

35th meeting of the Systemic Risk Council

14 December 2021

The Systemic Risk Council

www.risikoraad.dk

mail@risikoraad.dk

The current situation of very loose financial conditions, increasing asset prices and a high level of economic activity provides ground for risk build-up. Therefore, the Council recommends to the Minister for Industry, Business and Financial Affairs to increase the countercyclical capital buffer to 2.0 per cent from 31 December 2022.

After a relatively mild downturn, economic activity is also booming on the Faroe Islands. Therefore, the Council recommends to the Minister for Industry, Business and Financial Affairs to activate the countercyclical capital buffer at 1.0 per cent on the Faroese Islands from 31 March 2023.

Build-up of systemic financial risks in Denmark

There is continued economic growth in both Denmark and abroad. The Danish economy is booming, supported by an increase in private consumption and employment. Labour market pressures are more pronounced in Denmark than in the rest of the Nordic countries. Pressure on global supply chains has contributed to higher transport, energy and commodity prices and resulted in rising inflation. Sustained inflationary pressures may result in rising nominal interest rates and higher risk premia, which could lead to significant price decreases on a number of assets. The continued emergence of new corona variants increases the uncertainty about future economic growth in both Denmark and abroad.

The financial conditions are generally very loose, and asset prices have continued to increase in the 3rd and 4th quarters of 2021. Risk appetite is high in both equity and bond markets, and investors' demands for compensation for undertaking credit, liquidity and interest rate risks are historically low. Many investors take on significant risks to avoid a negative return. The current Danish situation with very loose financial conditions, increasing asset prices and continued growth in economic activity thus provides ground for the build-up of systemic risks.

There are still signs of risk build-up in housing lending. The overall credit development for households is moderate, but covers differences across market segments. There is high growth in loans with deferred amortisation in areas with large house price increases in and around the large cities. At the same time, the share of new lending to highly indebted households is increasing. Although price growth in the housing market has slowed down recently, prices are at a high level in some areas.

Credit institution earnings increased in the 3rd quarter of 2021. A number of institutions have further increased their expectations for their return on equity in 2021. The increase in earnings is mainly due to high activity in the housing market and continued very low impairment charges. The underlying earnings have not improved significantly. The very low level of interest rates, especially in combination with high economic growth, elevated asset prices and increased competition for customers, can provide an incentive for increased risk-taking by the credit institutions. Experience shows that tight risk management during periods of economic boom is essential for ensuring that a credit institution can weather an economic downturn.

The Council recommends that the countercyclical capital buffer is increased to 2.0 per cent.

Based on the development in the risk outlook, [the Council recommends](#) to the Minister for Industry, Business and Financial Affairs that the countercyclical capital buffer be increased to 2.0 per cent from 31 December 2022. The Council expects to recommend a further increase of the buffer rate of 0.5 percentage points to 2.5 per cent at its meeting in March 2022, unless there is a significant slowdown in risk build-up in the financial system. It is important that the buffer is built up when the economy is doing well, so that the institutions have cushioning when the economic trends reverse. Already at the end of the 3rd quarter of 2021, all the Danish institutions had sufficient capital to meet countercyclical capital buffer of 2.0 per cent.

Systemic risks in the commercial real estate market

The Council discussed systemic risks in the commercial property market as a follow-up to its discussion of this topic at its [meeting in September 2020](#). Danish institutions have significant exposures secured by rental properties, which is a segment that has seen significant losses during previous crises. The Council discussed in particular the ability of mortgage credit institutions to withstand a sharp downturn in the commercial real estate market, including declining property prices, rising interest rates and decreasing operating profit.

The Council finds that the sector's average risk weights on loans secured by residential rental properties are not sufficient to absorb the estimated losses in a hard, but not improbable, scenario.

Therefore, the Council urges the Danish Financial Supervisory Authority to address this issue in its dialogue with the institutions. The Council will also at its upcoming meetings discuss how risks related to low risk weights on rental properties can be included in the considerations about activating the systemic risk buffer.

Interconnectedness between Danish institutions

The Council discussed systemic risks related to the high degree of interconnectedness between Danish credit institutions. Interconnectedness can be direct, for example in the form of interbank loans or holdings of mortgage bonds, or indirect if two banks have loans to the same type of customers. These connections are important for an efficient financial system. However, a high degree of interconnectedness may also be a source of systemic risks, as shocks to a single player in the system may spread to others. Systemic risks related to interconnectedness will therefore form part of the Council's future considerations of activation of the system risk buffer.

The Council recommends that the countercyclical capital buffer is activated on the Faroe Islands

[The Council recommends](#) to the Minister for Industry, Business and Financial Affairs to activate the countercyclical capital buffer at a rate of 1 per cent on the Faroese Islands from 31 March 2023]. After a relatively mild downturn in connection with the coronavirus crisis, economic activity is booming on the Faroe Islands. At the same time, there is strong growth in house prices and lending. The Council therefore assesses that there are signs of a build-up of cyclical systemic risks that require activation of the countercyclical capital buffer.

Following a [recommendation from the Council](#), the increase in the general systemic risk buffer rate from 2.0 to 3.0 per cent on the Faroe Islands was temporarily suspended at the beginning of the pandemic in March 2020. The Council recommends that the general systemic risk buffer rate is maintained at 2.0 per cent.

The Faroese Systemic Risk Council, Føroya Váðaráð, has participated in the discussion of the buffer rates.

The Council has received a statement from the Faroese Systemic Risk Council regarding regulation of the Faroese housing market. At present, no provisions have been implemented that restrict access to risky types of loans for households with a high debt-to-income ratio and loan-to-value ratio. There is no downpayment requirement in connection with house purchases. The Council finds that it would be appropriate to introduce measures aimed at limiting the possibility of risk build-up in the Faroese housing market.

For further information, please contact mail@risikoraad.dk or *Teis Hald Jensen*, Communications and Press Officer, on tel. +45 3363 6066.