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The Financial Crisis in Denmark: Causes, Consequences and Lessons

Denmark: Ministry of Industry, Business and Financial Affairs

THE FINANCIAL CRISIS IN DENMARK

– causes, consequences and lessons

1. The Committee's conclusions on the causes of the financial crisis

1.1 Introduction

The Committee on the causes of the financial crisis has been formed to create a clearer picture of the causes and consequences of the financial crisis. The Committee is also mandated to make an assessment of the effects of the measures taken to support financial stability as well as growth and employment in the Danish economy. In this context it is only natural, by way of introduction, to establish what is understood by "the financial crisis in Denmark". The Committee has discussed this matter and arrived at the following outcome:

The financial crisis in Denmark really started in summer 2008 with the collapse of Roskilde Bank. Prior to that, the international financial system had already been facing challenges since mid-2007.

From summer 2008 to autumn 2010, Denmark lived through an actual systemic financial crisis in the banking sector as a result of great losses and write-downs as well as severe liquidity challenges in the banks With a view to maintaining financial stability, it consequently became necessary to have the government get involved in the sector by taking over and winding-up distressed banks, giving guarantees to the sector, providing capital injections and extraordinary liquidity support.

A financial crisis and subsequent government intervention occurred not just in Denmark but in the majority of western countries, including EU countries. Unlike several other EU countries, the Danish financial sector was charged to pay for the measures that have been implemented in order to cushion the impact of the financial crisis for Denmark.

The period from summer 2008 to autumn 2010 was characterized by large losses in the banking sector, and many banks found their solvency under duress. There were no traditional "bank runs" (with small savers queuing to withdraw their money), which should also be seen in the light of the unlimited government guarantee made to all depositors and other unsecured creditors under Bank Package I.

Many banks faced challenges in obtaining liquidity (market financing). The background to this was that a substantial part of the significant increase in the bankss' lending in the years leading up to the crisis was based on foreign market financing, including market-based deposits from other credit institutions and money market funds as well as bond issuances. This fundamental shift in the banks' financing situation, from traditional deposit-financed lending to an increasing degree *of financing obtained on foreign capital markets, can be described as a materially altered business model. The altered business model resulted in the accumulation of a considerable deposit deficit in the Danish banks prior to the crisis. The banks' increased dependence on short-term market financing was challenged in autumn 2008, when foreign credit institutions and the money market funds started to harbour doubts about the health of Danish financial institutions and hence their creditworthiness. That uncertainty meant that part of the Danish banks' obligations falling due in autumn 2008 were unable to be refinanced. This might be characterized as "a modern bank run". The Danish financial institutions were severely cut off from access to liquidity on account of the international crisis of confidence between financial institutions that arose in the wake of the American investment bank Lehman Brothers' bankruptcy in September 2008. Availability of the US dollar was also restricted, which was also instrumental in causing problems. Confidence was first partly restoredwith the government guarantee under Bank Package I, including for foreign creditors' loans and deposits.*

The financial crisis has challenged the individual financial institutions to varying degrees. Some banks got into very hot water and became distressed and have since been wound up under the auspices of the government winding-up company, Finansiel Stabilitet A/S, while other challenged banks found a private solution. A total of 62 banks in Denmark ceased operating during the period 2008 to August 2013. Many of these banks were small, and some did not cease as a direct consequence of the crisis. Finally, some banks have been challenged to a limited extent only, and some not at all. Roughly half the banks had a positive rate of return on equity (RoE) during the period 2008-11.

The Danish banking sector is the one that has chiefly been challenged by the financial crisis. Thus, despite falling housing prices, the mortgage credit institutions have not experienced material losses on loans. This is partly due to the relatively low unemployment in Denmark and the historically low level of interest rates. The Committee has not evaluated the significance of the financial crisis for the pension sector and the insurance sector.

The financial crisis has not led to a fall in total lending, despite the fact that there has been a steep drop in Danish GDP. However, there has been a shift (substitution) in borrowing from banks over to mortgage credit institutions.

The period from Bank Package I expiring in autumn 2010 to the time of writing cannot be characterized as a systemic financial crisis as such, but parts of the Danish financial sector are still under pressure, and the government continues to be involved in the sector through capital injections, co-ownership and loans with an individual guarantee. The liquidity situation has limbered up, but some banks have felt pressure on their solvency and have become distressed. Thus, in the period following the expiry of Bank Package I in autumn 2010, it was also necessary to manage some ailing financial institutions under the auspices of Finansiel Stabilitet A/S, just as certain private solutions were seen in the form of mergers and acquisitions.

Economic activity in Denmark fell sharply in connection with the financial crisis. Thus GDP fell during the crisis by just under 7 per cent from the turn of 2007/08 up to 2009. Since the crisis the recovery has been weak, also compared with other countries, and GDP is still about 5 per cent below pre-crisis level. The crisis in Denmark has thus had considerable derivedconsequences, including budgetary consequences, in addition to direct consequences for the financial sector.

1.2 The causes of the financial crisis in Denmark

The financial crisis in Denmark arose as a consequence of a complicated interplay between a number of previous factors, including relatively high and seemingly sustainable economic growth, which engendered widespread optimism and underestimation across the board of risk, pro-cyclical fiscal policy, pro-cyclical regulation of the financial sector, loose financing terms, risk-seeking credit institutions and inadequate corporate governance in a number of financial institutions. The cause of the financial crisis is thus a combination of many factors – both national and international – interacting, and it is therefore not possible to point to any one cause or any one culprit responsible for the financial crisis.

Denmark is a small, open economy which is tightly integrated, economically and financially, with the rest of the world economy. It is the view of the Committee, therefore, that Denmark could not have avoided being hit by the international financial crisis. At the same time, however, it is the Committee's opinion that a number of national circumstances resulted in the Danish economy and a sizable part of the Danish credit institutions having put themselves in a vulnerable position. Therefore, it is the general view of the Committee that the force with which the impact of the financial crisis was felt in Denmark could have been smaller if a different course of action had been taken prior to the crisis.

An account is given below of the primary causes of the financial crisis and its impact in Denmark as well as areas in which the Committee considers that different actions prior to the crisis might probably have lessened its consequences. In addition, there is an account of the initiatives taken to deal with the financial crisis.

i. Both internationally and in Denmark, the years before the financial crisis were characterized by relatively high and seemingly sustainable economic growth, low and stable inflation and low interest rates.

ii. This led to high levels of optimism. That optimism was broad based and left its imprint on both politicians, authorities and central banks as well as credit institutions, credit rating agencies, businesses and ordinary households.

iii. This broadly founded optimism led to real risks being underestimated, and hence to a low "payment" (premium) for barring what would later prove to be a big risk on many types of assets. Generally speaking, then, the crisis – and particularly its severity – was not predicted, neither by the relevant authorities and central banks, nor in Denmark or abroad.

iv. One of a number of central causes of the international financial crisis not having been generally foreseen was the mounting complexity of the financial system during the years prior to the crisis. At that point in time there was widespread confidence that new financial products which combined and "repackaged" risks into different categories enabled the risks to be spread more appropriately than had previously been possible, thus making the system more robust. The reality, however, turned out to be that the mounting complexity of the financial system made it more difficult to identify the accumulation of systemic risks capable of threatening financial stability. The mounting complexity and transparency of the financial system was of less relevance to the crisis in Denmark than to the crisis in the USA, for example.

v. Furthermore, the scope of the international financial crisis was not foreseen because of the substantial risks accumulated outside of the traditional banking system in the so-called "shadow banking sector", and hence not subject to the traditional banking system's regulation and supervision. To a major extent the growth in this market was a result of regulatory arbitrage, in which financial institutions moved activities to less regulated or non-regulated markets. In the USA, this market grew considerably in the years leading up to the crisis.

vi. A major cause of the financial crisis in Denmark was the influence of the international financial crisis. However, there were also national circumstances which contributed to intensifying the crisis in Denmark.

vii. Denmark's fiscal policy, by contrast with previous upturns, was pro-cyclical in the years before the crisis. That is to say that instead of counteracting powerful pressure on the labour market and the economy generally, the realized fiscal policy added pressure on the economy. Fiscal policy was thus pro-cyclical. This is a particular problem in an economy like the Danish one with a fixed exchange rate policy, as the monetary policy interest rate is set solely to defend the fixed rate policy and thus cannot be used to counteract economic overheating.

viii. The pro-cyclical implementation of fiscal policy fuelled the pre-crisis overheating but was not alone in helping the crisis take its toll on the Danish economy.

ix. A housing price bubble occurred on the market for private single-family houses and owner-occupied flats in Denmark in the years prior to the crisis. The housing price bubble did affect the level of economic activity, but it has not led to any appreciable degree of losses for the credit institutions. The housing price bubble on the single-family house and owner-occupied flat market was due to a combination of economic growth with low unemployment, relatively low interest rates, the property value tax freeze, great optimism and an increased credit supply, which reinforced economic activity. In addition, new forms of lending on the mortgage market contributed to stimulating the demand for housing. During the period 2000-07, prices rose nationally by 85 per cent for single-family houses and 105 per cent for owner-occupied flats. The housing price bubble was significant in Denmark, but many other countries also experienced housing price bubbles and some even more intensely than in Denmark. The price fall on the housing market began before the financial crisis started, and so the financial crisis was not the only cause of the fall in housing prices. The financial crisis did compound the price fall appreciably, however, and through this ended up affecting the Danish economy.

x. Similarly, prior to the crisis, there was a price bubble on the market for commercial real estate, with prices rising by approximately 200 per cent, and on the market for commercial properties for mixed residential and commercial purposes, which rose by about 150 per cent during the period 2000-07. This housing price bubble inflicted considerable losses on some financial institutions, so it is relevant to distinguish between two housing price bubbles before the crisis in Denmark: one for privately owned properties and an even larger one for commercial real estate. The big price rises on commercial real estate were accompanied by large loans to finance the trading and building of such properties from certain, particularly small and medium-sized, banks.

xi. In addition, there has also been a price bubble on agricultural land. However, the price fall on agricultural land after the bubble did not occur until later on in the course of events. Prices rose 90 per cent from 1st quarter 2005 to 2nd quarter 2008, since when the price fall has been significantly greater than on privately owned properties.

xii. The general liberalisation since the 1970s of international capital movements and of the financial sector, including the construction of financial supermarkets able to offer their customers a range of different financial products, is not considered to have been a cause of the crisis in Denmark as such. The general liberalisation of international capital movements, however, has been an underlying prerequisite for Danish banks' ability to finance the mounting deficit on deposits on the international capital and money markets before the crisis. However, the previous restrictions on international capital movements had been introduced on the basis of concerns about the balance of payments, exchange rates and so on, not with an eye to preventing financial crises. What is more, capital movements had been completely deregulated in 1988, and from this point of view they cannot be regarded as a direct trigger of the financial crisis, which came about almost 20 years later. Finally, the liberalisation of capital movements is a natural component of the general internationalisation that has taken place over the past many decades. The Committee believes that, in the absence of free capital movements, Denmark's economic prosperity would have been considerably less today. The advantages of free capital movements far outweigh the possible costs associated with them.

