FINANSRÅDET

BANKS – IN BRIEF

January 2012

A well-functioning and strong financial sector is a prerequisite for a country's growth and development, because the financial sector turns idle and unproductive capital into productive investment – which provides a boost to society and generates growth. And Denmark needs growth.

Moreover, the sector adds value to society via its widespread use of IT, which has helped put Denmark at the forefront of the digital age.

At this juncture, however, it is difficult for individual banks and the banking sector overall to contribute as much as they could to pulling Denmark out of the crisis. This is because earnings are under pressure: among other factors, due to high costs of funding, loan losses and write-downs, as wells as expenses to bank rescue packages and the deposit guarantee scheme.

New regulatory requirements for capital and liquidity combined with subdued economic growth in Denmark and abroad also mean that bank returns are expected to remain low relative to their substantial equity.

This brochure is intended to provide an overview of central key financial ratios, the challenges facing the banks and their potential.

Jørgen A. Horwitz
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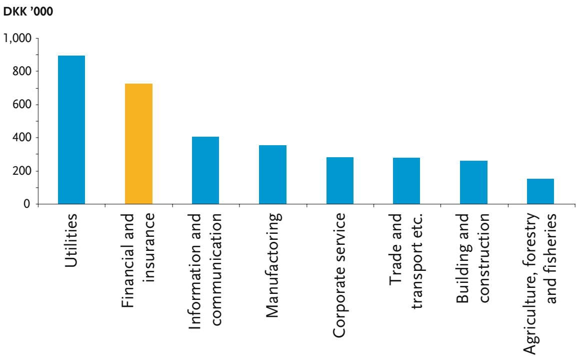
A productive financial sector

Financial undertakings – banks, pension and insurance companies, mortgage lenders etc. – are among the most productive undertakings in Denmark. If, for instance, a company's productivity is based on the number of hours worked, productivity in financial undertakings is significantly higher than that in trade and transport and more than double that of manufactoring.

Chart 1: Financial undertakings among the most productive.



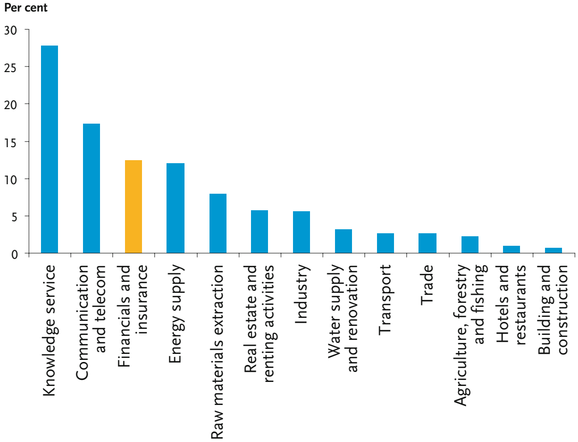
Note: Gross value added relative to the number of hours worked, DKK '000. Source: National accounts 2010, excluding raw materials extraction, homes, property trading, and commercial properties rental as well as the public sector, Statistics Denmark.

In 2010, the financial sector accounted for just under 6.3 per cent of total gross value added, though the sector made up only 3 per cent of overall employment.

The Danish banking sector employs more than 45,000 people while the financial sector overall employs more than 85,000 people. In the Capital Region of Denmark, the financial sector is one of the main employment segments of the private sector.

Furthermore, the financial sector employs a large number of people with a with a higher education. The proportion of people with a master's degree in the financial sector exceeded 12 per cent in 2010.

Chart 2: High proportion with a master's degree (or higher) in the financial sector.



Note: Percentage of employees with a master's degree (or higher) in the sector, 2010.
Source: Statistics Denmark.

