PRESS RELEASE

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Risk appetite in financial markets has increased based on expectations of a soft economic landing. The risk outlook is still characterised by high inflation and higher interest rates, which, together with the slowdown of economic growth in Denmark, are expected to weaken the resilience of some households and companies.

The Council assesses that there are still unaddressed systemic risks related to the commercial real estate market. During the financial crisis loans to commercial real estate companies were one of the areas with the highest losses, and distressed banks had a relatively high concentration of properties. The currently higher interest rates contribute to higher costs in the commercial real estate sector, which increases the risk of losses on loans. The Council recommends that the Minister for Industry, Business and Financial Affairs activates a sector-specific systemic risk buffer for exposures to real estate companies at a rate of 7 per cent applicable from 30 June 2024.

High inflation and the prospect of a continued slowdown in economic growth in a period with higher interest rates characterise the risk outlook. The decline in inflation in the euro area and Denmark in the course of 2023 is primarily due to lower energy prices, and, excluding the development in energy and food prices, inflation remains high. Despite the global economic slowdown, which has also occurred in Denmark, tight labour markets and further wage increases may contribute to maintaining a high underlying price pressure. This may imply that the central banks' interest rates will remain higher for longer.

Risk appetite in the financial system has increased despite a weakening of economic growth. Since the financial market turmoil in spring 2023, market expectations of a soft economic landing, including in the United States and the euro area, have contributed to higher equity prices and generally lower volatility for equities and bonds. Credit spreads on corporate bonds have also narrowed in 2023, only briefly interrupted by the turmoil in the spring. However, the slowdown in growth and the continued high interest rates create a risk that more companies will be challenged.

There are signs of a renewed upturn in the housing market. The decline in house prices that started in early 2022 has been replaced by moderate price increases in recent months. Increases in household income counteract the effect of higher financing costs. At the same time, a continued low level of households in arrears indicates that households have so far been able to withstand the economic pressure resulting from higher inflation and rising interest rates. This should be seen in the context of the households' holdings of liquid assets, the continued high employment, and the fact that the interest rate pass-through has not yet fully materialised. However, an extended period with the current higher interest rates will continue to affect homeowners' resilience, where especially homeowners with high loan-to-value ratios and variable rate loans are vulnerable.

Higher earnings in credit institutions create an opportunity to build up capital to both absorb losses and maintain credit granting in a crisis situation. The majority of the institutions have revised their earnings expectations for 2023 upwards, which are expected to be higher compared to 2022. The increase is mainly due to higher net interest income, but the earnings are also supported by continued low impairment charges on loans. Despite major differences between deposit and lending rates, the institutions' deposits have remained stable, and there have been no signs that the institutions' liquidity has been impaired. Higher earnings generally contribute to improved capitalisation of the institutions. Conversely, higher dividend payments and share buy-backs will contribute to reducing the build-up of capital.

Systemic risks related to the commercial real estate sector

The Council assesses that there are still unaddressed systemic risks related to the market for commercial real estate. The commercial real estate sector plays a significant role in the Danish economy and accounts for a substantial share of the institutions' lending. 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, cf. *The financial crisis in Denmark – courses, consequences and lessons [link].*

Lending to real estate companies increased significantly in 1st quarter 2023, and, for the banks, the lending growth is driven especially by medium-sized banks. Trading activity in the market for commercial real estate is currently low, which may be a precursor of price falls. A scenario of falling commercial real estate prices combined with high inflation and higher interest rates is rarely seen and may result in losses that are significantly larger than expected based on historical data.

The higher interest rates increase the financing costs of real estate companies. At the same time, a continued weakening of economic growth may lead to higher vacancy rates and falling rental income. Overall, it increases the risk of real estate companies defaulting on their loans. At the same time, the size of potential losses will increase if bankruptcies in the real estate sector lead to a fall in real estate prices.

The Council therefore recommends that the Minister for Industry, Business and Financial Affairs activates a sector-specific systemic risk buffer for exposures to real estate companies at a rate of 7 per cent applicable from 30 June 2024 [link]. The targeted measure will increase the credit institutions' capitalisation, and thereby improving their ability to withstand impairment charges and losses on their lending to real estate companies. It is expected that the measure will correspond to a half per cent of the credit institutions total risk-weighted exposure amount.

Systemic risks related to deferred amortization in the housing market

The Council still finds that deferred amortisation for homeowners with a high loan-to-value ratio is a source of risks in the housing market. This is due to a number of factors, including the fact that highly indebted homeowners with deferred amortisation and thereby the institutions' loans to these homeowners are more exposed to house price falls, as the debt is not paid off on an ongoing basis. The Council will therefore continue to oversee and analyse systemic risks related to the provision of loans with deferred amortisation. In addition, the Council was briefed on the Danish Financial Supervisory Authority's dialogue with the institutions concerning their exposures to these risks.

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 is maintained at 2.5 per cent of the risk-weighted exposure amount. The objective of the buffer is to ensure that the institutions have a cushion that makes them more resilient if risks materialise. 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 a severe tightening of credit granting to households and companies.

Other items

The Council was briefed on the cybersecurity work done by Danmarks Nationalbank and the financial sector. The Council regularly discusses operational risks, including cyber risks, as, in a worst-case scenario, such risks may threaten financial stability. In the financial sector in Denmark, targeted work is being done to increase resilience to cyberattacks. This includes preventing attacks and mitigating the damage caused in case of an attack. Related to these issues, the Danish Financial Supervisory Authority provided information on its work with cyber stress tests.

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