xiii. After Lehman Brothers' collapse in autumn 2008, pressure mounted on the Danish krone, resulting in Nationalbanken having to increase the interest rate on two occasions in order to defend the fixed exchange rate policy. That gave rise to some concern, as large swathes of households and the economy as a whole had become more sensitive to interest rate changes through the noughties. At the same time, the interaction between exchange rate policy and the monetary policy interest instrument in this way illustrates the impossibility of controlling e.g. the volume of lending in Denmark by means of monetary policy. However, the Committee is of the opinion that this does not generally indicate that the exchange rate regime was crucial to whether countries have been affected by the financial crisis or the extent to which they have been affected.

xiv. On balance, the pre-crisis years saw a large increase in risk-taking among the Danish financial institutions. Lending rose sharply, also from an international perspective.

xv. A fundamental shift in the banks' financing of their lending simultaneously took place as a result of amassing a deficit on deposits. This deposit deficit resulted in even small Danish financial institutions raising liquidity on the international capital and money markets in the years before the crisis. Such international financing made possible the vigorous growth in lending during the years before the crisis, but at the same time it increased the banks' exposure to fluctuations in the liquidity situation on the international financial markets. If the banks had held back, the effect of the international crisis on the Danish financial sector would probably have been smaller. In retrospect, it is apparent that there was a lack of sufficient awareness during the pre-crisis years that market financing might "dry up". The accumulation of a deposit deficit was not a peculiarly Danish phenomenon, however, since a similar situation applied to other countries.

xvi. In the years up to the crisis, and hence during a period when considerable credit expansion was already taking place, financial regulation was eased on certain central points, particularly by the new International Financial Reporting Standards (IFRS) and capital adequacy requirements (Basel II). In this context the financial sector attributed great importance to the fact that regulation in Denmark was not stricter than abroad ("level playing field"). In practice the introduction of the new financial reporting standards ended up reducing the financial institutions' cushioning against losses, as the banks did not increase their individual solvency needs sufficiently, as otherwise dictated by the transitional rules in the Danish implementation of the Basel II rules. The result was an increased leverage ratio instead. The shift in focus from capital cushion to risk management with the changeover to the Basel II rules proved de facto to provide the banks with an opportunity for greater equity leverage and increased lending. The financial institutions' capital cushion was thus reduced at an inappropriate point in time. Regulation has since been tightened. The regulatory pendulum thus swung sharply in the years before and after the crisis.

xvii. Prior to the crisis, regulation and supervision of financial institutions in Denmark was based on a fundamental principle that only the executive boards of the financial institutions were responsible for the banks' business models.

Hence the Danish Financial Supervisory Authority's (FSA) focus was more on ensuring that credit institutions were complying with the formal rules than on putting in place and monitoring signposts to gauge the sustainability of the business model chosen by those banks. This approach to supervisory operations during the years before the crisis may have been influenced by the FSA's experience during the previous financial crisis at the start of the 1990s, when the Authority was criticized for its sometimes pragmatic efforts to deal with distressed financial institutions.

xviii. In the years leading up to the crisis, the FSA did warn the financial institutions about certain risky features of the banks' business model, including the sharp growth in lending. The FSA's supervisory reports did issue a number of orders as well as providing information on risk to the individual financial institutions with a view to ensuring compliance with the legislation. From 2005, the FSA had the option of stipulating a higher individual solvency requirement for the banks than the solvency requirement computed by the banks themselves if the FSA judged that there was a sufficient basis and documentation to warrant this. However, no rulings on this point were made before January 2008 (bankTrelleborg). This may possibly have been to do with the fact that the stipulation of a higher individual solvency requirement than the one computed by the financial institutions requires documentation that can be more difficult to obtain in good times, when the measurable risks are small and the general mood in society is marked by optimism. Apparently, however, the FSA was cautious in its interpretation of the solvency rules and therefore, it was not tested whether it would have been possible to lay down higher individual solvency requirements. In addition, the FSA took the view that there was insufficient legal basis for making more proactive interventions with regard to certain banks' inappropriate business models.

xix. Before the crisis, the FSA adopted a relatively ‘mechanical' approach to its review of the banks' compliance with the legislation, not least in Denmark's enforcement of the IFRS rules. With regard to the enforcement of the IFRS rules, the FSA focused essentially on technical aspects, partly because the write-downs had to be approved for tax deduction purposes. Neither on the part of the FSA nor the financial institutions does there seem to have been any equivalent focus on the requirement that the management factored in the impact of the transition to new financial reporting rules in the individual solvency requirement.

xx. In the years up to the crisis, Nationalbanken highlighted various risks associated with the financial institutions' business model, including the high growth in lending. Overall, however, Nationalbanken considered the banking sector to be robust right up to the summer of 2008. Therefore, Nationalbanken's communications concerning the risks in the financial sector did not stand out as clearly as the bank's warnings about the Danish economy overheating, even bearing in mind that the actual fall-off in the economy turned out to be appreciably steeper than foreseen, as a result of the international financial crisis escalating in autumn 2008. After the crisis, it can be concluded that Nationalbanken and the FSA underestimated the liquidity risks that might arise as a result of the rapidly growing and very large deposit deficit accumulated in the financial institutions prior to the crisis, just as monitoring of the financial institutions' liquidity risks was inadequate.

xxi. Nationalbanken has no way of effectively controlling the financial institutions' lending. Consequently, Nationalbanken could not have halted the growth in lending during the years before the crisis even if it had considered there to be a need to do so. The experience from the 1970s and 1980s, when Nationalbanken used cash reserve requirements, quotas and other similar instruments in an attempt to retrench the growth in financial institutions' lending, was that, in practice, this was not possible in a way so that these instruments could effectively contribute to financial stability and adjustment for market fluctuations. These instruments were therefore abandoned during the 1970s and 1980s, cf. conclusion xii.

xxii. When the financial crisis escalated in autumn 2008, key parts of the Danish banking sector were affected, and a group of small and medium-sized financial institutions were particularly hard hit. Thus, there was considerable difference between the degree to which the Danish banks were challenged by the crisis, and this has therefore had a varying impact on the financial institutions too. After the crisis, the aggregate write-downs in the Danish banking sector were large by international standards. Denmark was thus hit relatively hard by the crisis as compared with other countries, both as regards the economy as a whole and the financial sector.

xxiii. A number of small and medium-sized financial institutions' lending rose very sharply before the crisis and often concentrated on few sectors, primarily commercial real estate. During the years prior to the crisis, several of these banks were characterised by inadequate corporate governance, including weak boards of directors, with no specific experience or knowledge of financial matters, and poor credit skills in the form of careless lending and weak credit competences. These financial institutions were thus unduly vulnerable at the onset of the crisis. Despite relatively healthy capital conditions at the time of entering the crisis, a large proportion of these banks ceased existing after the crisis set in. Some banks became distressed and were managed under the auspices of the government winding-up company, Finansiel Stabilitet A/S, while others devised private solutions. A comparatively large part of the losses in the banks handled under the auspices of Finansiel Stabilitet A/S stems from the banks' exposure to a very small group of customers who had obtained sizable loans with these banks.

xxiv. Unlike other countries, then, no attempt was made to keep distressed banks in Denmark going, but they were wound up under Finansiel Stabilitet A/S. A total of 62 financial institutions in Denmark ceased existing during the period 2008 to August 2013. Many of these banks were small, and some banks did not cease operating as a direct consequence of the crisis. The Committee notes that the characteristics typical of the distressed banks during the most recent crisis were largely identical to the characteristics typical of the distressed banks during the previous crisis in the early 1990s, including e.g. high growth in lending and a high concentration of large commitments in commercial properties for residential renting. The Committee is thus at a loss to understand why the lessons learned from the previous crisis had apparently been forgotten in the run-up to this crisis, especially by certain financial institutions, but partly also by the authorities.

xxv. In light of the economic outlook, other financial institutions, small and large alike, weathered the financial crisis relatively well.

xxvi. One large financial institution in particular – Danske Bank – pursued a business model in line with other large international credit institutions with high equity leverage and a high degree of market financing. Before Danske Bank embarked on its international expansion by means of acquisitions and fusions, the bank had no deposit deficit. In the space of a few years, Danske Bank accumulated a deposit deficit that had reached a level of about DKK 350bn by 2008, thus making up more than half the total deposit deficit in the Danish banking sector. A large part of Danske Bank's deposit deficit was a result of the deposit deficit from the bank's foreign units. The considerable degree of capital market financing led to Danske Bank finding itself challenged in terms of liquidity in autumn 2008, just like most other Danish financial institutions and foreign credit institutions. Furthermore, Danske Bank had sizable losses, particularly from the bank's Irish and Northern Irish activities. In spite of relatively large write-downs, however, throughout the crisis, Danske Bank was profitable every year and met the solvency requirements. It is generally difficult to gauge whether Danske Bank was more vulnerable to unexpected market conditions before the crisis than comparable foreign financial institutions. However, there is no doubt that the bank had put itself in a vulnerable position, which, given the size of the bank, could shake Denmark's financial stability if risks did materialize. Bank Package I, with an unlimited government guarantee for depositors and other unsecured creditors, should be seen partially in this light.

xxvii. In the years preceding the crisis, the mortgage institutions increased their use of short-term financing in keeping with the spread of floating-rate loans. Together with the spread of interest-only loans, that had the overall effect of increasing the banks' refinancing and credit risk.

xxviii. Generally speaking, however, the mortgage sector has not been challenged to the same extent as the banks, although a single mortgage credit institution has suffered greater losses.

xxix. Restrictions on voting rights and ownership were and are considerably more common in the financial sector than in other business sectors. These restrictions on exercising ownership are also more widespread in the Danish financial sector than abroad. Restrictions on voting rights and ownership may have kept major owners of capital/capital notes to stay away from a number of financial institutions, espicially smaller ones, who would otherwise have demanded more professional management. It cannot be ruled out that these restrictions were instrumental in several of these banks becoming distressed.

xxx. The size of incentive pay schemes increased in the financial sector in the years before the financial crisis. It is the Committee's assessment that incentive pay is likely to have prompted extra risk-taking in some financial institutions but, conversely, it did not trigger the problems in these banks or the crisis as a whole. Rather, incentive pay was a symptom of an already high level of risk-taking in some banks as well as partly inadequate executive skills and governance structures in the relevant banks. In a number of cases, the design of the incentive pay scheme was inappropriate and heightened the day-to-day management's incentive to pursue short-term and risk-prone banking. This is not in the interests of the shareholders.