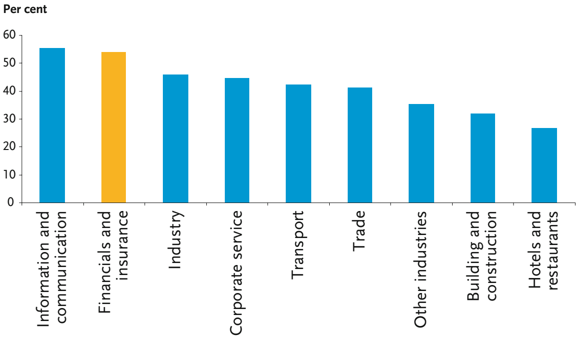
A visionary financial sector

Financial undertakings in Denmark are committed to digitalisation and the use of IT, as well as to innovation. The financial sector combines knowledge and expertise in creating an efficient IT infrastructure for payments services and securities trading.

Banks contribute to research and development

The stiff competition between international financial centres necessitates greater, better and faster innovation. Danish financial undertakings therefore invest in research, development and innovation activities alike, making them among the most innovative businesses in Denmark.

Chart 3: Financials among the most innovative.



Note: Proportion of innovative businesses by industry, 2009.
Source: Statistics Denmark.

In 2009, the financial sector accounted for approx. 8 per cent – corresponding to DKK 2.7bn – of total private investment in research and development in Denmark.

In recent years, the banks have strengthened their research partnerships with universities. Thus, the Danish Council for Strategic Research granted DKK 31.4m to research centre HIPERFIT (High Performance Computing for Financial Information Technology) at the Department of Computer Science of the University of Copenhagen in 2010.

Four banks participate in the centre's research, which, among other things, focuses on the processing of huge volumes of financial data. The project was initiated by the Copenhagen Finance IT Region.

Copenhagen Finance IT Region

The Copenhagen Finance IT Region (CFIR) was set up in 2009 to maintain and strengthen development between finance and IT. It is funded by the EU regional fund and the capital's growth forum (Vækstforum Hovedstaden) in cooperation with 13 partners, among them the Danish Bankers Association. The partners also include Aarhus University, CBS, Copenhagen Capacity, the Danish ICT and electronics federation (DI-ITEK), the Association of Danish Lawyers and Economists (DJØF), the Danish Metalworkers' Union (Dansk Metal), the Financial Services Union (Finansforbundet), the Union of Commercial and Clerical Employees in Denmark/private (HK Privat), the Danish IT Industry Association (IT-Branchen), the IT University of Copenhagen, the University of Copenhagen and PROSA (the union for IT professionals in Denmark). CFIR is a so-called cluster initiative intended to generate growth and innovation between finance and IT, attract and develop more high-value jobs as well as improve the scope for the export of services from Danish finance and IT businesses.

Equal framework conditions pave the way for growth

To increase the number of high-value jobs, it is important that the framework conditions for development are in place. In a global industry, equal framework conditions are a vital precondition.

If the competitive environment for asset management in Denmark improves, there is, for example, a good chance that economies of scale and synergies can be obtained. If asset management in Denmark is allowed to operate under the same conditions as it does in other European countries, this area will attract and maintain high-value jobs within finance and IT. This would be the case because asset management currently undertaken by Danish banks abroad could be relocated back to

Denmark. Danish assets under management abroad totals approx DKK 300bn, corresponding to about 300 jobs. This would boost the value added in the sector by about DKK 450m, and have a positive effect in the form of revenue to the economy.

Currently, EU directives are being implemented, which provide scope for improving the competitive environment for asset management – in Denmark, this will be investment associations and special-purpose associations. The new rules mean, *inter alia*, that asset management can now be administered across national borders within the EU.

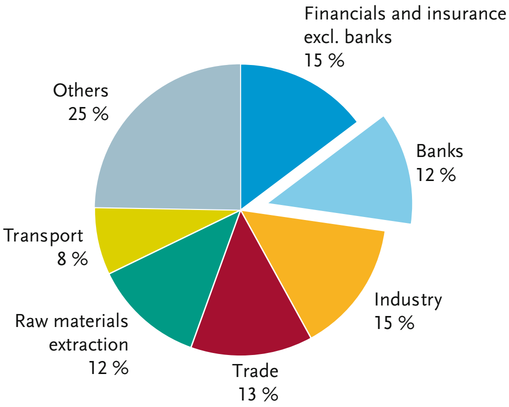
These directives are the UCITS Directive (on Undertakings for Collective Investment in Transferable Securities) as well as the AIFM Directive (on Alternative Investment Fund Managers). These directives open the way for increased cross-border competition. As Danish law currently differs from the law in other EU member countries, it will be possible to attract and retain important jobs if the two directives are implemented in Denmark without 'gold-plating', i.e. without special Danish rules.

