DET SYSTEMISKE RISIKORÅD

Activation of a sector-specific systemic risk buffer for corporate exposures to real estate companies

October 3, 2023

The Systemic Risk Council ('the Council') *recommends* to the Minister for Industry, Business and Financial Affairs to activate a sector-specific systemic risk buffer for exposures to real estate companies at a rate of 7 per cent, applicable from 30 June 2024.

Danish credit institutions have significant exposures to real estate companies, which have increased further in recent years. During the financial crises exposures to real estate were one of the areas with the highest risk of impairments. At the same time distressed banks were to a large extent characterized by a prior high increase in lending and a high concentration of large exposures to the real estate sector. Higher interest rates and a weakening of economic growth have a negative impact on the real estate companies' finances. This increases the risk that real estate companies will not be able to service their loans based on their current profits. In addition, declining prices in the commercial real estate market may increase the size of potential losses for the institutions. This entails a risk that problems in the real estate sector may affect financial stability.

The purpose of the buffer is to increase the credit institutions' capitalisation, making them better able to withstand impairment charges and losses on their loans to real estate companies. This will contribute to ensuring financial stability in Denmark, among other things by ensuring that the credit institutions still have adequate lending capacity, despite any losses, to enable them to lend to creditworthy households and businesses. It is expected that the measure will correspond to a half per cent of the credit institutions' total risk-weighted exposure amount.

To ensure a level playing field for Danish and foreign banks with exposures in Denmark, the Council recommends that the Minister requests that the authorities in other relevant countries acknowledge the systemic risk buffer rate of 7 per cent for exposures to real estate companies in Denmark. This will also contribute to the resilience of the institutions.

The Minister for Industry, Business and Financial Affairs is required, within a period of three months, to either comply with the recommendation or to present a statement explaining why the recommendation has not been complied with.

1. Grounds

The institutions have significant exposures to real estate companies, and they have increased further in recent years. Experience from, for example, the financial crisis shows that these exposures may result in substantial losses for credit institutions. This entails a risk that problems in the real estate sector may affect financial stability.

A number of significant factors point at build-up of risks in real estate companies

The Council assesses that there are a number of systemic risks related to the institutions' real estate exposures that should be addressed with a sector-specific systemic risk buffer. In its assessment, the Council has attached particular importance to the following factors:

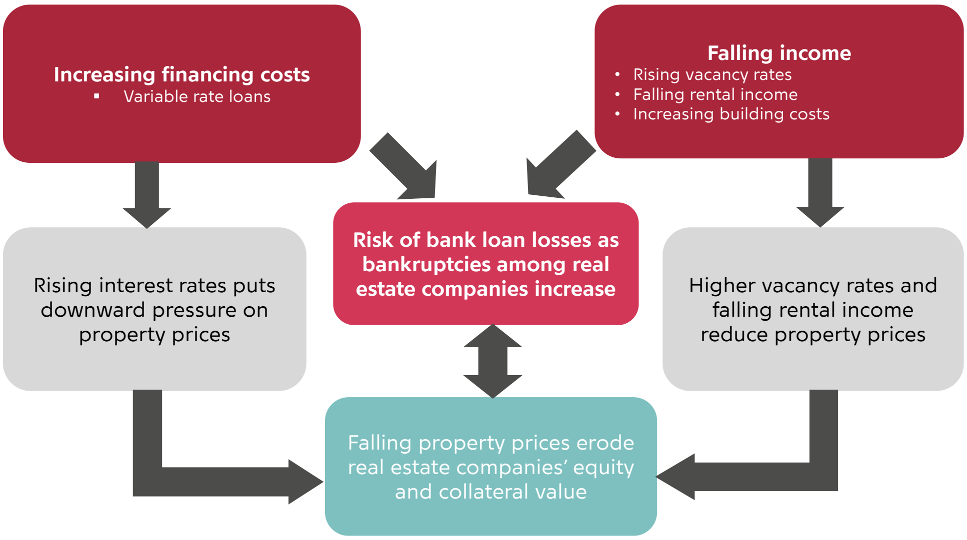
- **Both large and medium-sized credit institutions have significant and growing exposures to real estate companies.** Historically, periods with high lending growth have often been followed by rising impairment charges and losses. This reflects the tendency for credit quality to deteriorate in periods with high lending growth. As loans to real estate companies represent a significant share of the exposures, a negative shock may initially lead to significant losses for the institutions. During the crisis in the 1990s and the financial crises, many of the failing institutions had previously seen high lending rate and a high concentration of large commitments in the real estate sector.[1]
- **Higher interest rates and a weakening of economic growth have a negative impact on real estate companies' finances.** Interest rates have risen sharply since the beginning of 2022, resulting in higher interest costs for the companies. Previous interest rate increases have not necessarily been fully reflected in real estate prices and the companies' income. The real estate companies' rental income may also come under pressure in the event of a weakening of economic activity, through e.g., higher vacancy rates. This increases the risk that real estate companies will not be able to service their loans based on their current profits. Finally, there is a risk of further increases in interest rates.
- **Declining prices in the commercial real estate market may increase the size of potential loan losses for credit institutions.** Interest rate levels and general levels of economic activity have a significant impact on the value of the properties used as collateral for the loans. A very limited number of transactions during 2023 indicate that buyers and sellers are far from each other, and that a sale would require a downward price adjustment. This entails a risk of price falls, which will increase credit institutions' potential losses. In addition, a significant share of loans has high loan-to-value ratios and variable interest rates. Overall, this might lead to significant losses if real estate companies default on their loans.
- **Problems in the real estate sector may quickly spread to the rest of the economy.** The real estate sector constitutes an important part of the economy. Historically, the development in the commercial real estate sector has contributed to amplifying cyclical fluctuations, for example via its effect on construction activity. Problems in the real estate sector can therefore lead to losses on loans to other industries and among households.
- **The sharply rising inflation and interest rate increases seen in recent years, combined with the risk of falling commercial real estate prices, are an extremely rare scenario.** There is consequently a risk that problems in the real estate sector may result in losses which are significantly higher than would be expected based on historical data and for which the institutions have therefore not made capital provisions.
- **Credit institutions' impairment charges on commercial real estate exposures are currently low seen from a historical perspective.** This reflects a period of extraordinarily low interest rates and thus extraordinarily low financing costs. A long period characterised by favourable conditions and low impairment charge ratios may lead to an underestimation of the actual risks related to the segment and result in insufficient provisions. Experience from previous crises shows that negative shocks to the real estate sector may lead to a sudden increase in impairment charges and losses.

These are consequently significant systemic risks that may affect Danish credit institutions via several channels, see chart 1.

[1] The financial crisis in Denmark – causes, consequences and lessons (Link)

Rising interest rates and an economic slowdown increase the risk of losses in institutions via several channels

Chart 1



Overall, there are indications of an increasing level of systemic risks related to the commercial real estate market, while credit institutions' capitalisation has remained largely unchanged. Measures are therefore needed to ensure that credit institutions' capitalisation is increased.

Buffer must ensure sufficient capital to cover potential losses

Activating a sector-specific systemic risk buffer will secure more capital in the credit institutions, enabling them to bear any potential losses, without constraining credit to sound households and firms. This reduces the risk that credit institutions need to tighten their credit standards in order to comply with regulatory requirements. Such a tightening will entail costs for society and the economy, among other things because creditworthy households and firms are not able to obtain loans.

The Council assesses that the activation of a sector-specific systemic risk buffer of 7 per cent for exposures to real estate companies is necessary to address the systemic risk associated with the commercial real estate market. The rate of the systemic risk buffer reflects the increased risk that real estate companies might experience problems and default on their loans in a scenario with higher interest rates and falling income as well as potentially higher losses that a price fall in the market may entail. The size of the buffer rate is further based on the assumption that a significant share of real estate companies uses interest rate hedging for variable rate loans. In addition, existing provisions in the institutions' impairment charges and capital targets have been taken into consideration.

The Council recommends that the measure solely applies to exposures to real estate companies, i.e. firms engaged in activities under economic activity codes "Development of building projects" and 'Real estate', while exposures to 'Social housing societies and 'Cooperative housing societies" under activity code 'Real estate' are exempt from the measure.

A sector-specific systemic risk buffer is well-suited for addressing systemic risks related to specific loan segments

The Council recommends that the risk be addressed with a sector-specific systemic risk buffer, which aims precisely to address systemic risks related to specific segments in the credit institutions' loan portfolio.

