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The Purpose of Effective Financial Supervision

Risk Based Supervision - Danish experiences

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The views expressed in this lecture is my own and do not necessarily represent views in IMF or in the Danish FSA

For almost 100 years ago - around 1930 - there were a great recession in western world. It also hit Denmark with great strength and gave big problems for many banks. The problems were so great that the state had to help with a large support. When a crisis hits the financial system you will normally see that the politician want to tighten the rules in the law. It is the price for the banks. And the same occurred in 1930. And precisely the same is happening here in the years after 2008.

In 1930 the result of the political demands for more restrictive rules was an entirely new banking law in Denmark. There were not nearly as many paragraphs and rules as there are today in the international legal regime.

Sometimes I think that we now have too many rules and also too complicated rules in the international framework to day. But back to 1930 in Denmark – here we got some really important new rules. One of these rules was that there must be limits to how big a customer must be in relation to the size of the equity in the bank. This rule was important and it still is.

Another rule that was introduced in 1930 was that loans to costumers must be assessed with great caution and prudence - and even if there is a relative low risk the bank has to make provisions.

In notes to the Act were highlighted:

"Much better to have too many than too few provisioning."

The Bank should rather be much too careful than the opposite. This was when Denmark introduced a precautionary approach. If there are doubts whether the customer will be able to repay a particular loan then the bank should make a provision related to that same loan. Thus, pay the bill for the additional risk immediately. The Parliament decided also to give an incentive for the banks that would cause banks to act more quickly and be particularly prudent when making provisions on their loans to customers. The incentive was that banks could deduct all their new provisioning in the tax statement, even if there had been no losses yet. It was clever. It is always useful with a good incentive structure. I usually say that a good incentive structure especially works very well for animals, children and banks.

When I some years ago wrote a book about the Danish Banking system I read the minutes of the debate in the Danish parliament back in 1930. Of course Banking Supervision was heavily criticized in the newspapers and when there is criticism in newspapers there will be a follow up by the politicians. They will have the same criticism. You see just the same today. I did also notice in the minutes of the debate in the Parliament in 1930 that there was a member who had a good point: He said that one of the worst jobs in the world must be the Director General in the Bank Supervision. If it goes well then no one puts attention to the work. And if it goes bad for a bank it is because The Banking Supervision has made mistakes. There is nothing new under the sun - as we say in Denmark.

But why do I emphasize this importance of having prudent valuation principles for a bank's loan portfolio? It is because in 2005 new international valuation principles were introduced. Now it was important that the valuation of the loan portfolio was neutral. Denmark introduced these new neutral valuation principles from start in 2005. It was not wise. Anyway it was very bad timing. The Danish banks could in 2005 take as income several billion Danish kroner from the provision accounts that were built up in good times over many years.

Because of these changes, banks had some great years from 2005 to 2008 when the financial crisis hit. It was easy to be a bank. They could book most of their hidden reserves which would otherwise have given them the strength to stay the course in bad times. But the party led to problems for some banks.

As I mentioned earlier the hidden reserves could be used for growth. And that just happened. And the new solvency regime with small capital claims if small loss was also not good for stability. So many banks grew tremendously in the years up to the financial crisis in 2008. And some of these banks had to be closed. So therefore I recommend to all Banking Supervision Authorities to make sure to have extremely prudent valuation rules for banks loan book.

In my opinion prudent valuation of the bank loans to customers is much better for stability in the banking sector than high solvency requirements. A valuation system which provides provisioning to be "too little and too late" gives background for systemic instability in the financial sector. The solvency rules in Basel 3 try to repair the damage by introducing additional solvency requirements if there is a boom in the economy. This new solvency rules can repair a part of the damage. But rules which dictate that increased risk must be paid immediately in cold hard cash are most effective. As I mentioned before it is a good thing to have a strong incentive to make prudent provisioning. Such a strong incentive is to give banks possibility to deduct provisioning in the banks tax bill. This will certainly increase the willingness for banks to make provisioning. One can always find other ways of taxing banks if desired.

With this simple, but tested and tried lesson, I will continue and discuss in more general terms about so called Risk Based Supervision. In that context I have with interest read the Annual Report 2014 for FME here in Iceland. In the annual report there are many good considerations. In the opening paragraph, I noticed the statement about what Bank Supervisory Authority can do and what they cannot do.

I have a slide to give these broad statements.