Banks' contribution to the public finances

Banks' tax payments
Between 2000 and 2009, Danish banks paid an average of 12 per cent of the government's total revenues from corporation tax, equivalent to DKK 5.6bn annually. In 2010, the banks paid corporation taxes of DKK 2.5bn.

Moreover, the banks pay payroll tax exceeding DKK 2bn a year.

Chart 4: Banks account for a large share of corporation tax.



Note: Proportion of government revenues from corporation tax, 2000-2009. Source: Statistics Denmark.

Bank rescue packages have not cost taxpayer money
According to a statement from the Danish Ministry of Business and Growth of 7 November 2011, the government will generate a profit on the bank rescue packages of DKK 9.4bn up to and including 2012, provided that the government will not incur further expenditure as a result of defaulting banks.

The banks' expenses for the bank rescue packages up to and including 2012 total DKK 47.4bn, including expenses relating to Roskilde Bank.

Table 1: The banks expenses so far up to and including 2012.

	DKKbn	
Loss on Roskilde Bank	0.8	
Bank Rescue Package I		
- Guarantee commission in 2009 and 2010	15.0	
- Loss on defaulting banks (excl. Roskilde Bank)	10.0	
Bank Rescue Package II		
- Interest expenses on government capital injections in 2009-2012	14.0	
- Current commission relating to individual government guarantee 2010-2012	3.5	
- Loss on Amagerbanken, Fjordbank Mors and Max Bank	4.2	
Total (***)		47.4

Table 2: The government's preliminary statement of the bank rescue packages up to and including 2012.

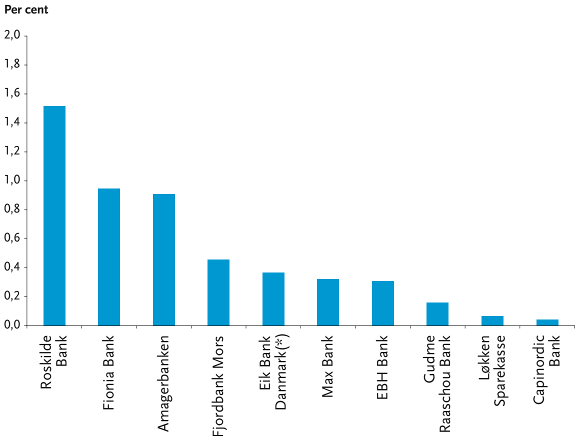
Bank Rescue Package I	**DKKbn**	
Government revenue		
- Recourse guarantee	10.0	
- Guarantee commission in 2009 and 2010	15.0	
Total		25.0
Government expenditure		
- Loss on acquisition of defaulting banks under Bank Rescue Package I	12.0	
- Loss on Roskilde Bank (*)	10.5	
Total		22.5
Profit on Bank Rescue Package I incl. Roskilde Bank		2.5
Bank Rescue Package II		
Government revenue		
- Net interest income, government capital injections 2009-2012	9.7	
- Guarantee commission, individual government guarantees	3.5	
Total (***)		13.1
- Loss on Eik Bank, Amagerbanken, Fjordbank Mors and Max Bank, capital injections	2.4	
- Loss on Amagerbanken, Fjordbank Mors and Max Bank, individual government guarantee	3.6	
- Unrealised loss on shareholdings in Aarhus Lokalbank and realised loss in Max Bank	0.2	
Total		6.2
Profit on Bank Rescue Package II (preliminary) (**)		6.9
Total profit for the government (preliminary) (**)		9.4

(*) Roskilde Bank was wound up before Bank Rescue Package I.
(**) Note that net interest income of about DKK 3bn for 2012 has been included on the revenue side, but that any future expenditure remains unknown.
(***) The sum may deviate from the total amount due to rounding.
Source: Financial Stability Company, Ministry of Business and Growth and Danish Bankers Association.