A sector-specific systemic risk buffer is a capital buffer requirement relative to the institutions' risk-weighted exposures. It became possible to apply a sector-specific systemic risk buffer following the implementation of the Capital Requirements Directive (CRD V) in 2021.[2] According to CRDV, the systemic risk buffer can be used to address systemic or macroprudential risks not otherwise addressed in capital requirements.

The buffer can be used to address systemic risks in general or systemic risks related to a specific subset of exposures, i.e., as a sector-specific buffer. A number of European countries have introduced a sector-specific systemic risk buffer.[3] Unlike the other capital buffers, a sector-specific systemic risk buffer only applies to selected exposures such as loans to real estate companies. This macroprudential instrument has several advantages:

- The requirement will primarily affect institutions with exposures to real estate companies. The larger the exposure, the higher the capital requirement, in Danish kroner. A sector-specific systemic risk buffer is therefore particularly well-suited for addressing systemic risks related to specific lending portfolios. For example, for a loan of kr. 1 million with a risk weight of 20 per cent, this will entail a requirement that the institution finance a larger part of the loan, kr. 14,000, with equity rather than external financing. Currently, the institutions already have an average total capital requirement of around kr. 40,000, part of which must be met with Common Equity Tier 1 capital. The activation of a sector-specific systemic risk buffer will require the institutions to finance an additional kr. 14,000 with equity.
- The requirement is determined as a percentage of risk-weighted exposures, which means that the relative risk weighting of the underlying portfolio is maintained. Exposures with higher risk weights will therefore have a higher requirement in Danish kroner than exposures with lower risk weights.

The requirement that credit institutions must maintain a sector-specific systemic risk buffer is not a so-called hard requirement. Credit institutions that fail to comply with the requirement will therefore not lose their banking licence. Instead, these credit institutions will be required to submit a capital conservation plan to the Danish Financial Supervisory Authority, and bonus and dividend payments etc., may also be restricted if the credit institutions fail to comply with the combined capital buffer requirement.

Developments in the commercial real estate market are monitored as part of the Council's ongoing oversight of systemic risks. Changes in the risk outlook will therefore be taken into account by the Council when determining the size of the buffer rate. A set buffer rate must be evaluated at least every two years.

Extraordinary profits enable institutions to increase their capitalisation

The institutions currently have an excess capital adequacy relative to the existing capital requirements. Furthermore, the institutions are currently generating high earnings. Therefore, the institutions will also be able to increase their capitalisation to meet a more stringent capital requirement by retaining profits. The Council consequently finds that the increased capital requirement will not affect creditworthy companies' access to financing.

The Council's recommendation is in compliance with current legislation.

[Signature]

Christian Kettel Thomsen, Chairman of the Systemic Risk Council

[2] See also [The Systemic Risk Council // The systemic risk buffer (risikoraad.dk)]
[3] Read more about systemic risk buffers in other countries: [Systemic risk buffer (europa.eu)]

Statements from the representatives of the ministries on the Council

Legislation regarding the Systemic Risk Council stipulates that recommendations addressed to the government must include a statement from the representatives of the ministries on the Council. Neither the representatives of the ministries nor the Danish Financial Supervisory Authority have the right to vote on recommendations addressed to the government.

The government notes, that the Council recommends to the government to activate a sector specific systemic risk buffer of 7 per cent for exposures towards real estate companies. The government intends to follow the recommendation, as it agrees, that there are unaddressed risks related to exposures towards real estate companies.

1. APPENDIX: Background

This appendix contains an elaboration on the background for the Council's recommendation that a sector-specific systemic risk buffer is activated for the institutions' exposures to real estate companies.

Systemic risks are the imbalances or vulnerabilities of households, companies, credit institutions that could, in the event of a negative shock, lead to problems in all or part of the financial sector and have negative repercussions for the economy.

