

38th meeting of the Systemic Risk Council

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The Systemic Risk Council

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Risks continue to build up in parts of the financial system. Corporate credit growth has risen sharply, and prevalence of risky loan types are increasing among households. The Council observes that the growing prevalence of variable-rate loans with deferred amortisation is contributing to the build-up of risk. Growth is set to decline due to rising inflation and interest rates but the capacity pressure in the Danish economy is high with a tight labour market, among other things. At the same time increased volatility in the financial markets has created a need for credit institutions to increase their focus on liquidity management.

The growth prospects for the global and Danish economies have deteriorated, but the pressure on the Danish economy remains high. Growth is expected to slow down significantly by the end of 2022 and in 2023, reflecting rising interest rates and the highest inflation rate in several decades. The pressure on the Danish economy is particularly evident in the labour market, where the labour shortage remains pronounced.

Increased volatility and reduced liquidity in the markets trigger a greater need for liquidity management in institutions. Central banks are tightening monetary policy against the backdrop of high inflation. As a result, interest rates on long-term government and mortgage bonds in particular have risen, while equity prices have fallen. Generally, large fluctuations were seen in both the equity and bond markets in 2022, which were also affected by the deteriorating growth prospects and the war in Ukraine. Lastly, large price fluctuations are seen in a number of energy and commodity markets, which increase the collateral requirements in these markets. This has resulted in lower levels of liquidity in the markets, triggering a greater need for institutions to focus on their liquidity management. However, institutions are still very much able to meet their liquidity requirements.

The institutions' earnings remain stable with low impairment charges. Going forward, rising interest rates are expected to contribute to increased earnings in the institutions. Most of the systemic institutions have either maintained or revised upwards their expectations for the 2022 results based on the financial statements for the first half of the year. The development in the institutions' earnings allow them to build up funds to withstand losses caused by rising inflation, rising interest rates and the prospect of weaker growth. The institutions continue to face a significant cyber threat which is affected by the war in Ukraine.

There are signs of risk build-up in the institutions' credit lending. Corporate credit growth has picked up since mid-2021. Historically, strong credit growth has been one of the best indicators of subsequent lending losses. The strong demand for credit is due to robust economic activity in several industries and stockpiling, among other things. Institutions have the capacity to support viable businesses with liquidity. At the same time, we are seeing a shift from fixed-rate loans to variable-rate loans with deferred amortisation, especially in connection with loan refinancings in the first half of 2022. Highly indebted home buyers continue to account for a significant proportion of new lending.

The Council observes that the growing prevalence of variable-rate loans with deferred amortisation is contributing to the build-up of risk

The latest development in Danish mortgage rates has led to a rapid increase in the prevalence of variable-rate mortgage loans with deferred amortisation which in particular has increased in connection with loan refinancings during the first half of 2022. In the light of the recent developments in credit lending to households, the Council finds, that risks continue to build-up in the financial system. The prevalence of variable-rate loans with deferred amortisation increases homeowners' sensitivity to interest rate hikes at a time when the Danish economy is characterised by the prospect of high inflation, interest rate hikes and weaker economic growth. Homeowners with variable-rate loans with deferred amortisation are particularly sensitive to interest rate hikes as it can lead to a considerable reduction in their available income. Overall, increased sensitivity to interest rate hikes could add to the institutions' losses during a cyclical economic downturn. The Council has therefore adopted an observation that the growing prevalence of variable-rate loans with deferred amortisation contributes to the risk build-up in the financial system. It is important that homeowners taking out variable-rate loans with deferred amortisation are resilient enough to manage large interest rate hikes. This is particularly important for those homeowners who increase their debt substantially in connection with loan refinancing.

Risks related to deferred amortisation

The Council discussed the use of loans with deferred amortisation in Denmark as well as the systemic risks of housing financing with deferred amortisation. When homeowners do not amortise on their housing debt, the gross debt level remains unchanged. Especially homeowners with high loan-to-value ratios are at greater risk of becoming technically insolvent. During the financial crisis, loans with deferred amortisation led to more debt defaults and higher losses in the institutions. Deferred amortisation for homeowners with a high loan-to-value ratio thus contributes to risks in the housing market. For homeowners with low loan-to-value ratios, deferred amortisation can be a sensible tool for smooth consumption over the life cycle and building larger liquid savings. For homeowners with high loan-to-value ratios, it remains important to build resilience to cope with any fall in house prices.

Risks in the rental property market

The Council discussed systemic risks related to the rental property market. Both large and medium-sized institutions have high exposures to rental properties. The increases in rental property prices and very loose financing conditions over the past 10 years have supported the market. During the covid-19 crisis, prices rose further, especially for properties used for residential rental purposes. With rising interest rates and weaker economic growth, there is a risk that the market for rental properties could be faced with price falls. This can result in losses in the institutions. In previous crises, rental properties have caused sizeable losses in Danish credit institutions. This is thus an area where credit institutions should exercise particular caution. The Council will continue to monitor the rental property market and follow the development closely.

The countercyclical capital buffer rate in Denmark

Every quarter, the Council assesses the suitable countercyclical capital buffer level. The Council still finds it appropriate to increase the countercyclical capital buffer to 2.5 per cent from March 2023, which was confirmed by the Minister for Industry, Business and Financial Affairs in March 2022. It is important to build up the buffer to make the institutions more resilient to any materialization of risks and losses that may occur. The Council is ready to recommend a reduction of the buffer rate with immediate effect if stress occurs in the financial system and there is a risk of severe tightening of credit lending to households and businesses.

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