DET SYSTEMISKE RISIKORÅD

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The Systemic Risk Council
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PRESS RELEASE

20TH MEETING OF THE SYSTEMIC RISK COUNCIL

It is the assessment of the Council that risks are building up in the financial system. The countercyclical capital buffer should be built up before the financial system becomes stressed. Consequently, the Council recommends that the Minister for Industry, Business and Financial Affairs activate the countercyclical capital buffer and initially set the buffer rate at 0.5 per cent from 31 March 2019. If the build-up of risk does not change materially, the Council expects to recommend a further increase of the buffer rate by 0.5 percentage points within the next year.

In October 2017, the Danish government presented new guidelines for housing loans for high-LTI households in response to the Council's recommendation regarding risky loan types at high levels of indebtedness. The Council finds that the government's follow-up generally complies with the recommendation.

Risks are building up in the financial system

The economy is in a solid upswing that has been balanced so far. Asset prices are rising, e.g. in the housing and commercial property markets. Risk perception is very low in the financial markets and liquidity is ample. At the same time, interest rates are still expected to be very low over the next couple of years. There are signs of increased risk-taking among certain market participants in their search for yield. The Council emphasises that sudden changes in risk perception may lead to substantial falls in asset prices.

The persistently low level of interest rates combined with a strengthening upswing and rising property prices could lead to a rapid rise in credit risks. Build-up of debt from an already high level of debt amplifies risks associated with future credit growth. Growth in total lending has been subdued so far, but there are indications of stronger lending growth in certain segments. It is mainly lending by banks to the corporate sector that is rising. At the same time, these institutions are easing their credit standards for corporate customers. Furthermore, some institutions are beginning to resume business activities that have previously led to subsequent losses. Overall, it is the assessment of the Council that risks are building up in the financial system.

The Council recommends that the Minister for Industry, Business and Financial Affairs set the countercyclical capital buffer rate at 0.5 per cent from 31 March 2019
On the basis of risk developments, the Council recommends that the countercyclical capital buffer be activated. If the build-up of risk does not change materially, the Council expects to recommend a further increase of the buffer rate by 0.5 percentage points within the next year.

The activation of the buffer is meant to ensure that the buffer is built up in time, before the financial system is hit by a negative shock that may have implications for financial stability and the real economy. According to the EU-rules, the buffer requirement will enter into force 12 months after the Minister for Industry, Business and Financial Affairs announces an increase. The recommendation to activate the buffer is based on the Council's revised method for assessing the buffer rate. This method implies that the buffer can be activated when early indicators, such as increased risk appetite, rising asset prices and easing of credit standards, point to risks building up.

The Council is ready to recommend a reduction of the buffer rate with immediate effect if considerable stress develops in the financial system. If such stress entails a risk of severe tightening of lending to households and firms, release of the buffer can help to limit the negative effects on the real economy.

Together with its recommendation, the Council has published various questions and answers about the countercyclical capital buffer.

It follows from the legislation on the Systemic Risk Council that recommendations addressed to the government must include a statement by the representatives of the ministries on the Council. The representatives of the ministries and the Danish Financial Supervisory Authority have no voting rights in relation to recommendations addressed to the government.

The Council finds that the government's follow-up of the Council's recommendation on risky loan types generally complies with the recommendation
In October 2017, the Danish government presented new guidelines for housing loans for high-LTI households that generally complies with the Council's recommendation on limiting risky loan types at high levels of indebtedness, even though it is a different model. The guidelines limit more generally a number of risky loans at high level of indebtedness and will apply to all of Denmark. To obtain deferred amortisation at high levels of indebtedness and high LTI ratios, homeowners must now have fixed rate loans. Nonetheless, access to deferred amortisation is not limited to the extent recommended.

The Council will continue to monitor developments in the housing market and in household debt. Combined with the low level of interest rates, deferred amortisation makes it possible to accumulate large debts while still keeping payments at a very low level. That increases the risk of excessive levels of debt.

Other issues
Following up the Council's recommendation on the systemic buffer in the Faroe Islands in March 2017, the Council discussed the level of the buffer, the phasing-in of a higher buffer rate and the countercyclical capital buffer. The systemic buffer has currently been set at 1 per cent from 1 January 2018. When the Council recommended this buffer rate, it also assessed that the buffer rate should be increased further in the coming years. The Council decided to await input on the timing and composition of the capital buffers from the Faroese systemic risk council, which is expected to be established in the near future. The Faroese authorities participated in the discussion.

The Council discussed possible consequences of the loan impairment rules that are part of the new International Financial Reporting Standards, IFRS 9. Under these rules, the banks must make impairment charges for expected losses, not merely incurred losses. In the Council's assessment, the new rules will lead to more true and fair impairment charges. Overall, the transition to IFRS 9 is not expected to have any major one-off impact on the banks' levels of capitalisation, one reason being that the banks are in a phase where impairment charges are being reversed.

The Council discussed whether there may be systemic risks associated with the use of centralised settlement of financial transactions. Today there are no central counterparties, CCPs, established in Denmark, but Danish financial enterprises operate with central settlement using foreign CCPs to varying degrees. The use of a CCP for settlement of transactions supports the stability of the financial system by reducing counterparty risk and increasing transparency in the financial markets. The CCP guarantees execution of the transaction, in return for which both parties must pledge collateral. The Council discussed whether there may be systemic implications if the CCP increases its collateral requirements in periods of strong market fluctuations. The Council also found that, in practice, only a few highly specialised participants provide settlement services. That entails a potential concentration risk.

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