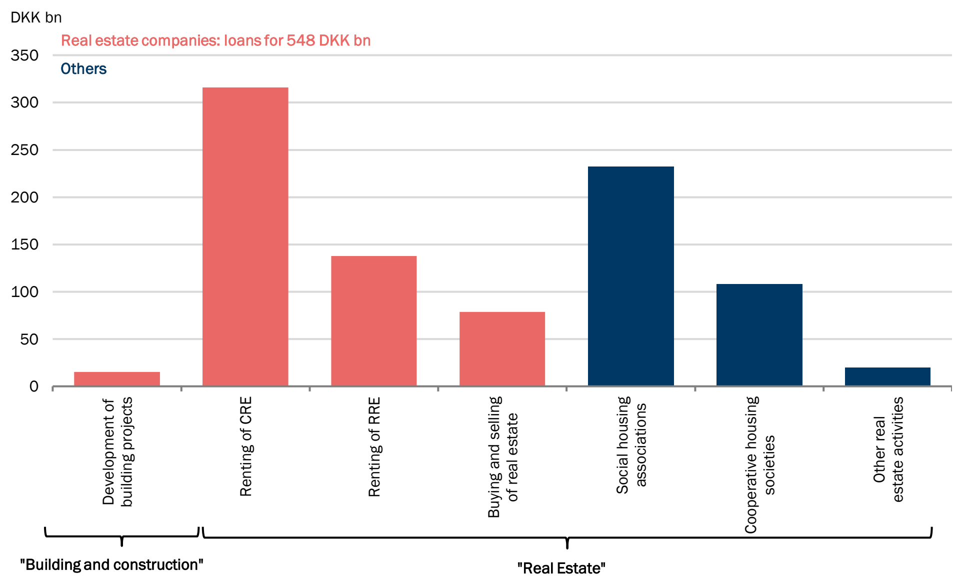
Systemic risks in the commercial real estate market relate both to the institutions' structurally significant exposures to real estate companies, but also to the current economic situation with rapid and significant increases in interest rates and the risk of an economic slowdown.

Measure applies to loans to real estate companies

The credit institutions have total lending of kr. 548 billion to real estate companies, see chart 2. Loans to firms engaged in activities under activity codes 'Development of building projects' amount to just under kr. 15.5 billion, while lending to businesses engaged in activities under activity codes 'Renting of non-residential buildings', 'Renting of real estate' and 'Buying and selling of real estate' amounts to kr. 533 billion.

Real estate companies are companies whose primary business is to own and rent out real estate, be it residential or commercial, as well as to develop and execute building projects with a view to a subsequent sale. During previous crises, precisely these companies have been the cause of significant losses for Danish credit institutions and contributed to worsening economic downturns. The Council recommends that the proposed measure only applies to exposures to real estate companies.

Measure applies to exposures to real estate companies Chart 2



Note: 'Real estate companies' covers the sub-activity codes 'Buying and selling of real estate', 'Renting of non-residential buildings', 'Other renting of real estate' as well as 'Development of building projects' under activity code 'Construction'. Real estate companies are here identified solely based on economic activity codes. The sub-activity code 'Other real estate activities' includes real estate agents as well as administration of real estate on a fee or contract basis, including owners' associations.

Source: Danmarks Nationalbank and own calculations.

Lending to 'Cooperative housing societies' accounts for approx. 12 per cent of lending to businesses engaged in activities under activity code 'Real estate'. Historically, these loans have not given rise to losses in the same way as real estate companies. The activities of cooperative housing societies also differ significantly from those of real estate companies in that they do not have a commercial purpose, but are owned by the members, who are jointly and severally liable for the debt. On this basis, the Council recommends that loans to ‘Co-operative housing societies’ be exempt.

Lending to ‘Social housing associations’ accounts for approx. 26 per cent of lending to businesses engaged in activities under activity code ‘Real estate’. Typically, these loans are supported by central government guarantees, which is why that part of the loan has a risk weight of 0 per cent. These loans will therefore not be affected by a sector-specific systemic risk buffer. On this basis, the Council recommends that all loans to ‘Social housing associations’ be exempt.

