely on sufficiently independent analyses and where the risk of getting trapped by firm-specific issues is small. But the council can be broader and include ministries, supervisors and independent experts. It is not realistic to have a broad shift of decision power on all instruments to such a council. But strong peer pressure is needed. We need formal recommendations, a voting procedure and a comply-or-explain system.

2. MACROPRUDENTIAL INSTRUMENTS

When it comes to macroprudential instruments, I will start off with the countercyclical capital buffer. Looking at the credit-to-GDP deviation from trend, a buffer based on credit growth – such as proposed by the Basel committee – had clearly been helpful in my country before the crisis. The calculation of the historical credit-to-GDP gap in Denmark shows that a cap on the buffer requirement of 2.5 per cent would not have been very ambitious, cf. chart 1.

Chart 1. Countercyclical capital buffer with no upper cap



Source: Danmarks Nationalbank.

The next crisis will likely differ and it would be risky to base the future countercyclical buffer entirely on credit growth. Other important indicators can be:

- ❖ Credit-to-GDP gap in households and non-financial enterprises, respectively
- ❖ General asset prices, houses and equities

- Balance sheets and leverage
- Depreciations and interest margins
- Market indicators for banks, stock prices and CDS-spreads
- Lending surveys.

We need a broader set of instruments and in that context one can raise concerns about the Commission's CRD-IV proposal, which strives for maximum harmonization. There are good arguments for maximum harmonization, as it ensures a level playing field. However, we have to shift the balance of emphasis – at least to some extent – from promoting the small annual efficiency gains in normal times to preventing the rare but large losses in crises-times.

The Commission suggests only three macroprudential instruments for use by national authorities: The countercyclical buffer, LTV and risk weights. I will argue that we need more. Candidates include liquidity, large exposures, transparency and dynamic provisioning.

On provisioning, I am among those who are skeptical towards the current accounting rules on provisioning which were implemented from 2005. The risk associated with lending is taken when the loan is provided, not after asset prices have fallen. Accounts grossly overstated the underlying profitability of financial institutions and fooled investors into excessive risk-taking. I understand that the rules on provisioning are being revised, but is it sufficient?

A final point on macroprudential instruments: One should never underestimate how difficult it is to take unpopular decisions in good times. Strong macroprudential councils can help a lot. But automaticity is better. Automaticity could be built into legislation directly, such as with dynamic provisioning. The countercyclical buffer is also a strong potential automatic stabilizer. Other indicators could equally trigger specific action.

3. LIQUIDITY

While we move ahead with better macroprudential regulation, we should be careful not to introduce new legislation which can be destabilizing. One such risk relates to the upcoming liquidity requirements. Sound requirements for liquidity may be helpful, but the definition of liquidity is not trivial and there are large institutional differences between countries to be taken into account. One can make big mistakes.

The proposed initial Basel standards on liquidity suggest preferential treatment of all government securities when counting liquid assets towards the LCR. According to that proposal only 40 per cent of the liquidity requirement can be met by, for instance, covered bonds, irrespective of their quality. Such preferential treatment of government bonds may be helpful in boosting demand for bonds from governments facing financing challenges. However, as regards financial stability, such preferential treatment would hardly be credible. It could potentially be destabilizing as markets are unlikely to perceive all government bonds as being fully liquid at all times.

My point here is not that the financial sector in my own country will have no chance of meeting such requirement due to a "shortage" of government bonds. Banks in Denmark would by and large be forced to buy up close to 100 per cent of all outstanding government debt to meet the requirement. That national problem can in principle be solved second best with an exception for countries with insufficient amounts of Basel standard "liquid" assets, in this case government bonds.

My concern is the financial stability in Europe at large and that I find it conceptually wrong to group the liquidity of assets solely on the basis of the institutional origin of the issuer. One thing is to insist that government securities are always risk free. For such securities to always be fully liquid is an even stronger (and less credible) requirement. Note that liquidity in this context is solely the marketability of the assets, namely the ability to sell the assets at short notice, at predictable prices and without creating market disruptions. It is positive that the Commission in the CRD-IV proposes to base the definition of liquidity on their actual performance ensuring their necessary qualities. That is at the same time safer, more credible and economically sound.

As an example, I can add that the actual liquidity performance of Danish mortgage bonds has been strong even at the worst of times during the crisis, and as strong as that of government bonds.

4. RESOLUTION SCHEMES

Finally, I will make a few remarks on resolution schemes. Resolution is of course at first glance more about crisis management than macroprudential policies. But the two issues interact. On one hand, the absence of credible resolution regimes gives rise to well-known moral hazard problems and put tax payer money at risk. On the other hand, evidence of creditor losses can trigger rating down-grades and upset funding due to contagion.