Banks in winding-up proceedings

Since 2008, ten Danish banks have been wound up. These banks held a combined market share of about 5 per cent.

Chart 5: Market share of banks in winding-up proceedings



Note: Market share is calculated on the basis of lending data for the year before the relevant bank was transferred to the Financial Stability Company. In the case of Capinordic Bank, the share is calculated on the basis of lending two years before bankruptcy.
(*) Faroese Eik Bank is not included.
Source: Danish Financial Supervisory Authority and Danish Bankers Association's calculations.

Banking sector earnings under pressure

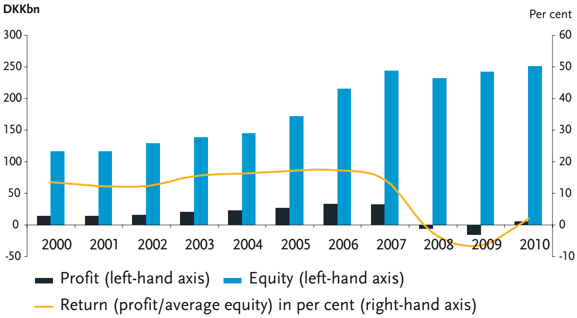
Banks' earnings have been under pressure in recent years. The main reasons are the significant cost of funding, expenses to bank rescue packages, increased loan losses and write-downs as well as the deposit guarantee scheme, which has secured depositors up to EUR 100,000 in the failed banks.

Due to new rules and regulatory requirements combined with subdued economic growth in Denmark and abroad etc., bank earnings are expected to remain low in the years ahead.

The banks posted pre-tax profits of DKK 6.5bn in the first half of 2011. This compares with equity at end-H1 of DKK 267bn, resulting in a return on equity of 2.6 per cent before tax. Such a low return on equity is not attractive for investors, who typically require a higher return on their investments.

Compared with other sectors, banks' return on equity is exceptionally low. The banks' average return on equity after tax was only 2 per cent in 2010. However, the return in C20 – the 20 largest listed Danish companies – exceeded 18 per cent.

Chart 6: Bank profits at very low levels.

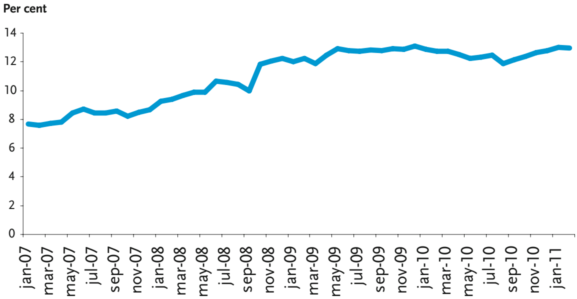


Note: Trend in banks' post-tax profit in DKK billion and equity. 2010 figures exclude Amagerbanken. Including Amagerbanken, the total profit for 2010 would be significantly lower.
Source: Danish Financial Supervisory Authority's financial data and Danish Bankers Association's calculations.

Increased costs for banks lead to higher prices

The costs of raising capital for Danish banks have risen sharply since the onset of the international financial crisis in 2007. Higher costs of capital combined with requirements for increased capitalisation have put significant pressure on the sector.

Chart 7: Rising costs of capital for Danish banks.



Note: Calculated on the basis of the method in "The cost of equity for global banks: a CAPM perspective from 1990 to 2009", BIS Quarterly Review September 2009. Covers Danske Bank, Jyske Bank, Sydbank and Nordea Bank AB.
Source: Nasdaq OMX and Danish Bankers Association's calculations.

Rising costs have for some time meant that Danish banks have had to raise their lending rates or cut their deposit rates. However, given current interest rate levels, only the lending rate can be changed in practice.

It is not only the rising costs of capital that are passed on to prices. Turmoil in international financial markets – and the resultant higher money market rates – leads to the same outcome. At the same time, domestic and international surveys show that various bank taxes are typically passed entirely on to customer prices.

In fact, it is not possible to spend the banks' profits on funding the increased costs, as equity and hence the capital buffer would become unacceptably low relative to the increasing capital requirements imposed on the banks.