xxxi. The auditors are the public's representatives, also in dealings with finance companies. It is a task that was not performed satisfactorily in all instances prior to the crisis. The winding-up of ailing financial institutions has shown that auditors' handling of a number of aspects was dogged by serious errors and omissions.

xxxii. Since 2008, the Danish Parliament, Folketinget, has adopted a number of initiatives whose purpose has been to guarantee financial stability in Denmark, including in particular the five so-called "bank packages". The bank packages were of sizable proportions in Denmark, even from an international perspective. It is, in the Committee's opinion, extremely inappropriate that the financial system had become so vulnarable that it was necessary to introduce the bank packages and hence material intervention by the government.

xxxiii. Overall, it is the Committee's view that the bank packages were generally appropriately designed considering the vulnerable situation on the financial markets and in the economy as a whole at the time the bank packages were adopted and given the ownership structure in Danish credit institutions.

xxxiv. In the public debate on the bank packages, a number of alternative solution models have been presented, particularly with regard to Bank Package II. Even with the experience gleaned from the course of events during and after the bank packages, it is not easy to give an unambivalent answer to whether there could have been other, more expedient solutions, because the interaction between the solutions and economic developments is complex, and decisions are taken on the basis of the knowledge available at the time, not the knowledge available when the bank packages are subsequently evaluated. In this light, it is uncertain whether the alternative models that have been discussed would unambigously have worked better than the models chosen.

xxxv. The creation of the unlimited government guarantee with Bank Package I, designed under great time pressure, was necessary and created stability in the sector. The government guarantee was considerable in scope and included requirements imposed on all depositors and other unsecured creditors. The sector was charged for the government guarantee, payment being based on an estimate of a market-like price; but it was an estimate, as there was and is no market for such guarantees. Furthermore, the sector's payment for Bank Package I must be evaluated in the light of the considerable losses that could have been realised if Bank Package I had not been implemented. In conjunction with Bank Package I, a government winding-up company, Finansiel Stabilitet A/S, was also set up to handle distressed financial institutions, which were to be wound up rather than rescued. The Committee acknowledges and applauds the considerate political vigour that was displayed in connection with the adoption of Bank Package I.

xxxvi. The government capital injections and individual government guarantees in Bank Package II facilitated a difficult transition on the cessation of Bank Package I. The specific design of the government capital injections in Bank Package II have subsequently been debated, particularly in relation to the question of whether the government was sufficiently compensated for the risk it took on, and whether Bank Package II made a sufficient contribution to ensuring that the sector was made more robust. However, it is uncertain whether a different design of the packages would unambigously have worked better in terms of obviating a credit squeeze.

xxxvii. Bank Package III superseded Bank Package I, which ceased on 30 September 2010. Bank Package III saw the start of a return to normal market-economic conditions without a government guarantee, in which unsecured creditors could anticipate losses if an institution became distressed. However, since, contrary to expectations, other countries deferred the setting-up of similar schemes, Denmark ended up being "left alone" with the approach to handling distressed banks introduced by Bank Package III. An alternative solution in the form of an extension of the unlimited guarantee with Bank Package I would have dragged out normalisation of the sector further still. It subsequently became clear that Bank Package III per se did not give the financial institutions sufficient incentives to enter into private solutions.

xxxviii. Bank Package IV ("The Consolidation Package") provided greater possibilities for consolidation between financial institutions and reduced the risk of Bank Package III being applied. Bank Package IV was sensible, seen in the light of the experience with Bank Package III and the development in the eurozone.

xxxix. The transfer of a property portfolio from FIH Erhvervsbank A/S to Finansiel Stabilitet A/S as part of Bank Package V ("The Development Package") remedied the situation for FIH, which had seriously exposed itself to the property sector and alternatively would have had to forcefully slim down its balance sheet, while at the same time the government was protecting its interests as a creditor. In accordance with Bank Package II, at the time Bank Package V was adopted, the government already had considerable exposure to FIH in the form of an individual government guarantee and government capital injection, as well as exposure to other financial institutions which might be indirectly affected by FIH's slimming-down of the balance sheet. The solution in relation to FIH illustrates the dilemma that government involvement in the sector can entail. On the one handgovernment involvement in the sector brings with it a natural need for the government to protect its creditor interests. On the other hand it should be avoided that government involvement and protection of its creditor interests creates an incentive for the owners of the institution in question to take increased risks. This could happen on the basis of an expectation that the institution will be "rescued", should it become necessary. Given the government's considerable exposure to FIH, however, it is deemed sensible for the state to have protected its creditor interests. In the Committee's opinion, however, it ought to have communicated clearly that the point was to protect creditors' interests, and it was not a general scheme in the form of a bank package that could benefit several banks.

xl. The financial sector in Denmark, unlike several other EU countries, paid for the Bank Packages itself and hence for the specific crisis solutions.

xli. Households followed a more risky investment strategy in the years leading up to the financial crisis. E.g. households' relative proportion of shares in their portfolio rose, while the relative proportion of bonds fell.

xlii. Mounting sales to private customers of a number of complex financial products and banks' own shares took place before the crisis. Several of these products were rather impenetrable to ordinary customers and subsequently gave rise to customers suffering considerable losses. This led to a big increase in the number of complaints lodged with the Danish Complaint Board of Banking Services. There is much to suggest that the advice provided on some of these products was not thorough enough.

xliii. Apart from the direct consequences for the financial sector, the financial crisis – in connection with the pre-crisis overheating – has had very considerable consequences for the economy. The total write-downs in the financial institutions during the period 2008-2011 were DKK 147bn. In addition, economic activity (GDP) fell sharply in connection with the crisis, and economic development was weak following the crisis. Nationalbanken has estimated that production in Denmark (real-term GDP) in each of the years 2009-13 averages 2.25-2.5 per cent below the level it would have been at in the absence of the financial crisis. That makes for a total cumulative production loss over the five years of about 12 per cent of GDP. That is equivalent to about DKK 200bn. Moreover, public debt has increased since the crisis, and unemployment has risen, though is still relatively low.

Statement from a minority of the Committee

Finn Østrup observes that the supervisory activities and the rules governing credit institutions prior to the crisis have been discussed in the Committee. During this discussion, it was disclosed that the FSA found it difficult to intervene against the credit institutions on the basis of the existing legislation in the run-up to the crisis. In response, it must be emphasized that several provisions in the pre-crisis legislation enabled the FSA to intervene, including an increase in solvency requirements and an order to account for a credit institution's financial position. These rules are described in Chapter 7. Moreover, the minority observes that the responsible ministry (the Danish Ministry of Economic and Business Affairs) could have taken steps to amend the legislation to curb the growth in lending. Such initiatives include: (i) abolishing or restricting interest-only mortgage credit loans, (ii) abolishing or restricting adjustable rate loans, (iii) raising the general capital requirements in credit institutions and (iv) introducing liquidity rules to reduce the risk in connection with the rising deposit deficit. Moreover, the right for private individuals to deduct interest on their loans could have been restricted to reduce the growth in lending. Against this background, the question remains if the FSA's management or possibly Nationalbanken's management could have called the Minister for Economic and Business Affairs' attention to the possible risks of the high growth in lending. Also, the FSA could have required even wider powers if it felt that it did not have sufficient authority to intervene against the credit institutions. During its work, the Committee was informed that the FSA has not contacted the Ministry in this regard. The Ministry could have launched its own initiatives to curb the growth in lending. In this context it must be observed that as soon as in February 2006, the growth in lending in the financial institutions was already discussed in the media.[1]

Statement from the rest of the Committee

The other Committee members note that the questions raised by Finn Østrup have been considered in connection with the preparation of the report.

[1] See the newspaper articles in Jyllandsposten of 19 February 2006 and in Berlingske of 30 May and 21 October 2006. On 21 August 2006, Dagbladet Børsen published a front-page article.

2. The Committee's recommendations to the government

In addition to identifying how and why the financial crisis hit Denmark the way it did, the Committee has been asked to assess whether the initiatives launched to prevent a similar crisis in the future and thereby as far as possible prevent history from repeating itself are sufficient.

As a consequence of the crisis, the regulation and supervision of the Danish financial sector has generally been tightened. Some of this tightening is rooted in new international regulatory measures adopted in the EU which therefore influences Danish financial regulation such as, e.g. the new liquidity and capital adequacy requirements (the Basel III/CRD IV rules). However, a wide political majority has also implemented a number of specific Danish rules, including in the consumer area.

Below, these tightening measures are described briefly followed by the Committee's assessment of the measures. Finally, the Committee recommends further measures to be taken. In this section, descriptions of the adopted tightening measures and recommendations are categorised according to the overall characteristics addressed.

The Committee notes that regardless of the regulation and supervisory measures implemented, it will never be possible to completely prevent a new financial crisis from emerging in the future. On the other hand, the Committee finds that the extent and character of the recent financial crisis, which required considerable government participation in crisis management, means that we should strive to prevent history from repeating itself in the form of a similar crisis in the future. Hence, the preparation of regulation and the planning of supervisory activities should be balanced to ensure that the economic benefits of such measures are deemed to exceed the related economic costs. Whether this is the case depends on an assessment of the specific initiatives.

2.1 Macropolicy and optimism

The years leading up to the crisis saw a comparatively high and seemingly sustainable level of economic growth, a low unemployment rate, a pro-cyclical fiscal policy and rising housing prices due to e.g. the property value tax freeze etc., which caused excessive optimism. The combination of relative economic prosperity, rising optimism and abundant liquidity led both financial credit institutions, the Danish central bank, Nationalbanken, the authorities, businesses and individual consumers to underestimate economic risks. As a consequence of this underestimate, risk premiums were low, causing debt burdens in the private sector to increase. Due to this higher debt burden, households and credit institutions increased their risk exposure and became increasingly vulnerable.

In the light of these developments, a number of post-crisis initiatives have been launched to ensure a macroeconomic setting that contributes to a stable economic development and mitigates excessive financial risk-taking.

Hence, the Danish Budget Act (*budgetloven*) has introduced caps on government, municipal and regional spending. Due to these caps, the planned and actual development in spending in each individual year has been restricted, as the caps for the following year must be reduced if exceeded by a corresponding amount. To provide the right incentive to stay within the financial limits, including complying with the caps on spending, municipal and regional sanctions have been introduced. These rules make collective and individual off-setting against the block grant possible.