The experience of the Danish resolution regime may have some interest. Insightful people claim that they followed our resolution policies with interest. As a starting point, I would like to point out that all EU countries share the same deposit guarantee system – with a ceiling of 100,000 Euros – and EU competition law suggests no special treatment to creditors of banks as compared to creditors of other private enterprises. However, in Europe – unlike the US – practice has been much more lenient. Authorities have, on a case by case basis, done their utmost to manage resolution in such a way that also uninsured depositors and senior bond holders bear no losses. In part, this may have been due to an absence of other practical arrangements to ensure the stability for bank customers and payment systems etc.

The point of the Danish resolution regime is that we found a practical way to manage resolution over a weekend including full take over of the bank, allocating losses as appropriate and still ensuring that all customers have continued access to their savings and payment services on Monday morning. That is not possible through normal bankruptcy proceedings.

According to the Danish resolution regime, the distressed bank is taken over by our so-called Financial Stability Company (FSC). Based on a government relending facility, the FSC injects capital and liquidity into a bridge bank. Shareholders, providers of hybrid capital and subordinated debt holders bear losses. For unsecured creditors and uninsured depositors an initial haircut – if necessary – is applied. The haircut is based on a very conservative gone-concern assessment of the assets by independent auditors. The creditors will typically receive more funds later when a new assessment is made after 3 months and eventually when all assets are sold. For the first bank (those dealt with under the resolution regime have been small banks) managed under the system in early 2011 an initial haircut of 41 per cent was 3 month later revised down to 15 per cent.

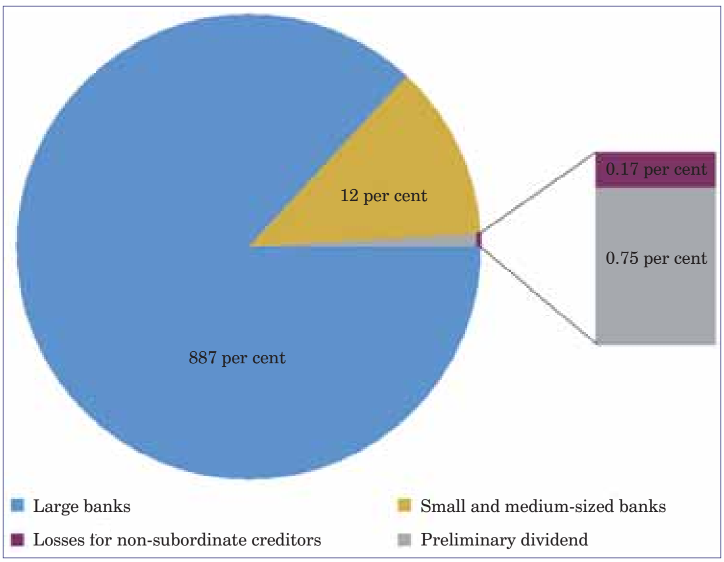
Four points should be made on the Danish experiences so far:

- First, this is the preferred kind of solution. Distressed banks should acknowledge their trouble much earlier and seek mergers with more healthy banks. In September 2011, another small bank was managed in such a manner, assisted by some new legislation allowing for a dowry provided by the government on the basis of the imputed loss otherwise to be born by government due to losses on government guaranteed funding. Admittedly also, the regime is unlikely to be applied for large banks were they to become distressed.
- Second, the heated public debate on the resolution regime has been out of proportion. The vast majority of the Danish banking sector is in good shape. The larger banks all passed the 2011 EBA-stress test with high margins. Among more than 100 small banks, most have sound fundamentals. But there is a minor tail of vulnerable small banks which before the crisis exposed themselves not least to risky property developers. The two failed banks in Spring 2011 made up less than 1 per cent of the sector. The temporary haircut of 15 per cent applied for them thus compares to less than 0.2 per cent of total non-subordinated debt in Danish banks, cf. chart 2.
- Third, according to anecdotic evidence, foreign funding for other Danish banks was nevertheless negatively affected during spring, possibly triggered by rating down-grades of the so-called systemic support element for banks, and an exaggerated public debate. It is more difficult to offer hard evidence of funding

stress during the spring. Funding definitely took place and in the context of a fairly healthy liquidity position other banks no doubt postponed new funding contracts. The stress observed in funding markets in the second half of 2011 appears to be due to the general European issues.

❖ Fourth, banks appear to be speeding up their consolidation efforts across the board, pointing to a healthier sector a few years ahead, although possibly to some extent, at the expense of their lending. Such a sound resolution regime will contribute to a healthier sector looking ahead, but the transition is harder in the absence of a level playing field. Several other Member States are moving in the same direction, although with no actual resolution being implemented yet on those lines. We therefore look forward to the EU-Commission's proposal for a common resolution and crisis management framework and hope a sound proposal will be backed by Member States.

Chart 2. Non-subordinated debt in Danish banks



Source: Danmarks Nationalbank.