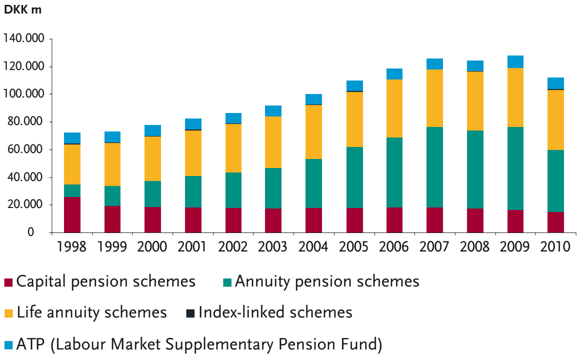
Consequences of the pension ceiling

When the ceiling on deductions for annuity pension payments etc. is reduced to DKK 55,000, pension payments are likely to decline. This will, for example, affect people with relatively varying income – typically the self-employed, including entrepreneurs. Moreover, it will affect people, who for some reason did not begin to pay into pension schemes until relatively late in their working lives.

It is questionable whether such an initiative will generate additional revenue for the public sector. Some people will opt for life annuity products, opt out of pension savings altogether or relocate their savings to areas with lower taxation.

Experience from the introduction of the DKK 100,000 ceiling in 2010 shows that payments into annuity pensions are reduced without being accompanied by a corresponding increase in payments into (e.g.) life annuity pension schemes. Payments into annuity pension schemes fell by almost DKK 12.1bn in 2010 compared with 2008, while payments into life annuity products rose by a mere DKK 1.3bn in the same period. Pension payments will thus in all probability fall further when the ceiling is lowered to DKK 55,000.

Chart 8: Declining pension payments in 2010.



Note: Deflated by the consumer price index to 2010 levels.
Source: Danish tax authorities, Statistics Denmark and Danish Bankers Association's calculations.

New extensive sector regulation

Many new rules have been introduced since the financial crisis broke out in 2008. More than most people think. To illustrate the reality facing banks in their everyday work, we have listed the rules already introduced as well as the rules currently being introduced.

Danish regulation implemented since 2008

> New principles of measurement, classification and valuation of banks' assets (IAS 39).
> The Supervisory Diamond – introduction of a number of benchmarks for banking activities.
> Publication of individual capital needs.
> Completion and reporting of mandatory liquidity stress tests.
> Selected Danish banks must participate in Europe-wide stress tests.
> Guidance on the Pillar II process. Resulted in a de facto tightening of the stress tests that banks must be able to pass.
> The banks have to publish orders, reprimands and risk information, which in the view of the Danish Financial Supervisory Authority, is vital to the undertaking's customers, depositors, other creditors or the financial markets, in which the shares in the undertaking or securities issued by the undertaking are traded.
> Possibility for the Danish Financial Supervisory Authority to remove members of the executive board and the board of directors.
> Tighter fit-and-proper requirements on management.
> New rules on management and control of banks with stricter requirements on the board of directors' rules of procedure and duties, as well as stricter requirements on the institution's management/operation.
> Limitations on variable salaries for management in financial undertakings.
> Possibility for the Danish Financial Supervisory Authority to intervene in bank operations and order specific measures if, for example, there is a significant risk that the bank can no longer meet its capital requirement.
> Automatic abolition of limitation to voting rights in savings banks and cooperative banks if the guarantee capital or the cooperative capital accounts for a certain percentage of equity.