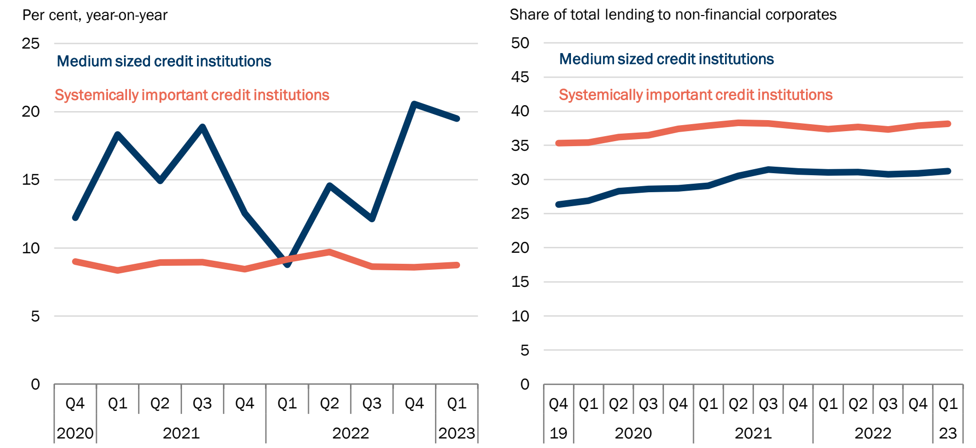
Certain institutions’ loans to real estate companies are growing rapidly

The institutions’ total lending to real estate companies is growing. Especially lending by medium-sized banks and mortgage credit institutions has grown substantially in recent years, see chart 3, left. Medium-sized banks’ lending has grown by just over 20 per cent, while lending by systemically important credit institutions has grown by almost 10 per cent in the 1st quarter of 2023 relative to the same prior-year period. Lending to real estate companies also constitutes a significant share of credit institutions’ corporate lending, see chart 3, right.

Historically, periods with high lending growth have often been followed by rising impairment charges and losses. This indicates that credit quality tends to deteriorate in periods with high lending growth.

Credit institutions have significant and growing exposures to real estate companies. Chart 3

Significant growth in lending to real estate companies in both mortgage credit institutions and medium-sized banks	Credit institutions have significant exposures to real estate companies



Note: The charts show lending to real estate companies, excluding lending for ‘Development of building projects’. *Left-hand chart*: The chart shows the annual growth in the institutions’ lending to real estate companies. *Right-hand chart*: Lending to real estate companies as a percentage of total corporate lending (to non-financial corporations).

Source: Danmarks Nationalbank.

High lending growth and a high concentration of large exposures in the real estate sector were also characteristic of the failing institutions during the financial crisis and the crisis in the 1990s.[4] Negative shocks to the real estate sector have resulted in significant losses, especially for medium-sized credit institutions during previous crises.

Higher interest rates and risk of economic slowdown increase institutions’ risk of losses on lending to real estate companies

In addition to the institutions’ structurally significant exposures to real estate companies, the current real economic development with rapid and significant increases in interest rates

[4] The financial crisis in Denmark – causes, consequences and lessons (Link)

and the risk of an economic slowdown also entail systemic risks. The risks particularly relate to:

- Risk of increased loan defaults due to rising financing costs and falling income for real estate companies
- Risk of lower mortgage values due to falling property values and thus greater losses for institutions in case of default.

This entails a risk scenario in which bankruptcies, liquidations and defaults increase *while* the collateral behind the loan decreases at the same time. Seeing that the institutions have large exposures to real estate companies, a negative shock may initially lead to significant losses for credit institutions.

If credit institutions experience significant losses, they may be forced to tighten their credit standards to maintain their capitalisation. This may mean that otherwise creditworthy projects may not be able to obtain funding. This may lead to a fall in consumption and investments, impacting the economy and leading to further losses.

Rising interest rates may put pressure on real estate companies' debt servicing ability

The significant increases in interest rates translate into higher financing costs of real estate companies. At the same time, an economic downturn will reduce the profits of real estate companies, as the demand for residential rental property and especially commercial rental property depends on economic activity. These conditions may result in a number of real estate companies not having sufficient income to meet their financial obligations.