(Slide 1)

- The authorities cannot prevent the failure of a bank
- The authorities can contribute to increase resilience for the bank
- The authorities can with the right tools limit or mitigate the effect of failure
- The authorities can restrict the risk taking

All these activities are very important for The Supervisory Authority. I also noticed in the annual report 2014 that FME consider what an effective supervision shall do. These headline I have on the next slide.

(Slide 2)

The Authorities shall

- Monitor the compliance to laws
- Monitor risk forward
- Strong equity and liquidity position is not enough
- Early identification of problems
- Shall have knowledge to understand the main risk factors
- Be able to make the right priorities
- Allocation of resources in the most efficient way.

And allocation of resources in the most efficient way is precisely what you can call Risk Based Supervision.

And here in the next slide I have some important statements in relation to Risk Based Supervision.

(Slide 3)

- Calculate the risk by possible coming events
- Look for impact - if foreseeable
- Stress test - using probabilities for the effect
- Impact assessment
- Use risk mitigation measures
- Proactive supervision
- Not all regulated entities are equal
- The limited resources shall be used in a way that provides the best goal achievement

These are the goals. But for sure it is much easier to write these principles than to work with them in the real world. In Denmark we use a special model in relation to Risk Based Supervision. The model is called “Supervisory Diamond”.This model is used particularly in order to become more proactive in the Danish Supervisory Authority and to give input to the assessment of the individual bank's business model.

Later in my speech I will come back to this model. But first I will give a little information about the situation up to the financial crises in Denmark starting in 2008.

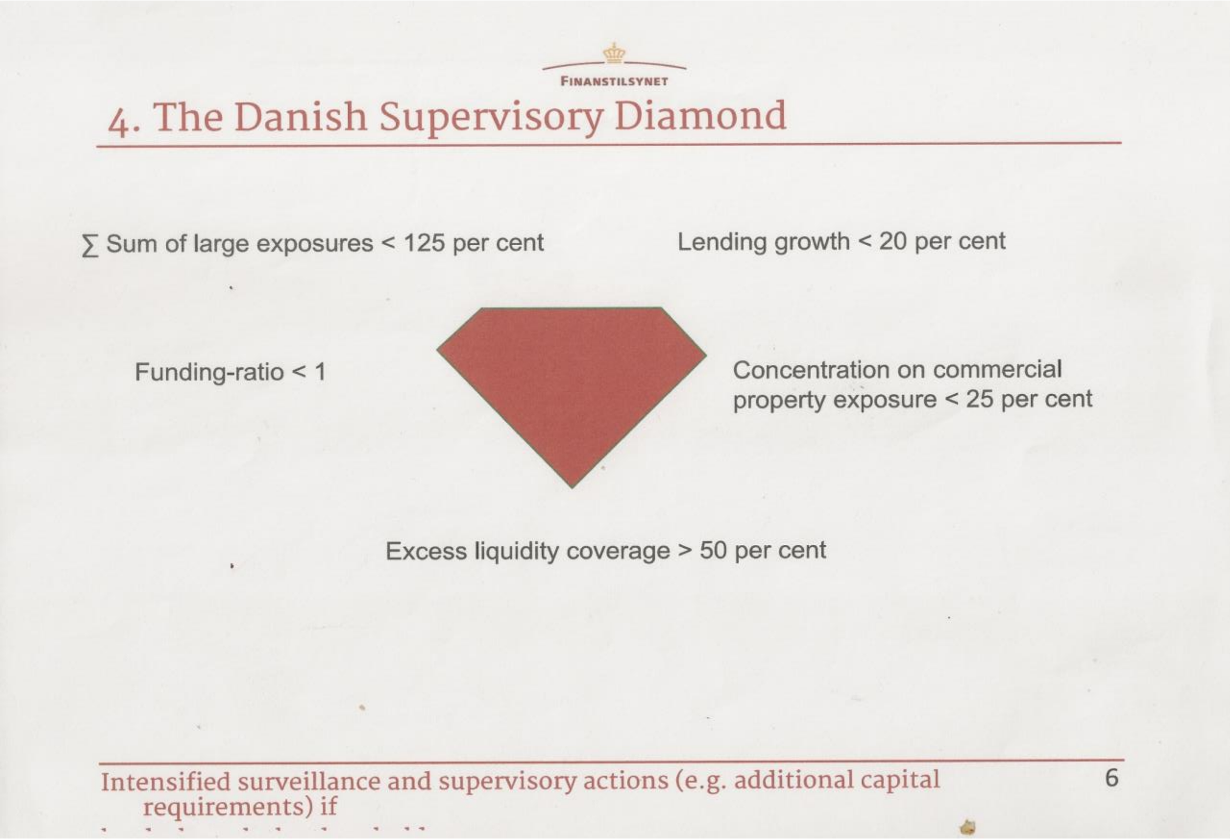
When the Danish financial sector in 2008 ran into the financial crisis we could see that some of these problem banks up to the financial crisis had good solvency and liquidity and yet suddenly ran into big problems. In some cases these problems let to restructuring in other cases to liquidation. The accounts were audited by certified public accountants without comment. And yet things went wrong for a number of banks.

