

40th meeting of the Systemic Risk Council

21 March 2023

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The risk outlook is still characterised by high inflation, higher interest rates and expectations of lower economic growth, both globally and in Denmark. At the same time, substantial financial market turmoil has emerged, which may pose challenges for issuance of capital and debt instruments. The Council finds that the Danish banking sector in general is in a good position to withstand the deterioration of the financial market conditions.

High price increases combined with higher borrowing costs weaken the debt servicing ability of households and companies. However, this has not led to significant impairments on the loan portfolios of credit institutions. At the same time, high earnings create an opportunity to build up capital to absorb losses and maintain lending.

The international financial markets are currently affected by turmoil triggered by problems in specific banks in the US and Europe. The development emphasizes that changes in risk perception in financial markets can occur suddenly and lead to large fluctuations in a short time. At the same time, this is an important reminder, that sound risk management and robust liquidity and capital buffers are important tools to maintain the trust in individual banks and in the financial system.

The market turmoil may among other things pose challenges for the issuance of capital and debt instruments. Furthermore, the ECB is rolling back its asset purchase programme, which may contribute to higher volatility in capital markets going forward. Therefore, it is important that banks focus on capital planning and liquidity management taking into account periods of limited refinancing opportunities. The Council will follow closely further developments in banks' refinancing conditions.

The Council finds that the Danish banking sector in general is in a good position to withstand the deterioration of the financial market conditions. This reflects, among other things, that the measures taken since the financial crisis have increased the robustness of the financial sector in Denmark.

There are prospects of lower growth in 2023, both globally and in Denmark. Inflation remains high, but has fallen in recent months, due to lower energy prices among other factors. High price increases and higher interest rates are eroding household incomes, weakening their ability to service debt. The downturn in the Danish economy has so far primarily been evident in the housing market and lower private consumption. The labour market is still characterised by high capacity pressure, with a low unemployment rate and high employment.

Lower trading activity in the housing market and refinancing of mortgage loans contribute to declining mortgage lending to households. House prices have fallen since spring 2022 after a period of high house price growth. The outlook of further price decreases means that highly indebted homeowners risk becoming technically insolvent. This risk is greatest for recent home buyers. In addition, homeowners with variable-rate loans, in particular loans with deferred amortisation, are experiencing higher financing costs. This adds further pressure on home-

owners' disposable income, which is already being eroded by high inflation. However, the development has not yet given rise to a significant increase in the institutions' impairment charges. One reason for this is the continued low level of unemployment.

Corporate lending has decreased after a period of high lending growth. There has been high credit demand by companies since the end of 2021, one reason being large companies in particular drawing on existing credit facilities. This development has led to a greater need for liquidity. Credit demand diminished towards the end of 2022. In the same period, the number of bankruptcies and liquidations has been higher than in recent years. However, the increase in the number of bankruptcies and liquidations has not yet given rise to a significant increase in the institutions' impairment charges.

The institutions' earnings create leeway for absorbing losses and maintaining credit granting to the economy. Rising net income from interest as a result of higher interest rates in particular makes a positive contribution to the institutions' basic earnings. At the same time, the institutions' earnings are supported by limited impairment charges on their lending. However, a cyclical downturn is expected to deteriorate some customers' ability to service their debt, which, in combination with falling asset prices, entails a risk of higher impairment charges in the long term. In the course of 2022, the majority of the systemic institutions have increased their management estimates for impairment charges, which provides a buffer against future loan losses.

Countercyclical capital buffer in Denmark

Every quarter, the Council assesses the adequate 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 decided by the Minister for Industry, Business and Financial Affairs in March 2022. The objective of the buffer is to ensure that the institutions have a cushion that makes them more resilient if risks materialise. The current earnings also create an opportunity to build up capital to absorb losses and maintain credit granting. 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 granting to households and companies.

Development in systemic risks on the Faroe Islands

The Council is responsible for identifying and monitoring systemic financial risks in the Faroe Islands. At the end of 2022, the Faroese economy was still experiencing a boom with very low unemployment and rising house prices. At the same time, the Faroese housing market is characterised by a large share of variable-rate loans with very short interest rate fixation. Housing market risks have also been building up in recent years. The Council was briefed about regulatory measures on mortgage lending in the Faroe Islands, which are currently in process.

In the context of the current risk outlook, the Council recommends that the level of the countercyclical capital buffer be maintained at 1 per cent. A countercyclical capital buffer rate of 1 per cent was decided by the Minister for Industry, Business and Financial Affairs in March 2022 and will enter into force from 31 March 2023. The Council will at a future meeting revisit the framework for capital buffer requirements on the Faroe Islands.

Other items

The Council discussed potential systemic risks related to the recovery and resolution of life insurance and pension companies in case of elevated financial stress. The Council noted, that the Danish life insurance and pension sector is currently robust and able to withstand significant financial stress without breaching their capital requirements. A new EU Directive is expected to be implemented in 2025 and aims to harmonise national rules for recovery and resolution of life insurance and pension providers in the EU.

The Danish life insurance and pension sector manages a significant part of household assets and is a major player in the financial markets. The Council is therefore continuously monitoring developments in the sector.

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