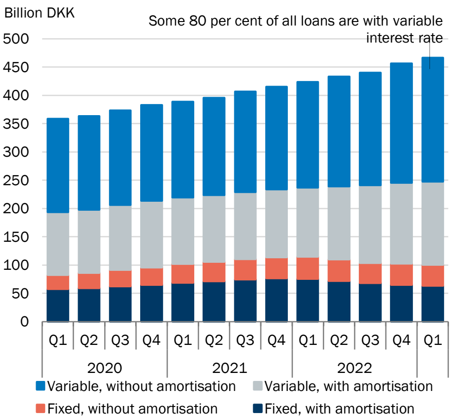
Development in interest rates is of great importance to real estate companies' current expenses

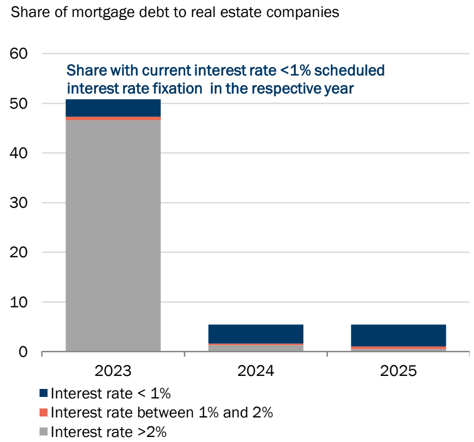
A large part of the companies' costs consists of interest expenses and debt amortisation. As the real estate companies mainly have variable rate loans, the development in interest rates is of relatively great importance to their current expenses. In 1st quarter 2023, approximately 80 per cent (kr. 366 billion) of the mortgage credit institutions' lending to real estate companies had variable interest rates, see chart 4, left. About 60 per cent of these loans were without amortisation.

Although some real estate companies hedge part of their interest rate sensitivity through interest rate derivatives, the sharp interest rate increases since the beginning of 2022 will have an impact on the companies' expenses. On the face of it, hedging interest rate risk can be expected to make the companies more resilient to interest rate increases in the short term. Conversely, the current interest rate environment will mean that it will be more expensive to renew interest rate hedging contracts. Therefore, interest rate hedging does not mean that the companies are not affected by interest rate increases – just that the pass-through is more sluggish. At the same time, it should be noted, that while hedging interest rate risk might provide protection against increasing debt servicing costs, it does not provide protection against the negative effect of higher interest rates on property prices.

Moreover, the interest rate increases have not yet been fully passed on to the companies' mortgage debt. Up until the end of 2025, around 12 per cent of the loans will see a significant interest rate increase, see chart 4, right. This is due to the fact, that the most recent interest rate fixation for these loans was before the substantial increase in interest rates.

The majority of loans are variable-rate loans	Chart 4
Nearly 80 per cent of the companies' loans have variable interest rates	Just under 12 per cent of the loans will see a significant interest rate increase between now and the end of 2025





Note: The charts show lending to real estate companies, excluding lending for activity 'Development of building projects', see definition in chart 1. *Left-hand chart:* Mortgage lending broken down by interest rate fixation (variable or fixed-rate) and amortisation profile. It should be noted that some of the variable-rate loans are adjustable-rate loans. *Right-hand chart*: Mortgage lending broken down by year of next interest rate adjustment and current interest rate level.

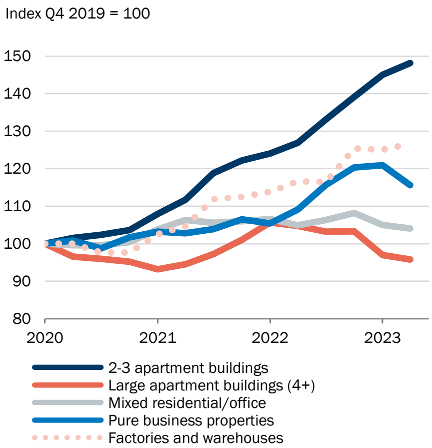
Source: Danmarks Nationalbank (the Credit Register)

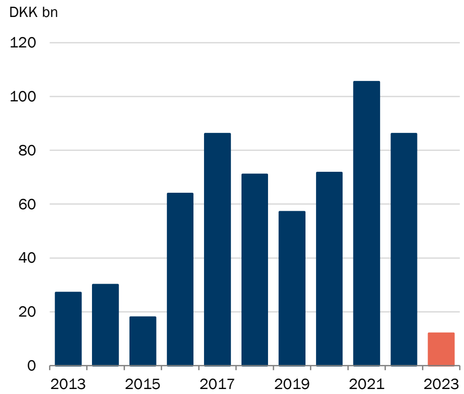
Lower property values increase the size of potential losses

Rising interest rates not only entail an increased risk of default for real estate companies, but also a risk of greater losses for credit institutions in the event of default. The reason for this is that the level of interest rates and the general economic activity are of decisive importance to the value of the properties used as collateral for the loans.