The Budget Act also implements the provisions of the fiscal compact on a budget balance rule and an automatic correction mechanism. The budget balance rule is deemed to have been complied with if the annual structural deficit is at the same level as the Danish medium-term budgetary objective, however with a lower limit for the structural deficit of 0.5 per cent of GDP. In case a deviation from the rule is deemed to exist, such deviation must be corrected. Moreover, legislation stipulates that The Economic Council must be an "independent watchdog" in relation to fiscal policy and caps on spending. Hence, The Economic Council must assess, on an ongoing basis, whether the caps on spending are balanced with the medium-term projection and whether the caps on spending are exceeded.

Moreover, the Systemic Risk Council has been set up. The purpose of the Council is to monitor and identify systemic financial risks and to issue recommendations to the Danish Financial Supervisory Authority (FSA) and – if they relate to legislation – to the government on how to handle such risks. The Council's recommendations are not compulsory, but if a recommendation is not complied with, the recipient must explain this decision.

The views of the Committee:

Stable and healthy macroeconomic conditions are essential to ensure financial stability. If the macroeconomic conditions are not stable, it is difficult to avoid financial instability, even in a situation with well-functioning financial institutions and appropriate financial regulation and supervision.

The run-up to the crisis showed that it may be difficult to hold back on the fiscal policy, including keeping the budgets, in times of prosperity and that a too lenient fiscal policy may be instrumental in overheating the economy. This is particularly a problem in an economy such as the Danish that has a fixed exchange rate, as the monetary policy interest rate is determined solely for the purpose of defending the fixed exchange rate policy and therefore cannot be used to counter an overheated economy. The Committee therefore welcomes the adoption of the Budget Act, as it may be instrumental in ensuring healthy public finances. However, the Committee would also like to point out that the Act is not in itself sufficient to ensure a pro-cyclical stabilisation policy.

The Committee therefore also finds that we must be careful in future in terms of removing automatic stabilisers that may have significant derived consequences in relation to financial stability in the economic policy. Experience shows that it is difficult to pursue a discretionary pro-cyclical fiscal policy, and automatic stabilisers with limited structural policy disadvantages are therefore required. In this respect it should be noted that housing taxes can be determined on the basis of national considerations even more so than the implementation of international financial regulation. Housing taxes can be converted to ensure that they follow the development in housing prices in a way that does not affect the level of revenues in the short term.

Experience generally shows that housing prices should be under special observation and that intervention should be considered in the event of particularly high price increases.

The Committee also finds that the run-up to the crisis showed that it may be difficult to focus on risk-building in the financial system in times of prosperity. For this reason, the Committee welcomes the setting-up of a systemic risk council. The Committee expects the Systemic Risk Council to play a significant role by e.g. identifying developments in the financial sector that may affect financial stability.

Due to the tightened requirements for credit institutions as a natural and necessary follow-up on the crisis, there is a possibility that risks will build up, to a higher extent than previously, in the parts of the financial system that are not subject to risk management requirements to the same extent as credit institutions such as e.g. the mortgage market, and that do not have any experience in assessing and managing credit risk such as e.g. the pension sector. However, several lending sources may involve benefits in that they may e.g. increase competition and support substitution between different lending sources if financial or economic shocks hit the economy. However, when assessing financial stability risk, it is important to know where the overall lending takes place and how the risks may materialise. The Committee therefore finds that it is important for the Systemic Risk Council and the FSA to focus on such risk building outside the traditional financial institutions and mortgage credit institutions.

The Committee notes that the ministries are heavily represented in the Systemic Risk Council. On the one hand, this will probably mean that the Council's recommendations will have quite an impact on the authorities who must later consider such recommendations. On the other hand, it will probably also mean that the practical work involving the preparation of the recommendations will have to focus on whether the Systemic Risk Council to a sufficient extent acts as an "independent watchdog" regarding unfortunate developments within the financial area. In this respect, the Committee has noted that ministry representatives do not have voting rights in connection with the Council's adoption of recommendations to the authorities.

Experience from the financial crisis has exposed the limitations of the stress tests used by the authorities. These limitations were expressed by the models' failure to identify the financial sector's general vulnerability in the run-up to the financial crisis.

The Committee therefore welcomes the subsequent improvement of the models through stricter stress scenarios and increased focus on assessing risks outside the traditional model analysis area such as the interaction between solvency and liquidity matters. Although the models should also be further improved in the future via new knowledge and a focus on including low-probability but high-consequence scenarios, the Committee finds it important to emphasize that results from stress tests do not bring all matters in individual banks to light, and stress test results should therefore not be overinterpreted.

Recommendations regarding maintenance of systemic stability:

1. The Committee recommends that housing taxes be changed to ensure that they follow housing prices, thereby automatically stabilising such prices. Today, the freeze of the property valuation tax and the maximum land tax adjustment rate mean that housing taxes no longer follow the development in housing prices. A change in such housing taxes can be effected without changing the current level of taxation and will curb future decreases as well increases in housing prices. This will contribute to more stable economic cycles and thereby contribute to a more stable development in the financial sector.

Minority statement:

A. The ministry representatives point out that a wide majority of the Danish parliament, Folketinget, as part of the 2012 tax agreement endorsed that the property valuation tax corresponding to the current legislation is maintained until 2020. The ministry representatives furthermore point out that any changes to housing taxes must be seen in the light of the current situation in the housing market and that stable framework conditions must be taken into consideration in this regard.

2.2 Financial supervision

In the years leading up to the crisis, the regulation and supervision of the financial sector was to a wide extent based on a belief in market discipline and strong confidence in the banks' risk management abilities. A number of measures were implemented, leading to a liberalisation of the regulation of financial institutions, including e.g. new capital requirements regulation for credit institutions and new write-down rules. As a consequence of these measures, capital was freed up in the credit institutions which they used to increase their lending. The regulation therefore had a pro-cyclical effect by actually easing the capital requirements in a period of already appreciable credit expansion and moreover enabled a reduction in the banks' capital cushioning.

Before the crisis, the supervision of Danish financial institutions focused more on complying with new rules and verifying business procedures than on the sustainability of the business model selected by the banks. Managements were responsible for ensuring a viable and sustainable business model, and only if statutory requirements etc. were not complied with would the FSA intervene. However, the Authority did issue warnings on risky developments in financial institutions prior to the crisis but found that there was no legal base for intervening more firmly with risky business models in the banks. Apparently, the Authority was cautious in its interpretation of the solvency rules and therefore, limits were not tested as to whether it would have been be possible to lay down higher individual solvency requirements.

This has changed markedly after the crisis, and both the regulation and supervision of the financial sector has been tightened considerably. Under this regulation, the FSA has been given a number of new competences, permitting an increase in the Authority's supervisory practices, emphasizing more offensive supervisory work and increased focus on all significant risk factors, and meaning that the Authority is critical in its assessment of the sustainability of the business models and may intervene much earlier if a business model is deemed to be unsustainable.

A number of other measures have been introduced such as risk-based supervision prioritising audits and inspections, setting-up of a creditor register to monitor large customers, increased monitoring of solvency requirements and stricter write-down requirements.

The views of the Committee:

The regulation and supervision of the financial sector is vital for maintaining a stable and confidence-inspiring development in the financial sector and therefore vital for ensuring financial stability. A well-functioning financial sector is an important element in the efforts to ensure growth in the general economy. The Committee finds that one lesson to be learned from the crisis is that tighter regulation and supervision is necessary.

For this reason, the Committee commends that the financial regulation has been tightened backed by broad political support and that the FSA has been given more competences and given the opportunity of pursuing a more proactive approach in the implementation of its supervisory activities. Accordingly, the Committee supports the enhanced possibility of carrying out preventive supervision which makes it possible to implement measures at an earlier point in time, the purpose of which is to turn the development in an institution and hence reduce the risk of the institution becoming distressed. However, the Committee also points out that preventive supervision requires a more analytical approach to supervisory activities.

The Committee commends that in order to embed the experience from this and the previous crisis, the FSA has set up five benchmarks that indicate banking activities which initially should be regarded as having a higher risk profile, including limits for lending growth and lending to the property sector (the so-called "Supervisory Diamond"). Financial institutions that exceed these limits may end up being ordered to adjust their business model to reduce the identified risks. The Supervisory Diamond therefore marks an appropriate balance between on the one side countering excessive risk-taking and on the other side ensuring that healthy financial institutions can run a profitable business and provide the required lending to firms and households. The Committee finds that it is important to maintain this anchoring of the lessons learned from the two crises, also in the future when we may see a pressure to ease the Supervisory Diamond limits. However, it is also important that the FSA is open to the possibility of including other risks in the Supervisory Diamond that may be relevant, as future risks may be found other places than in the present Supervisory Diamond focus areas. In this respect it should be noted that the previous crisis was followed by a certain expectation that the financial sector had learned from the crisis and that this learning was "anchored" in the individual banks and in the attitude to good banking, including the importance of good credit skills and good credit management. Following the recent crisis, this cannot be said to have been the case in a number of financial institutions.

The Committee finds that the easing of the capital requirements – following the implementation of the Basel II rules – which took place prior to the financial crisis was inappropriate, especially as the implementation coincided with a period of economic prosperity. Furthermore, the new International Financial Reporting Standards (IFRS) implied that the banks had to reverse their provisions for bad debts, freeing up capital which also was to a great extent used to increase lending. In this respect, the Committee notes that the FSA for various reasons was particularly careful to enforce the introduction of the new financial reporting rules before the crisis, among other reasons to ensure correct tax assessment under the Danish Tax Control Act (*skattekontrolloven*).

During and after the crisis, legislation has been tightened, and the FSA has also tightened its administrative practice, including in relation to the rules on loan impairment charges. The Committee points out that this required tightening of the rules on loan impairment charges are taking place under the same EU Regulation as formed the basis of reversal of impairment charges before the crisis. This emphasizes that there is room for manoeuvre and that another track could have been chosen in the mid-noughties. At the same time, the Committee points out that many banks chose to use the freed-up capital following the new financial reporting rules to increase their lending and therefore did not sufficiently allow the effect of the new rules to be included in the assessment of the individual solvency requirement under the Basel II rules which was otherwise, by implication, required by the banks under the legislation.

The Committee recognizes that the new international financial reporting and capital adequacy rules and their implementation in Denmark were not intended to make the sector more vulnerable. De facto, however, the introduction of these rules ended up easing the capital requirements for the sector. This was inexpedient, as the sector became even more vulnerable when the crisis hit that it would otherwise have been. Moreover, the easing of the requirements before the crisis created a strong need for tightening measures during and after the crisis. The Committee finds it important to avoid such "pendulum" regulation in the future. Experience shows that there may be a risk to see pressure, in times of prosperity, to ease the regulation and the requirements for banks.

