

41st meeting of the Systemic Risk Council

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The Systemic Risk Council

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The risk outlook has been characterised by turmoil related to problems in specific banks in the United States and Europe. The turmoil lead among other things to rising funding costs for Danish and foreign financial institutions and very few new issuances of debt instruments in the markets. The episodes underline the importance of sound risk management and a robust maturity profile for the institutions' issuances to financial stability.

The risk outlook is also characterised by higher interest rates and high inflation which is expected to weaken the resilience of some homeowners and companies. Risks are especially pronounced in the commercial real estate market and for highly indebted homeowners with interest-only loans. The Council will uncover risks related to the real estate market and consider policy actions to address these risks.

High inflation and prospects of lower growth globally characterise the risk outlook. Although inflation has fallen during 2023, it remains at a high level. The high inflation has led to a tightening of monetary policy and sharply rising interest rates, putting a damper on demand in the Danish economy. Inflation is however at risk to remain at a relatively high level, which could result in further interest rate increases.

Higher interest rates and consumer price increases weaken the resilience of homeowners with spill over effects to companies. As the pass-through of interest rate increases continues, the interest costs of businesses and homeowners rise and their resilience is expected to be weakened. This is especially the case if the interest rates increase further. At the same time, falling property prices increase the expected loss in case of loan defaults. However, most homeowners are expected to be able to withstand the challenges. This is due to among other things the build-up of wealth in recent years, expected increases in real wages and continued high employment. The development may, however, lead to a further decline in consumer demand, which affects companies' revenue. Declining consumer demand will initially affect the consumer-facing retail and service industries, which may have spill over effects to other industries. For instance, the letting companies are dependent on rental revenue from detail retail and service companies.

The Institutions' earnings remain high, enabling them to build up resilience. Higher interest rates continue to contribute positively to higher deposit margins and higher net interest income. At the same time, impairment charge ratios are low. Higher earnings contribute to strengthening the institutions' first line of defence against potentially higher impairment charges and enable them to build up resilience.

Systemic risks on the property market

The Systemic Risk Council, the Council, assesses that systemic risks related to commercial and residential real estate should be addressed.

Both large and medium sized institutions have large exposures towards commercial real estate. The current environment with higher interest rates and lower economic growth implies a

risk of falling asset prices in the commercial real estate market. This may result in losses for the institutions. During previous crises, commercial real estate has contributed to significant losses in the Danish credit institutions.

The Council have previously made the assessment, that systemic risks related to interest-only loans for highly indebted borrowers remain unaddressed [\[Link\]](#). Furthermore, homeowners with interest-only adjustable-rate mortgages are particularly vulnerable to interest rate increases, as this would result in substantially reduced disposable income [\[Link\]](#). Increased sensitivity towards interest rate increases may add to losses in credit institution.

The Council will uncover risks related to the real estate market and consider policy actions to address these risks.

The liquidity and funding situation in Danish financial sector

The Council discussed the liquidity and funding situation in the Danish financial sector in light of the recent banking sector turmoil in the United States and Europe. Poor risk management contributed to problems in specific US banks in March and during spring 2023. Concurrently, the banking sector turmoil led to a period of increased funding costs for the institutions and with very few new issuances of debt instruments in the markets. The events show that sound risk management and prudent diversification of the institutions' issuances are important to financial stability. In Denmark, the institutions are generally well equipped to withstand liquidity stress and turbulence in the financial markets.

Countercyclical capital buffer in Denmark

Every quarter, the Council assesses the adequate countercyclical capital buffer level. The Council finds it appropriate that the countercyclical capital buffer rate be maintained at 2.5 per cent. 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.

The Council has updated its method for assessing the countercyclical capital buffer rate

The Council discussed the experience with the release of the countercyclical capital buffer in March 2020. The purpose of releasing the buffer is to give the institutions leeway to absorb possible losses while maintaining their credit granting during a crisis. It may thus be relevant to release the buffer in a situation in which the institutions' lending capacity is under pressure. The methodology for assessing the countercyclical capital buffer has been updated to reflect the existing practice for releasing the countercyclical capital buffer more clearly [\[Link\]](#).

There are signs of a build-up of systemic risks in Greenland

The Council discussed systemic financial risks in Greenland. Greenland is undergoing a long economic upswing with great labour market pressure. At the same time credit growth is high and surpassed the growth in economic activity in 2022.

The Council will analyse these risks further in corporation with the Greenlandic authorities and will at a future meeting assess if there is basis for activation of the countercyclical buffer in Greenland. The purpose of the countercyclical buffer is to ensure that credit institutions are able maintain credit granting under an economic downturn. Representatives from the Greenlandic authorities participate in the Council's discussions regarding Greenland.

Other items

The Council discussed lessons learned from the recent handling of problems in specific foreign banks. The episodes have highlighted the importance of the authorities being prepared for banking crises and of ensuring transparency and credibility in their handling of resolution situations.

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