According to Statistics Denmark's price index, the rate of price increases on most property types has abated, see chart 5, left. Especially prices of large residential properties (more than four apartments) have fallen in the first quarter 2023 relative to the first quarter 2022.

Low trading activity may indicate an imminent correction in commercial real estate prices	Chart 5
The price increase rate on most property types has abated	...but low transaction volume may be a precursor of price falls





Note: *Left-hand chart*: Quarterly frequency. Four-quarter moving average. The most recent observations are from 1st quarter 2023. *Right-hand chart*: Transaction volume of commercial real estate in Denmark. The data point for 2023 consists of the sum total of the 1st and 2nd quarters.

Source: Statistics Denmark, Colliers.

There has been only a slight fall in the prices of properties with mixed housing in the same period. The annual rate of price increases for purely commercial properties and factory and warehouse properties has slowed down but remains positive. Conversely, prices of small residential properties (2-3 apartments) are still rising sharply. This development should be seen in the context of a very low number of transactions at present, see chart 5, right.

The commercial real estate market is characterised by a high degree of heterogeneity, which can make simple price comparisons over time difficult. The limited data basis on which the price statistics are based means that the development in prices is subject to great uncertainty. A very low number of transactions may in itself indicate that buyers and sellers are far from each other, and that any sale will require a downward price adjustment. Overall, this may indicate an imminent price fall in the commercial real estate market.

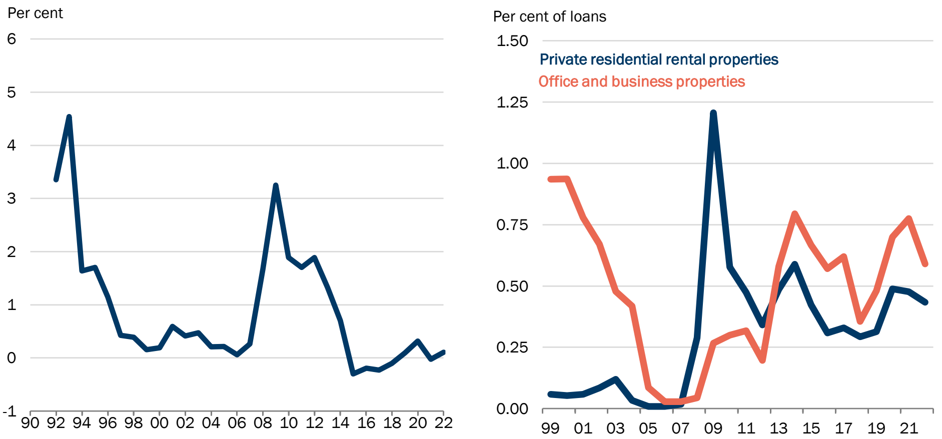
Real estate exposures have given rise to significant impairment charges during previous crises

During previous crises, negative shocks to the real estate market have given rise to significant impairment charges for credit institutions, see chart 6. A large share of credit institutions with significant exposures to real estate companies failed during the financial crisis, despite a relatively good capital situation at the onset of the financial crisis.[5]

A long period characterised by favourable financial conditions and low impairment charge ratios may lead to an underestimation of the actual risks for the segment and thus too low capitalisation. The aim of introducing a capital measure is to secure more capital so that credit institutions can bear potential losses without breaching regulatory requirements thus reducing the risk of repeating the course of events from previous crises.

High impairment charges in connection with previous crises for institutions' commercial real estate exposures Chart 6

High impairment charges for banks' lending to the activity 'Real Estate' ... | ... as well as mortgage credit institutions' impairment charges on rental properties in connection with previous crises



Note: The charts show impairment charges on the institutions' commercial real estate exposures. For the banks, impairment charges are shown for activity code 'Real estate', while, for mortgage credit institutions, impairment charges are shown for private residential rental properties and office and business properties, respectively.

Source: The Danish Financial Supervisory Authority and own calculations.

[5] The financial crisis in Denmark – causes, consequences and lessons (Link)