- Ban on banks' loan financing when they sell own shares or guarantee certificates, even if the loan offer does not come from the bank itself.
- The Danish Financial Supervisory Authority can order a bank to initiate an independent investigation of conditions at the bank if the Authority finds that this would be of significant importance to the supervision of the undertaking.
- Stricter rules on outsourcing, implying that the Financial Supervisory Authority can better supervise the banks' outsourcing activities.
- Executive order on the statement of base capital (new requirements for common equity tier 1 and hybrid core capital – implementing CEBS standards).
- Executive order on large exposures (including new rules on interconnected exposures and indirect exposures to collective investment schemes – implementing CRD II and CEBS standard).
- Reporting on credit quality of exposures (Executive Order on Accounts and guidance for financial reporting – the credit register).
- Stricter requirements for internal models in the market risk area (Executive Order on Capital Adequacy – implements CRD II and CRD III).
- Stricter requirements for investors' due diligence when investing in securitisations and stricter requirements on suppliers of securitisations (Executive Order on Capital Adequacy – implementing CRD II).
- Special capital requirements for resecuritisations (Executive Order on Capital Adequacy – implementing CRD III).
- Certification of investment advisors (certification and competency requirements for investment advisors).
- Introduction of a DKK 100,000 ceiling on deductions for payments into annuity pension schemes etc. In connection with the Budget 2012 proposal, the proposed ceiling has been reduced to DKK 55,000, preceded by a two-year period with a DKK 50,000 ceiling.
- Payroll tax increase from 9.13 per cent to 10.5 per cent.
- Bringing the introduction of the payroll tax increase forward by two years – coming into force on 1 January 2011 instead of 1 January 2013.

> Equalisation tax on large pension disbursements.
> The Act on Investment Associations (better risk management, introduction of compliance function etc.).
> Establishment of audit committees.

Initiatives relating to the winding-up of banks

> *Bank Rescue Package III:* The purpose of Bank Rescue Package III is to function as a kind of exit scheme for banks that default and have to be wound up via the Financial Stability Company.
> *Dowry scheme:* This scheme allows the Guarantee Fund for Depositors and Investors, which is funded by the banks, to add funds and provide guarantees in connection with the transfer of a defaulting bank's activities to another bank.
> *Bank Rescue Package IV/Consolidation package:* An extended dowry scheme, making it more attractive for healthy banks to take over defaulting banks. In the future, the banks' payments to the Guarantee Fund for Depositors and Investors are to be based on an insurance-style funding with annual premiums. A committee is to identify a number of systemically important financial institutions. (The dowry scheme alone has entered into force).

Future Danish regulation

> Risk identification of loans (traffic lights: red, yellow and green loans).
> Danish Financial Supervisory Authority's credit register: the purpose of the register is to issue early warning signs about weaknesses regarding customers with substantial loans in several different banking institutions. (The register has not yet come into force, but is expected to be established as of 1 January 2012).
> Future rules on systemically important financial institutions.

EU regulation

> Introduction of capital buffers beyond the 8 per cent solvency requirement and the potential supplementary Pillar II solvency requirement.
> Stricter requirements regarding the capital base of financial undertakings with a stronger emphasis on equity.

- Considerably stricter requirements on the quality of the capital elements eligible for base capital as well as higher requirements for the relative quantitative size of common equity tier 1.
- Major changes in the write-down model for bank lending.
- New rules for netting assets and liabilities.
- New rules for treating financial liabilities.
- Full harmonisation of the solidity regulation in the EU (single rule book).
- Reporting of gearing targets in view of a future maximum gearing requirement for credit institutions' equity.
- New capital requirement for OTC derivative transactions.
- Liquidity reports in view of future quantitative liquidity requirements such as the short-term liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).
- SIFI regulation – stricter requirements for large systemic institutions, including for capital, supervision etc. (expected to be tabled in 2012)
- Crisis Management – stricter requirements for supervision, early intervention and crisis management of banks (expected to be tabled in 2012).
- New supervisory structure in EU rules on closer cooperation and rule issuance in the EU (implemented from 1 January 2011).
- Stricter requirements for financial undertaking management (as part of the proposal for a change to CRD IV).
- Deposit guarantee – changes to deposit guarantee regulations concerning coverage, increased funding etc. (currently being negotiated).
- Investor guarantee – changes to the investor guarantee regulation concerning coverage, increased funding etc. (currently being negotiated).
- The size of administrative fines that can be imposed on institutions and individuals is considerably higher than the traditional level for fines established in Denmark.
- Whistleblower scheme. Comprising the European Commission's proposed directive on credit institutions' operations (CRD IV).
- Self-regulation at EU level: transparency and comparability of fees relative to payment accounts.
- Directive on credit agreements relating to residential property (responsible lending): regulates loans secured on real property.