In our thinking about what we could do, we came to the conclusion that supervision should be much more proactive in intervening in bad business models. In 2009 we therefore developed a model which we called "Supervisory Diamond". We had - more or less - a legal basis through articles in the bank law. One article in the law was that The Supervisory Authority may order that a bank shall take the measures necessary within a time limit if the financial position in the bank is developing so badly that the depositors are at risk. This article in the law was originally only intended to be used as last resort. However, we decided to use the article as a warning to the management in banks where we believe they were on the wrong road with their business model. But we knew that we needed a better legal basis in the banking act. Therefore we got an amendment in the banking law.

It became clearer that the Supervisory Authorities could order the management to prepare a report of the financial circumstances and future prospects.
Such a report shall include a statement made by the external auditor and the report shall be approved by the board of directors. With reference to these articles and especially to the comments to the law, the Danish Supervisory Authority can and shall intervene if they find that a bank is moving in the wrong direction. Or in other words, if a bank's business model is too risky then The Supervisory Authority shall intervene.

But what can we do? It is not an easy question. But anyway the experience we have gained after several banking crises shows us: Growth is filled with risk. The same is true for large exposure to customers and especially for financing of commercial properties. Large exposures are also dangerous especially if there are a relatively large number of them. In addition the financial crises had proved that liquidity had been a major risk area. And it was quite new. The liquidity risk became much bigger in 2008 than we had previously experienced. Therefore, we developed our own limits for all these risk areas. The limits are set to what we basically find suitable. The Financial Supervision has for the moment selected 5 risk areas which are followed especially close. I have here a slide which shows the limits or pointers and in this way provides us with some important information about the development in a bank.

(Slide 4)



We have placed the five risky areas at a diamonds surfaces. The figure has 3 dimensions – just like a diamond. I can only show 2 dimensions on a slide. But try to imagine that the figure is a diamond.The risk or activity areas must be located inside the diamond. If a bank is placed outside the diamond it can be too risky. It is not immediately a break of the rules for a bank to go beyond these limits. Or be placed outside the diamond. But if a bank goes outside the limits then the bank must have good reasons for exceeding the limits. It is The Financial Authority's own limits and these limits are more restrictive than the rules which are in the banking law. And some of the limits are not mentioned in the legislation at all. But when these limits are exceeded The Supervisory Authority will particularly monitor the institutions concerned. And there will be used extra resources to monitor these institutions. In this way the model is used as a component of the Risk Based Supervision. On the slide you see the Diamond 5 surfaces or pointers.

- Sum of large exposure "must not" exceed 125 % of the capital
  (There are for the moment plans to change this pointer)
- Property exposure "must not" exceed 25 % of the capital
- Loan growth "must not" exceed 20 %
- Excess liquidity coverage "shall be" bigger than 50 %
- Funding ratio "shall be" less than 1

There can be more limits if you like and the figures can be changed. If a bank exceeds one or more limits this will provides background for a dialogue with the credit institution. This dialog can end with an order to change the business model. As examples of orders which have been used I can mention

- Orders to sell assets.
- Orders to limit the expansion of the branch network or closure of branches
- Orders to stop for financing of commercial real estates.

Based on the dialogue with the bank, The Supervision Authority may decide that the bank is under what is called "Increased supervision". If a bank is under increased supervision this will usually involves a deep on the spot inspection of the risk area - or if needed throughout the bank. And the bank must report and disclose to the public how the bank fulfills the limits. This is a good incentive to be on the road. As mentioned we called the boundaries of surfaces for a diamond. I cannot remember why we in 2009 called the model ”The Supervisory diamond". However, the model should be able to be remembered both in the institutions and in the public. Anyway we think that the word” Supervisory diamond” is a powerful word. We hope it will work. But there are no guaranties.

That was my words for today.

Thank you for your attention.