The Committee finds that one lesson learned from the crisis is that before the crisis, certain banks had a higher focus on the value of collateral in the individual loan commitment than on the commitment's liquidity/earnings. Another lesson learned is that the resilience of the debtor's liquidity/earnings was often a better guarantee against loss on commitments than collateral in the debtor's assets.

The Committee notes that the organisational placing of the Financial Supervision Authority is a frequently discussed subject in Denmark as well as abroad. The question of the organisational placing of the FSA has also been discussed after the crisis. In this connection it should be noted that, historically, there have been differences in the organisation of the financial supervision across the EU countries. Thus, the organisation of the supervision has depended on various factors, including the historical development in the relevant country, the status and independence of the central bank, handling of crises etc. In a number of EU countries, the central banks have the supervisory responsibility or are contemplated to play an even bigger supervisory role after the crisis whereas others – especially the Nordic countries – have maintained their financial supervision as unitary supervision (joint supervision of banks, insurance companies, securities traders etc.) by one independent authority under the responsible minister.

The Committee finds that the placing of the supervisory authorities has not been a decisive factor so as to whether and to what extent a country was hit by the financial crisis. Their placing is therefore not seen as a contributing factor to the crisis. This also applies to Denmark which has increased the possibility of exchanging information after the onset of the crisis and thereby formed the basis for even closer collaboration between the FSA and Nationalbanken and the Danish State Prosecutor for Serious Economic and International Crime (SØIK). The Committee notes that the previous government set up a committee (the Committee on the Structure of Financial Supervision in Denmark), the purpose of which was, among other things, to look into the placing of the FSA, including whether supervision of the financial sector would be improved if the Authority was placed under Nationalbanken. The work on these questions was, however, suspended by the present government and therefore, no final report and analysis of pros and cons regarding the placing of the FSA was submitted. Instead, the Committee on the Structure of Financial Supervision in Denmark was asked to look into the establishment of a systemic risk council and submitted a report on this.

Recommendations in relation to financial supervision:

2. The Committee is worried to see a pressure to ease the tightening of the financial regulation that has been or is being implemented to ensure robust credit institutions, including the coming capital and liquidity requirements and the change in administrative practice. Such pressure may be seen in times when there is a wish that the economy needs a boost but maybe in particular in times with prosperity, optimism and low write-downs. The Committee recommends that great care is taken in respect of such easing, even when the pressure for easing becomes intense.

3. More specifically, the Committee recommends to "hold on" to the Supervisory Diamond, even if pressure arises to ease its requirements. At the same time, the

Committee recommends that the FSA regularly monitors whether the Supervisory Diamond contains the relevant risk factors of importance to the viability of the individual institution.

4. The Committee has found that before the crisis, several financial institutions focused greatly on the value of collateral assets in their credit rating instead of having focus on the debtor's ability to generate liquidity and earnings. Against this background, the Committee recommends that the provisions stipulated in the Executive Order on Management (ledelsesbekendtgørelsen) on the credit policy risk management principles be clarified in this area.

2.3 The financial institutions

The years leading up to the crisis saw a, on average, significant increase in risk-taking in the Danish financial sector. Lending increased dramatically, even by international standards. As a deposit deficit was generated, the need for access to market financing increased. As opposed to previous practice, even medium-sized Danish financial institutions started financing their deposit deficit internationally. As the banks depended on access to international market financing, they became even more sensitive to liquidity fluctuations in the international financial markets. The Committee finds that the banks did not at the time focus sufficiently on the possibility that their access to liquidity could be cut off or strongly reduced and therefore become a problem. As the international financial markets froze and the access to liquidity disappeared in autumn 2008, the crisis therefore dealt a hard blow to a number of financial institutions. At the same time, however, some financial institutions were not hit too any significant extent. Thus, the severity of the blow differed greatly within the Danish financial institutions.

Following the onset of the crisis, a number of initiatives have been launched to reduce risk-building in the credit institutions. Among other measures, new international capital and liquidity requirements have been adopted, the so-called Basel III standards, in Europe introduced in the form of CRD IV. As part of CRD IV, it is possible to set additional capital and liquidity requirements for the so-called systemically important financial institutions (SIFIs).

The views of the Committee:

It is the responsible management in the individual credit institution, i.e. the board of directors and the day-to-day management, that has the main responsibility for ensuring a sustainable business model for the institution, including proper credit management and sufficient capital and liquidity to ensure that the institution is sufficiently robust to withstand losses and write-downs etc. The fact that the banks' compliance with the rules in force is supervised and that such supervision may close in on the banks' performance of their activities (including an assessment of the business model), does not alter the management's responsibility either. Furthermore, the management is responsible for the timely recognition if the business model and strategy chosen are not viable and if necessary for taking any required steps as a consequence of this. One important element in terms of restoring confidence in and credibility of the sector and hence the foundation underlying the activities of the credit institutions, therefore rests with the responsible management in the individual banks.

In this connection, the Committee has especially noted that part of the small and medium-sized financial institutions that have ceased to exist changed their business model in the years leading up to the crisis. The banks abandoned a precautionary principle to stick with simple guidelines and only do business with customers that – figuratively speaking – could be seen from the top of the local church tower (the “church tower principle”). They moved outside their traditional business area and hence into areas that neither the executive board nor the board of directors seem to have been sufficiently competent to understand and act on. At the same time, the banks increasingly, as stated above, used (international) market financing to finance their high growth in lending, a growth that in a significant part of the banks that ceased to exist was often aimed at comparatively few large commercial property commitments and to a certain extent the agricultural sector. In many cases, the distressed financial institutions were therefore exposed to the same type of management failure in the form of poor credit skills and poor management. In this respect, it gives food for thought that the same mistakes to a wide extent triggered the previous banking crisis and that these banks did therefore not learn from the previous experience.

The Committee welcomes the FSA's setting-up of a credit register to which all financial institutions must report their major customers and certain detailed information on such customers. The crisis has shown that a limited number of individuals have caused major losses in a number of small and medium-sized banks that have subsequently experienced difficulties. Setting up a credit register makes it possible to more systematically monitor the whereabouts of large and bad debtors and therefore to launch measures in advance to prevent individuals from having commitments in several banks of a size that may cause such banks to experience difficulties if an individual faces problems. In relation to small and medium-sized banks, this may for example be the case when individuals have commitments in several banks that total DKK 250-500m. The Committee has noted that under the existing legislation, the FSA generally cannot share its knowledge with the relevant banks, even increase knowledge-sharing among banks for the purposes of avoiding inexpediencies in relation to debtors.

The Committee generally welcomes a number of the measures under the Basel III/CRD IV rules and the SIFI Committee's recommendations on increased capital requirements. The Committee finds it particularly relevant that the banks must in future have more core equity capital (tier 1) and that the requirement is made even stricter, depending on the size of the institution. Such requirements and the requirements to ensure more stable liquidity conditions will help ensure a more stable capital and liquidity situation for credit institutions. However, the Committee also notes that the Basel III/CDR IV rules are considerably more complex than any previous regulation, which may, all else being equal, impede compliance with these rules, particularly for small banks that wish to provide their customers with the same portfolio of financial services as large banks.

Moreover, the Committee notes that the future rules will only to a very limited extent provide for a possible regulatory distinction between business models for large and small banks. On the other hand, the rules allow banks to deselect certain business areas (such as investment advising), and thereby opt out of the regulation for these sub-elements of the total possible business universe.

The determination of the banks' equity requirement may be specified relative to an institution's total number of unweighted assets (leverage ratio) and relative to the institution's total risk-weighted assets. Capital requirements relative to total risk-weighted assets take into account the individual institution's risk profile, meaning that an institution that selects a more risky combination of assets will be subject to higher capital requirements. On the one hand, this approach acknowledges the diversity of the banks in relation to being able to control risks and variation across asset types. On the other hand, estimating the risk weights used in the calculation of an institution's risk-weighted assets is subject to uncertainty. Capital requirements relative to a credit institution's total unweighted assets ensure a certain minimum level of capital in a credit institution, even if the institution's estimated risk-weighted assets specify an even lower capital level, i.e. a kind of backstop to ensure that the capital level is not too low.[1] The Committee finds that focusing on only one of these capital requirements may lead to unfortunate regulation: Regulation without leverage ratio may lead to capital levels being too low, whereas regulation without risk-weighted assets may give banks an incentive to take on more risk. The Committee therefore supports that the new regulation of capital in credit institutions comprises both capital requirements relative to the total volume of unweighted assets and the volume of risk-weighted assets.

In relation to determining the banks' capital adequacy based on the risk-weighted assets, the Committee is, however, concerned about the precision with which risk weights are estimated, i.e. concerned about parameter uncertainty. Moreover, the Committee notes that the concern internationally in this regard is also rising. This concern particularly relates to the risk weights estimated by primarily large banks for use in the so-called "Internal Risk Based models" in connection with the calculation of the capital adequacy requirements. Via the large banks' optimisation of their capital structure that began in the early 1990s, the risk weighted assets share of total unweighted assets has thus been reduced from approximately 65 per cent to approximately 30 per cent in 2010. The Basel Committee has admitted that the calculation of e.g. the risk-weighted assets may be comparatively random due to model and measuring errors and weights determined by regulation.

Against this background, the Basel III standards have been supplemented by a minimum requirement for the amount of traditional equity relative to an institution's total unweighted assets (leverage ratio), including a definition of which assets that should be included in the calculation and what level of equity ratio that may be expected for the banks. According to the Basel III standards, the starting point is a level of 3 percent, but a binding target is not expected to come into force until 1 January 2018

1 Requirements for an institution's total unweighted assets are the same as requirements for total risk-weighted assets where risk weights for all assets are 100 per cent, i.e. that less risky assets are not scaled down.

based on an observation period from 2014 to 2017 and the banks' publication of leverage targets from 1 January 2015.

In connection with the current implementation of new European regulation (CRD IV/CRR) based on the Basel III standards, there will also be a process of observing the banks' leverage levels until 2018 and determine specific leverage targets for the banks. This process begins in 2014 and also covers considerations of whether and in such case how the banks must face increased capital requirements as a consequence of high leverage.

The Committee is generally sceptic as to whether a leverage limit of 33 1/3 (3 per cent) in ordinary banks is sufficient to ensure that the banks are sufficiently robust and that the requirement is therefore sufficient to prevent future crises in the financial institutions.

The Committee notes that all banks in the USA must meet a general leverage target of 4 per cent calculated according to a national standard. Furthermore, very large banks in the USA that use advanced internal models must meet an additional leverage target of 3 per cent. The additional leverage target includes e.g. off-balance sheet items in the denominator and can be compared to the adopted Basel III standard. Very large banks that use advanced internal models must therefore meet a general leverage target of 4 per cent as well as an additional leverage target of 3 per cent. Moreover, the Dutch government has decided that Dutch banks must meet a leverage ratio of 4 per cent, even if this is not a joint European requirement.