> Future far-reaching and extended requirements for external audit.
> European Commission's green book on audit conditions.
> New leasing rules.
> Convergence between IFRS and the US accounting standards (FASB).
> Revision of the Conglomerate Directive.
> New reporting requirements for accounting and solvency information, including a new format.
> Move from the European Commission expected regarding revision of the MiFID directive.
> Final regulation of short selling pending (the European Commission published a draft in September 2010).
> Final regulation on OTC derivatives and CCPs pending (the European Commission published a proposal in September 2010).
> Changes in the scope for accounting treatment of risk hedging (hedge accounting).

Negative consequences of transaction tax

Tax on financial transactions would be imposed on ordinary firms and consumers. It is a widely-held misconception that such a tax would only affect professional investors. By far the majority of financial transactions are executed on behalf of the banks' customers, and therefore the tax will also lead to additional costs for them. Danish pensioners, for instance, face the risk of seeing their monthly pension disbursement eroded by up to DKK 700.

The European Commission's proposal for a financial transaction tax (FTT) implies a 0.1 per cent tax on securities transactions involving equities and bonds, for example, and a 0.01 per cent on derivatives transactions. Unlike the previous Danish tax on equity trades, this taxation will also include transactions between financial undertakings. Furthermore, both the buyer and the seller would have to pay tax if both parties are domiciled in the EU. Under the previous Danish scheme, the tax was only imposed on buyers.

It is important to emphasise that a substantial share of a transaction tax burden would have to be paid by pension funds. This will affect individual pension savers.

The negative impact of the transaction tax on pension savers can be illustrated by an example calculation for a person with an annual income of DKK 360,000. 15 per cent of the income is paid into a pension scheme, with 30 per cent invested in equities and 60 per cent in bonds. We assume that the turnover rate for the equity portfolio is 2, while the turnover rate for the bond portfolio is 1. If we further assume that contributions are made to the pension scheme[1] for 40 years and that the pension is disbursed over a 20-year period as an annuity pension scheme, the introduction of a tax on equity trades of 0.1 per cent would reduce the monthly pension by about DKK 700 after tax in present value. This corresponds to a reduction in the pension disbursement of some 5.6 per cent.

Depending on the pension product, the turnover rate for equities can be lower – e.g. around 0.5. Under this assumption, the transaction tax will erode the monthly pension by about DKK 400.

The introduction of a transaction tax would thus reduce the spending power of future pensioners.

Global equity markets are closely interconnected, and an EU transaction tax would counter the development towards integrated capital markets. This initiative would distort competition for European citizens and undertakings. The consequence would typically be that trading is moved outside the EU. Less trading leads to deterioration in price formation, an increase in undertakings' funding costs, and funding will be impeded. This would harm investments and hence employment and productivity.

The transaction tax is backed in the EU by Germany and France in particular, while the UK and Sweden oppose it. Sweden used to have a similar tax, but a large proportion of trading in equities, bonds and derivatives left the country, and did not generate the expected revenue.

1 Assuming return according to the applicable assumptions in society for pension projections, and it is also assumed that investment in equities is made via an investment association, where equity portfolios are traded twice annually.

The government has pointed out to the Danish Parliamentary Committee on Europe that the proposal *"therefore [will] have negative socio-economic consequences for Denmark in the long term. The magnitude of this will depend on a number of uncertain factors, including the risk of relocation of financial activities and hence declining turnover in financial markets, reduction in other tax bases etc. The extent of these risks is uncertain and will depend on a variety of assumptions."*

In addition to a tax on financial transactions, the EU is also considering a tax on financial activities. It is dubious whether a tax on financial activities will generate the expected revenue. Again, the reason is that financial activities are largely expected to be moved outside the EU's borders, unless such a tax is introduced on a global scale.

The introduction of an activity tax in individual countries would distort the single market, which is not compatible with the notion of a 'level playing field' between EU member countries. Against this backdrop, Denmark's tax on financial activities in the form of payroll tax also distorts competition. Besides Denmark, only France levies a payroll tax.

FINANSRÅDET

Amaliegade 7
DK-1256 Copenhagen K

Tel. +45 3370 1000
Fax +45 3393 0260

mail@finansraadet.dk
www.finansraadet.dk

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