The Committee supports the introduction of additional requirements in relation to capital, liquidity and resolution plans in large credit institutions. Against this background, the Committee welcomes the main ideas in the report from the Committee on Systemically Important Financial Institutions in Denmark (the SIFI report).

The Committee agrees with the recommendation in the SIFI report of higher capital requirements for systemically important financial institutions. However, it points out that even higher capital requirements than the level recommended in the SIFI report may be required for these banks. The Committee notes that the issue of whether requirements for more equity in financial institutions will increase the total capital costs in such financial institutions has been much debated. However, the Committee finds that it is very important to point out that higher financing costs may have a negative impact on the banks and this must be considered in relation to the overall economic benefit of safer credit institutions and hence a lower risk of one or several banks becoming distressed with subsequent significant economic consequences. The Committee is aware that the adjustment to stricter capital requirements may have a negative impact on lending in the transition to the new requirements. The Committee therefore supports the SIFI Committee's recommendation to phase in the requirements over a comparatively long period of time

In the Committee's opinion, the course taken by the financial crisis in Denmark would not have been fundamentally different if large banks, including SIFI's, had been separated into banking, mortgage and insurance activities or banking had been separated into retail and investment activities as recommended in, e.g. the so-called Liikanen report. In this context it should be mentioned that investment activities constitute a comparatively small share of total banking activities in Danish financial institutions. Still, the Committee finds that a more detailed assessment may be required to determine whether – and in such case how – it may be appropriate to require large Danish institutions to be separated in some way. The Committee has noted the development in the area under the auspices of the EU which is currently carrying out a consultation on separation etc., and a majority of the Committee finds that any further discussion on this subject must be made under the auspices of the EU.

Moreover, the Committee finds it important in connection with the identification of SI-FI's to remain focused on the fact that the failure of several small banks may also be of systemic importance and therefore, special measures may be required to counter this risk. The Committee welcomes the use of trigger levels for certain types of capital, including limiting dividend and interest payments. It is important that the levels do not deviate considerably from the trigger levels that will be used in other countries, unless specific reasons apply. This is to ensure that Danish credit institutions can sell these types of capital on the markets on an equal footing with foreign competitors.

The Committee has noted that negotiations on a banking union are currently taking place under the auspices of the EU, that it has been agreed to set up a joint supervisory authority (Single Supervisory Mechanism) and that negotiations are taking place regarding a joint resolution authority (Single Resolution Mechanism). The Committee has not assessed pros and cons of Danish participation in a banking union, as such an assessment will depend on the final layout of the elements in the banking union.

The Committee generally commends the various other Danish measures. As mentioned above, the Committee supports the introduction of the Supervisory Diamond, as the Diamond identifies several of the risks that have led to the distress of a number of small and medium-sized financial institutions under the current and the previous banking crisis. The Committee also finds that such measures only partly reduce the risk that small and medium-sized financial institutions take on too much of the same type of risk as identified in the run-up to the current crisis.

The Committee finds that it is decisive to maintain a robust mortgage credit system. The Committee is therefore concerned about certain changes in the mortgage credit sector and in its product range that were implemented prior to the crisis. Changes that have considerably increased mortgage credit institutions' risk. This particularly holds true for the vast volume of loans to be refinanced frequently and the related refinancing risk and the extensive use of interest-only loans. The Committee notes the sector's own initiatives to reduce the risk by e.g. spreading refinancing auctions over the year, introducing so-called "two-layer loans" and differentiated contribution rates. However, the Committee finds that continued efforts are required to ensure a robust sector in the future.

Recommendations in relation to the financial institutions:

The Committee has found it relevant to divide the recommendations in relation to the financial institutions into three sections: Recommendations that will probably have a comparatively bigger impact on small and medium-sized banks, recommendations that will probably have a comparatively bigger impact on large banks and special recommendations for mortgage credit institutions.

Recommendations with a comparatively bigger impact on small financial institutions:

5. The Committee has found that an important reason why many financial institutions have become distressed is that they are exposed to large loan commitments, particularly in the commercial property sector. The Committee notes that the same factors applied during the previous banking crisis in the early 1990's. Against this background, the Committee recommends that the FSA tightens up the Supervisory Diamond limits for large exposures.

6. The Committee recommends a legislative change to allow the FSA to a wider extent exchange data information on large exposures in its credit register with the banks. Such exchange of credit information from credit registers is found in other countries such as, e.g. Germany.

7. The Committee finds that it would be expedient to introduce specific rules on the operation of "simple and secure savings bank activities in the local community", meaning rules defining the "church tower principle". This would make it possible to define simple and secure banking activities for savings banks and co-operative savings banks and to operate under a simpler set of rules. This is, however, not an option under the current international financial regulation, including in particular CRD IV. The Committee therefore recommends that the government strives internationally to make this possible.

Recommendations with a comparatively bigger impact on large financial institutions:

8. The Committee finds that with the current regulatory setting there is a risk that too low risk weights may be used in internal risk-based models to calculate the regulatory capital requirement. The Committee therefore recommends that banks using internal models should also disclose what the regulatory capital requirement would have been using the standard method.

9. The Committee furthermore recommends that a lower limit be determined for the risk weights used in internal models. This can be seen as a differentiated form of leverage ratio, as it uses minimum risk weights to be followed by all banks for the various types of assets.

10. The Committee recommends setting up a group of experts to assess whether the general leverage ratio should be higher (with all assets weighting 100 per cent) than the 3 percent requirement on which the Basel III standards are based. In connection with such an assessment, the group of experts must include the interaction between the general leverage ratio, the differentiated leverage ratio and the capital requirements. The expert group must also assess whether the general leverage ratio limit should be different for banks and mortgage credit institutions

and for banks that use, respectively do not use internal models. The work performed by the group of experts could, among other things, form the basis of the Danish position in connection with the discussions on higher leverage level requirements for banks under the CRD IV rules leading up to 2018. Finally, the group of experts must assess whether economic prosperity will increase if the requirements for Danish credit institutions' equity are higher than in CRD IV and the recommendations of the SIFI Committee.

Minority statements:

B. A minority (Finn Østrup and Anders Grosen) recommends requiring that Danish credit institutions must carry out significant foreign activities through independent undertakings. This will make it possible to reduce the vulnerability of the Danish financial system, as it will be possible to let the foreign undertaking go bankrupt in emergency situations, in the same way as a crisis in the foreign undertaking will be handled by the host country's authorities and not the Danish authorities. In this context it should be noted that large international banks' foreign activities are primarily run by special undertakings and not in the form of branches.

C. A minority (Finn Østrup and Peter Møgelvang-Hansen) recommends aiming at an upper limit for the size of Danish financial institutions. Today, Danske Bank ranks third in size among banks in the old industrial countries, measured relative to the country's economy, and must be expected to advance and rank second within a few years (after the clean-up of the Cypriot banking sector). The failure of Danske Bank or any other large financial institution may inflict considerable losses on the Danish public funds as well as have enormous consequences for the Danish economy in the form of reduced lending etc. Here, reference can be made to experience from other European countries where the failure of large financial institutions have triggered an economic crisis. A Danish membership of the European banking union is hardly a satisfactory solution to the problem of large Danish financial institutions, and from a fundamental point of view, it seem unsatisfactory that issues regarding Danish surrender of sovereignty are decided with regard to the interest of individual financial institutions. On a European level, the Liikanen report proposes separating existing financial institutions into investment bank activities and commercial bank activities. A similar separation is being implemented in several European countries. An expedient solution to the problem adjusted to Danish circumstances could be a requirement to reduce the balance sheet by divesting e.g. mortgage credit activities.

Special recommendation for mortgage credit institutions:

11. The Committee is concerned whether the mortgage credit institutions' own initiatives in terms of reducing the increased risks following the extensive use of loans with a refinancing risk and interest-only loans are sufficient to ensure a robust sector in the future. The Committee therefore recommends that the FSA prepares a "Supervisory Diamond" that is particularly aimed at mortgage credit institutions. The Committee finds that such a Supervisory Diamond should include landmarks that reflect the risks of an institution, including, e.g. limits on the share of mort-

gage credit loans with frequent refinancing (more than every two years) issued by an institution and limits on the share of interest-only loans to selected customer groups that constitute a significant share of the property value.

Minority statements:

D. A minority (Finn Østrup and Peter Møgelvang-Hansen) recommends implementing legislation on the use of two-layer loans when providing mortgage credit loans. Such a requirement means that the outer layer of the loan cannot be provided with SDO loan bonds and therefore does not involve a risk that the institution must provide additional security for this part of the loan. The outermost mortgage credit loans cannot be provided as interest-only loans, nor can they be provided as adjustable rate loans. The minority finds that only through statutory requirements for the mortgage credit institutions is it possible to ensure the consistency in the issue of mortgage credit bonds that has traditionally characterised the Danish mortgage credit system and ensured low-cost and efficient financing.

2.4 Corporate Governance

Before and during the crisis, a number of financial institutions were characterised by poor management and inexpedient management structures. In certain banks, executive directors had too much power relative to their boards of directors and therefore acted high-handedly. A contributory factor was that the boards of directors lacked the required competences to be able to actually challenge the day-to-day management professionally as well as in management terms. Moreover, the conversion of savings banks into limited liability companies created an unfortunate confusion of management in the funds and in the banks that enabled inexpedient business transactions with the funds. Restrictions on ownership and voting rights in a wide range of financial institutions may have kept major shareholders that would have demanded a professional management away from the banks. Finally, the use of incentive pay schemes in the financial sector increased in the years leading up to the crisis.

Following the financial crisis, a number of measures have been taken. These include more stringent requirements on the banks' management, including stricter eligibility and integrity requirements (fit & proper) that make it easier for the FSA to remove the management of an irresponsibly run financial institution. A self-assessment process has been established for the competences of boards of directors in financial institution for the purposes of ensuring that the managements actually consider whether the boards have the required competences. Also, the ratio of fixed to variable pay for management and employees whose activities have a significant impact on the undertaking's risk profile has been capped. Also, additional requirements have been introduced as to the appointment of boards of directors in savings banks funds to ensure actual independence between the individual savings bank funds and the underlying financial institution.

The views of the Committee:

It is important that the management – the board of directors and the executive board – in the individual credit institution is conscious of its responsibility and continuously considers whether it has the right competences to fulfil its individual areas of responsibility. As mentioned, the management of the institution is responsible for ensuring that the institution continuously is robust and viable and that it does not assume any incalculable risks. The executive board is responsible for the day-to-day management of the institution, and the board of directors has the overall strategic responsibility for the institution. Anyone who assumes such responsibility by joining a board of directors must also be certain that he/she has the required competences to meet this responsibility. Hence, all boards of directors are obliged to carefully study and consider the bank's activities to be able to challenge and cooperate with the executive board. Also, the Committee finds that it is decisive that owners of capital/capital notes in the banks have the possibility to exercise active ownership. Only then can the owners take a constructive and critical position on the management's actions and exert influence.

The Committee finds that the boards of directors of Danish financial institutions are too involved in the granting of credit commitments. The involvement of the board of directors in the granting of individual credit involves a risk that the board of directors lifts off the responsibility of the day-to-day management to ensure proper lending. The day-to-day management may therefore claim that the board of directors has approved the individual credit commitments. The result of this practice is an inexpedient corporate governance structure. The Committee therefore finds that increased independence between the day-to-day management and board of directors of financial institutions is necessary to allow the board of directors to perform its function as supervisor of the day-to-day management to an even higher extent.

However, the Committee notes that the Executive Order on Management stipulates that the board of directors cannot confer powers on the executive board to grant unusual or important commitments, a requirement which is deemed necessary by the Committee. The Committee also appreciates that the boards of directors of small financial institutions are more closely involved in the process of granting, in particular, large individual commitments than in large banks, as such large individual commitments may threaten the viability of a small financial institution. At the same time, the boards of directors should intensify their focus on actively monitoring the institution's overall risks, including through e.g. increased requirements for the day-to-day management's reporting to the board of directors. This is to ensure that the board of directors constantly has a detailed overview of the institution's overall risks, including, not least, lending and credit risks.

With regard to incentive pay, the Committee finds that it cannot be ruled out that it increased risk-taking in Danish financial institutions before the crisis, but the introduction of incentive pay in the individual banks was not the main cause of the increased risk-taking and therefore not a significant contributory factor to the crisis. Hence, risk-taking in the banks that introduced incentive pay was higher even before incentive pay was introduced in the institution. The use of incentive pay in certain banks is therefore more a token of poor corporate governance.

Furthermore, the Committee notes that a competent board of directors does not necessarily mean that a financial institution will not experience difficulties. Indeed, reducing the probability of experiencing difficulties presupposes the setting up of competence centres such as credit departments and commercial departments. Setting up such competence centres is a challenge to small financial institutions. However, the Committee generally finds that competent boards of directors will reduce the probability of difficulties in financial institutions. In this context, the Committee notes that particularly small and medium-sized financial institutions, in the Committee's view, are not very good at complying with the recommendations on corporate governance. The Committee deplores that the banks not to a greater extent complies with soft law and their own interest group's recommendations in this area, but more or less automatically use standard phrases to explain why such recommendations are not followed. The Committee notes that the Danish Bankers' Association on 24 June 2013 issued new recommendations to its members, recommending that they take a position on all the recommendations published by the Committee on Corporate Governance of 6 May 2013. The Committee hopes that this will be instrumental in positively changing the attitude towards the recommendations.

The Committee finds that restrictions on ownership and voting rights may have made it difficult to ensure professional management in certain small and medium-sized banks prior to the financial crisis. Accordingly, the Committee finds that certain restrictions on ownership and voting rights provided for in legislation and Articles of Association may have protected the board of directors of an institution that would otherwise have been removed by the owners and may complicate the required capital contributions in the banks from owners who wish to gain influence in accordance with the size of their contribution. Moreover, restrictions on voting rights and ownership may have prevented a structural adjustment, large or small, that could have been expedient in the light of the mounting requirements for individual banks. On the other hand, restrictions on voting rights and ownership are an efficient safeguard against control by major owners who may have a negative impact on the risk profile of the institution.

As to the previous voiced concern that a major shareholder may have irresponsible motives for being a majority owner, the Committee notes that the FSA, subject to further conditions, must approve any owner that attains certain levels of holdings, allowing the FSA to refuse such approval if it suspects irresponsible operation etc.

For these reasons, the Committee acknowledges that it should generally be up to the shareholders in the individual banks to decide whether they wish to be subject to restrictions on voting rights and ownership even though it may in certain cases involve appreciable practical challenges to change such restrictions. However, the Danish Financial Business Act (*lov om finansiel virksomhed*) contains statutory restrictions on voting rights for savings banks and co-operative savings banks, the historical reason being to safeguard the banks' decentralised structure and democracy without control from individual participants. These restrictions may prevent the owners from deciding on which rules should apply in the individual institution.

The Committee notes that a proposal was made in 2010 to repeal the statutory restrictions on voting rights based on similar considerations as stated above and with a two-year transition period to ensure that the savings banks and co-operative savings banks that wished to keep the restrictions on voting rights had time to implement such restrictions in their Articles of Association. The Committee furthermore notes that the legislative proposal was not implemented despite the fact that all savings banks and co-operative savings banks have restrictions on voting rights and ownership in their Articles of Association, and that instead, regulations were implemented that remove the restrictions on voting rights and ownership when the distributable reserves in the individual institution fall below a specified limit. The Committee finds that this is insufficient to improve corporate governance in these banks as required.

Recommendations regarding corporate governance:

12. The Committee recommends that the statutory restrictions on voting rights and ownership for savings banks and co-operative savings banks in the Financial Business Act be repealed, as the Committee finds that the current statutory restrictions on voting rights are too restrictive. However, the Committee also recognizes that some owners of capital/capital notes may wish to be able to withdraw if a dominant single shareholder enters a savings bank or co-operative savings bank. The Committee therefore recommends repealing the statutory restrictions on voting rights in savings banks and co-operative savings bank and at the same time introducing a statutory obligation to make a takeover offer to owners of capital in a savings bank or co-operative savings bank if a single owner gets the majority of the voting rights and therefore control. The value of the takeover offer may e.g. correspond to the price most recently paid by the dominant owner, as a minimum, for the capital notes.

13. The Committee recommends a clarification of the Executive Order on Management to allow boards of directors in financial undertakings to perform their function as supervisor of the day-to-day management to an even higher extent. Accordingly, the Committee recommends that the board of directors of a financial institution should not handle and consider individual cases on credit commitments, unless such commitments are unusual or very significant, e.g. as defined by the board of directors' guidelines on large commitments, or if banks take on a considerable exposure to a new business area. In this context, small and medium-sized financial institutions should be differentiated. At the same time, the Committee recommends that the board of directors' obligation to actively relate to the institution's overall credit risk profile be strengthened, e.g. through increased requirements for regular reporting from the day-to-day management to the board of directors, giving the board of directors a constant and detailed overview of the institution's overall credit risk profile.

14. The Committee recommends that new members of boards of directors be obliged to complete a course of study in which they are introduced to the most important obligations and functions to be performed by board members in a financial institution. The Committee therefore recommends determining specific requirements regarding such introductory courses for board members in financial institutions and that providers of such courses must be approved by the FSA

Minority statements:

E. A minority (Anders Grosen) recommends that, in future, work be distributed more appropriately between the banks' managements and their shareholders. A necessary condition for this is that the shareholders are generally entitled to vote for their shares. It is therefore suggested that restrictions on voting rights and ownership in Danish listed companies be removed. The restrictions on voting rights and ownership cannot be removed on the shareholders' initiative due to precisely the restrictions on voting rights and ownership, the general rules of the Danish Companies Act (aktieselskabsloven) and individual Articles of Association in a wide range of banks. The restrictions on voting rights and ownership can be removed via legislation, either through the Companies Act, the Financial Business Act or the stock exchange legislation.

F. A minority (Jens Thomsen and Finn Østrup) finds that an increasing number of rules have been laid down in recent years on material to be submitted to the board of directors in addition to the recommendations on corporate governance. It is important to regularly review the relevance of these rules to ensure that the board of director's remains focused on the credit institution's risk, particularly in relation to lending.

2.5 Auditors

An auditor's intended role is to be the public's supervisor of financial statements and other financial reporting from, among other undertakings, the financial institutions, and auditors therefore play a crucial role regarding the confidence in the financial sector. In connection with the financial crisis and the handling of a number of distressed financial institutions, there have, however, been a number of cases in which audited financial statements have not been presented fairly and the auditors' work could therefore be criticized. Moreover, a number of examples show that the external and internal auditor did not report a range of material identified circumstances in the financial institution, including e.g. reporting on identified weaknesses in lending, overstepping of authorities etc., in time to the board of directors, making it impossible for the board of directors to consider the problems in due time.

In continuation of the crisis, training requirements for auditors of financial undertakings have become stricter to prepare the auditors for the special circumstances in the world of finance, and a certification scheme has been implemented for the undersigning auditor(s) in financial institutions, mortgage credit institutions and insurance companies, including life assurance companies and pension providers, as such financial institutions are particularly complex and their viability is significant to the confidence in the financial sector. This scheme allows the FSA to respond swifter and more efficiently vis-à-vis the auditors of financial institutions if errors and omissions are found relating to their audit.

The views of the Committee:

It is important to inspire confidence in the financial sector that the external auditor performs his role as the public's representative and is conscious of his responsibility. In this context it is important that the auditor is obliged to be objective in his work. In this light, the Committee finds it remarkable that there was a tendency in several distressed financial institutions handled during the crisis to find several serious errors and omissions in the financial statements despite a clean audit report and to find omissions in the banks' other financial reporting.

The external auditor must immediately inform the FSA of any circumstances that are decisive for the institution's ongoing activities. The auditor must also inform the board of directors of any material issues regarding his audit such as material uncertainty, errors or omissions concerning the bank's bookkeeping records, financial reporting or internal control.

If the auditor fails to live up to his responsibility, the confidence in the financial sector may suffer. The Committee therefore supports the implementation of stricter requirements for auditors in the form of increased training requirements and requirements for certification etc. of auditors. The Committee finds that the training requirements for certification must focus on measuring lending. The Committee has also noted that the FSA may take away auditors' certification to audit financial institutions. An auditor's certification may be taken away if the auditor has accepted the valuation of the institution's large loan commitments in the long-form audit report, but such valuation was not performed in accordance with the financial reporting rules. This may be the case if an objective indication of impairment has not been sufficiently identified or if the debtor's ability to repay the loan has not been assessed using realistic expectations.

Also, it should be considered whether more unambiguous communication and matching of expectations is required relative to the auditor's role and work, as the Committee finds that, currently, there seems to be a gap between the work and responsibilities conferred on the auditor by the public and the actual work performed and responsibility assumed by the auditor.

The EU has also criticized the auditor's role, emphasizing two elements; partly a wish for better communication to users of financial statements as well as to the audited undertaking of the auditor's critical observations, partly the concentration of audit services in a small number of audit firms. As a consequence, the European Commission has brought forward a proposal to change the existing regulation of auditing in the form of a Regulation that intensifies the auditor's obligations in relation to Public Interest Entities. Given the negotiations on new auditor obligation regulations in the EU, the Committee suggests that the government follows these negotiations. If the relevant parts of the Regulation, in particular, are adopted without changes to apply to all financial institutions, the Committee does not find that other initiatives are required relative to the auditor's obligations.

With respect to the enforcement of the auditor's failure to meet his obligations, the Committee has noted that the formal independence of the disciplinary board for state-authorised public accountants and registered public accountants (*Revisornævnet*) has been strengthened but that the board's processing time is still too long to actually make it possible to assess whether the change in the composition of the board has had the desired effect. The processing of cases involves the exchange of pleadings with a completion period of roughly six months. After this period, there is a waiting time for the disciplinary board for state-authorised public accountants and registered public accountants to handle and close the case. So far, this waiting time has been roughly two years. The cases currently pending are expected to be closed after a waiting time of six to eight months.

The Committee has noted that auditors who audit financial institutions as from the 2014 financial statements must be certified by the FSA. The Committee finds that the training requirements for certification must focus on impairment.

Recommendations regarding auditors:

15. The Committee recommends that the disciplinary board for state-authorised public accountants and registered public accountants extraordinarily be supplied with resources to be able to close cases concerning the audit of financial undertakings during the crisis within due time.

2.6 Consumers

The combination of comparative prosperity, optimism and abundant liquidity before the crisis meant that risk was neglected, and households and ordinary consumers demanded and were offered – and therefore invested in – risky financial products to an even higher extent. Households and ordinary consumers started speculating to get a share of the expected continued boom – be it on the securities market in the form of shares and other financial products, on the housing market by purchasing an extra home, holiday homes, etc., or on a completely different market. These investments were to an appreciable extent financed with borrowed money.

After the crisis, a number of measures have been taken to increase bank customer's security though better consumer information and transparency in the financial sector. Such measures include requirements for risk-labelling of investment products and loans and requirements for investment advisers. Furthermore, the aim has been to increase transparency in relation to investment product costs by requiring that retail customers be given information on the Annual Percentage Rate of Charge (APR) and that APR be stated on the annual statement of fees or the deposit statement when purchasing investment products which also includes information on any distribution agreements and commission and any other payment for distribution or advisory services. Moreover, debt-financed sale of own shares in the financial institutions is no longer permitted. Moreover, the mortgage market and financial (impartial) advisers have been regulated and finally, the Consumer Ombudsmand has been strengthened through increased powers and resources.

The views of the Committee:

The foundation of a well-functioning financial sector is that customers, private as well as commercial, understand their possibilities as well as the consequences of their choices and that the relationship between the individual customer and the financial institution inspires confidence. It is important that, when purchasing financial services, the individual private customer is active and seeks the knowledge and information that he/she deems necessary to be able to make his/her decision. As in all other purchasing decisions, the individual private customer is responsible for the decisions he/she makes on the financial market, be it in the form of purchasing securities, taking up loans or selecting specific accounts. The individual private customer – the individual consumer – is responsible for making the best possible decisions based on the customer's specific situation.

To allow consumers to make the best possible decision, it is important that they are provided with balanced and comprehensive information. Also, it is important that financial advisers in banks provide proper and satisfactory advice to the individual customer. Accordingly, to allow consumers to make well-founded decisions it is decisive that information on costs, contract terms etc. is open and transparent. Only then can consumers determine the consequences of their choices.

The Committee generally finds that a number of reasonable and positive measures have been implemented in continuation of the crisis and that they may contribute to inspiring more consumer confidence and security.

The Committee is aware that the risk-labelling schemes for investment products and for loan products should not stand alone when advice is provided and aims to find a simple way of providing the customer with a better understanding of the risk of various investment and loan products. However, the Committee is sceptical about the relevance of the chosen risk-labelling scheme, as it is too wide-meshed and can send unfortunate signals regarding the risk of various products. The Committee, however, finds that the increased competence requirements for investment advisers that were introduced at the same time as the risk-labelling of investment products are relevant and should be maintained.

The Committee finds that the risk that conflicts of interest in the provision of investment advice has negative consequences for the customers should as far as possible be countered by clear rules. This also applies in respect of openness and transparency in relation to bonuses etc. The Committee has noted that under the agreement between the Danish Bankers' Association, the Danish Shareholders Association and the Danish Consumer Council with effect from 2013, a scheme has been established with information on commission etc. in connection with the actual advice provided prior to a purchase and on an ongoing basis on the annual deposit statement and that there are currently no legislative plans to introduce a prohibition against third-party commission, as the experience gained from the information scheme and from the newly introduced prohibition in this area in the UK and the Netherlands is still awaited.

The Committee finds that it is incompatible with working as an investment adviser to have a personal financial interest in making the person seeking advice purchase one or several securities or a certain type of securities based on the advice provided. Variable pay that depends on the volume or quality of the securities sold for persons involved in the provision of advice/sale of securities to retail customers should therefore not be possible for providers of investment advice.

The Committee finds that it is important for consumers to have access to an efficient complaints system if they have been given insufficient or incorrect advice from a financial undertaking and wish to complain. The private complaints boards, including the Danish Complaint Board of Banking Services (the Complaint Board) and the other complaints boards in the financial sector, are not courts of law and therefore, in terms of due process it is not possible to make the decisions from these complaints boards binding on financial institutions.

In the light of these developments, the Committee welcomes the legislative change implemented in 2009 which means that today, under certain circumstances, it is possible to enforce the Complaint Board's decisions, provided that the Board finds in favour of the consumers. The same holds true for the other financial sector complaints boards. If the financial institution remains passive within a period of 30 days from the service, the decision can be enforced after the end of such period. The consumer can then go to the enforcement court to collect the amount payable by the financial institution according to the decision. To also be able to strengthen compliance with the complaints board decisions in cases where the financial institution express that it does not intend to comply with the complaints board's decisions, the Committee welcomes that in 2010, the Danish Competition and Consumer Authority was enabled to cover the costs of a consumer in connection with legal proceedings based on a decision or a settlement in which the Complaint Board has found in favour of the consumer, either fully or partially. The same holds true for the other financial sector complaints boards. This ensures that a consumer will not for economic reasons refrain from instigating legal proceedings against the financial institution when the financial institution fails to comply with a decision made by the Complaint Board or a settlement made in connection with the procedure.

However, the Committee finds that it is important for the legitimacy of the work performed by the financial complaints boards that the sector ensures that the financial sector complaints boards have the required resources to ensure an effective and swift procedure and that the sector contributes to disciplining itself within its own ranks by complying with the complaints boards' decisions. This is particularly relevant for unanimous decisions against financial institutions in the Complaint Board where the Committee has seen an unfortunate tendency of increasing failure to comply with such decisions.

The Committee furthermore finds that to improve the protection of consumers it should be considered to increase the legal sanctioning relative to the specific codes of conduct that have been introduced in the Executive Order on Good Business Practices (*god skik-bekendtgørelsen*) and the Executive Order on Investor Protection (*investorbeskyttelsesbekendtgørelsen*). Also, it is relevant to look at the liability to pay damages where the consumer has suffered a financial loss due to insufficient financial advice. In this context, the Committee has noted that the government has set up a committee which is currently reviewing these issues.

Recommendations regarding consumer affairs in the financial markets

16. The Committee recommends that risk-labelling of investment products and loans is either (i) thoroughly and comprehensively reviewed to ensure stricter classification of the products and that the classification of the individual products is regularly updated or (ii) abolished.

17. The Committee recommends that a prohibition against variable pay be introduced that depends on the volume of securities sold for persons involved in the provision of advice/sale of securities to private customers.

Minority statements:

G. A minority (Jens Thomsen, Anders Grosen and Finn Østrup) recommends that purchasers of certificates in investment funds should be allowed to deselect advisory services. In such cases, any "kick-back" from the investment fund to the financial institution must go to the investor. A consequence of such an adjustment will be that a financial institution cannot become liable to pay damages for loss or disappointment to any person who has deselected such advice.

H. A minority (Finn Østrup and Anders Grosen) recommends setting up an institution as financial consumer ombudsman. If for administrative reasons it is not desirable to set up such a new institution, consumer affairs competences in the financial sector should be returned to the Consumer Ombudsmand where they used to be. The minority finds that focus on consumer protection will increase if consumer protection considerations are handled by an institution with this as its sole purpose. This also prevents any coordination problems due to having two public authorities in this area (currently the FSA and the Consumer Ombudsman).

I. A minority (Anders Grosen and Finn Østrup) suggests that legislation along the lines of e.g. the Netherlands and the UK, be adopted on a new fee model for the provision of investment advice to private individuals. Instead of the current model under which the lion's share of the financial institutions' earnings from the sale of investment products comprise "hidden" commission, the minority suggests a visible advisory fee (hourly rate or fixed fee) and a prohibition against "hidden" commission. A legislative initiative is required, as neither financial institutions nor customers have any incentive to change the current model. The reason for this is that

   1. the financial institutions' earnings will be reduced;
   2. many customers are under the illusion that advice is free of charge;
   3. tax rules favour the current model with an indirect allowance for investment costs whereas direct advisory fees are not deductible.

2.7 The Danish Guarantee Fund for Depositors and Investors

Due to the financial crisis and the winding-up of distressed financial institutions, the financial institutions' financing of the Danish Guarantee Fund for Depositors and Investors has fluctuated greatly – in a period when the sector was already facing economic challenges. The financing form has therefore been changed and increased for the purpose of ensuring a smoother and more predictable strain on the financial institutions.

The views of the Committee:

The Committee welcomes the initiative to ensure smoother and increased payments to the Danish Guarantee Fund for Depositors and Investors. However, the Committee deplores the fact that the individual financial institution's payments to the Guarantee Fund fail to reflect the risk within the institution (so-called risk-based payments) as also suggested by, among others, the IMF in November 2012 and as practiced in e.g. the USA. Such risk-based payment will be a more reasonable system and also reduce the incentive to excessive risk-taking in the financial institutions. The Directive currently in force is not deemed to prevent the introduction of risk-based payment. Should Denmark introduce risk-based payment of premium to the Guarantee Fund, Denmark would, as far as the Committee is aware, be the first country to introduce such payment in the EU whereas the system is already known in other non-EU countries (such as the USA). Such unilateralism should generally be avoided, but if joint EU rules are not adopted within a reasonable period of time, Denmark should nevertheless introduce risk-based payment of premium.

The Committee recommends:

18. The Committee recommends that payments to the Danish Guarantee Fund for Depositors and Investors be risk-based. However, the Committee finds that the introduction of such risk-based payment should generally await the implementation of the future Directive on a guarantee fund for depositors and investors. If such a Directive has not been adopted by 2015, the Committee recommends that Denmark introduces a risk-based payment scheme.