



## Recommendation

### Activation of the countercyclical capital buffer

*The Systemic Risk Council, the Council, recommends that the Minister for Industry, Business and Financial Affairs set a countercyclical capital buffer rate in Denmark of 0.5 per cent of credit institutions' total risk exposures in Denmark from 31 March 2019.<sup>1</sup>*

*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 Council is ready to recommend a reduction of the buffer rate with immediate effect if substantial stress occurs in the financial system and there is a risk of severe tightening of lending to households and firms.

Every quarter, the Systemic Risk Council assesses what is a suitable level for the countercyclical capital buffer. When the Council finds that the rate should be changed, it will publish a recommendation addressed to the Minister for Industry, Business and Financial Affairs. The Minister is responsible for setting the buffer rate in Denmark.

The Minister is required, within a period of three months, to either comply with the recommendation or present a statement explaining why the recommendation has not been complied with.

### Explanatory statement

It is the assessment of the Council that risks are building up in the financial system. The Danish economy is in a balanced upswing. Risk perception is very low in the financial markets and liquidity is ample. There are signs of increased risk-taking among certain market participants in their search for yield. At the same time, prices and activity in both the residential and commercial property markets have risen strongly in recent years. Overall lending growth is subdued, but there are signs of credit growth in certain market segments. Furthermore, total lending is at a high level.

The persistently low level of interest rates combined with a strengthening upswing, rising property prices and easing of credit conditions for corporate lending could lead to a rapid rise in credit risk. Build-up of debt from an already high level amplifies risks associated with future credit growth. This indicates that measures should be taken at an early stage of this development.

Overall, the credit institutions are deemed to be well capitalised, and at the current capital level, the vast majority of the institutions would be able to comply with a requirement for a countercyclical capital buffer rate of 0.5 per cent of total risk exposures.<sup>2</sup> According to the legislation, the buffer requirement will enter into force 12 months after the Minister has announced an increase, giving the institutions one year to meet the requirement. Moreover, it is easier for the institutions to increase their capitalisation in periods of economic

<sup>1</sup> Credit institutions are banks, mortgage banks and investment firms.

<sup>2</sup> The institutions must meet the countercyclical capital buffer requirement with Common Equity Tier 1 capital. The vast majority of the institutions would also be able to comply with a further increase of the buffer rate by 0.5 percentage points, which is what the Council expects to recommend within the next year.

expansion and positive earnings, e.g. by reducing share buy-backs or dividend payments.

### **Purpose of the countercyclical capital buffer**

The countercyclical capital buffer should contribute to limiting the negative effects on the real economy of a future financial crisis. The buffer is to be built up during periods when risk is increasing in the financial system. Once the buffer has been built up, it can be reduced when risks materialise, e.g. when the financial system is hit by a negative shock. This will release capital for use by the institutions. In so far as the institutions do not use the released capital for absorbing losses, it may be used for new lending or as a contribution to their excess capital adequacy. This helps the credit institutions to maintain a suitable level of lending in periods of stress in the financial system.

The buffer is primarily an instrument for strengthening the resilience of the institutions. The buffer should not be regarded as an instrument for managing business cycles.

The countercyclical capital buffer was introduced in international regulation after the financial crisis as part of a larger set of reforms aiming to make the financial sector more robust. The countercyclical capital buffer differs from the other capital requirements in that it can be eased in times of financial stress, whereas the other requirements apply in both good and bad times.

### **Activation of the buffer is to ensure that it is built up in time**

The Council has revised its method for assessing the buffer rate.<sup>3</sup> The revised method aims at early phasing-in to ensure that the buffer is built up in time, before the financial system is potentially hit by a negative shock that may have implications for financial stability and the real economy. Early phasing-in also increases the possibility of phasing in the buffer gradually. This gives credit institutions more time to make the necessary adjustments, e.g. by retaining earnings.

### **Information basis for the Council's assessment of the buffer rate**

The Council's assessment of the buffer rate is based on a broad information basis. Selected key indicators are to capture the build-up of systemic risk at various stages of financial development. Supplementary indicators and other relevant information are also taken into account to provide a more detailed picture than that painted by the key indicators.

The early stage of a financial upswing is often characterised by an increasing risk appetite among investors. This is reflected in higher asset prices, including prices of residential and commercial properties, and easier credit standards for households and firms. At a later stage, households and firms may increase their debt in the expectation that property prices will continue to rise. This means that some indicators, such as property prices, signal the build-up of systemic risk earlier than other indicators, e.g. lending to households and firms.

The overall picture emerging from developments in key and supplementary indicators is that risks are building up in the financial system, see Appendix 1.

### **Other information**

The Council also includes other policy initiatives in its considerations regarding the countercyclical buffer rate, including the phasing-in of future requirements. In mid-2017, the vast majority of the institutions had sufficient capital to meet both the buffer requirements<sup>4</sup> that are being phased in until 2019 and a countercyclical capital buffer of 0.5 per cent of total risk exposures. Moreover,

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<sup>3</sup> The revised method paper can be found at the Council's website [www.risikoraad.dk](http://www.risikoraad.dk).

<sup>4</sup> The buffer requirements comprise the capital conservation buffer for all institutions and a SIFI buffer for systemically important financial institutions, SIFIs.

the institutions can increase their capitalisation towards 2019 by retaining earnings.

Another future requirement for credit institutions is the MREL, i.e. the minimum requirement for own funds and eligible liabilities.<sup>5</sup> The MREL differs significantly from the countercyclical buffer. The purpose of the MREL is to ensure that institutions can be restructured or resolved without the use of government funds, without such resolution having any substantial negative impact on financial stability. This differs from the purpose of the countercyclical capital buffer, which is to make it easier for the credit institutions to maintain suitable credit extension in periods of stress in the financial system. The countercyclical capital buffer should preferably be built up before such a period begins. The MREL may be met using several types of capital and debt instruments, whereas the buffer requirements can be met using Common Equity Tier 1 capital only.

Future requirements for the institutions also include the Basel Committee's recently published recommendations for adjustment of the capital requirements. According to the Basel Committee, the purpose is to ensure a more uniform calculation of risk-weighted exposures across countries. However, the requirements to be adjusted are of a permanent nature, whereas the countercyclical buffer can be reduced when risks materialise. The Basel Committee envisages full phasing-in of the adjusted requirements by 2027. A lengthy negotiation process between the EU member states will now start in preparation for the implementation in EU legislation.

The Danish Financial Supervisory Authority expects that the banks and mortgage banks have capital targets that are sufficiently high to ensure that they can comply with the capital requirements in the Authority's severe stress scenario. According to the Danish Financial Supervisory Authority, the countercyclical capital buffer should not be taken into account in the institutions' capital targets, as it must be assumed to have been released in a severe stress scenario. Furthermore, the requirement that the banks must maintain a countercyclical capital buffer is not a "hard" requirement. So banks in breach of the requirement will not lose their banking licences. Instead, they will be required to submit a capital conservation plan to the Danish Financial Supervisory Authority, and bonus and dividend payments etc. may be limited if the banks fail to comply with the combined capital buffer requirement.<sup>6</sup>

Foreign credit institutions with risk exposures in Denmark must also comply with the Danish countercyclical buffer requirement. According to EU legislation, the institution-specific countercyclical buffer rate will be calculated as the weighted average of the countercyclical buffer rates applying to the countries in which the institution has exposures.<sup>7</sup>

The Council's recommendation is in compliance with current legislation.

*Lars Rohde, Chairman of the Systemic Risk Council*

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<sup>5</sup> Eligible liabilities can absorb losses and recapitalise an institution in a resolution situation. As a main rule, the MREL will be phased in towards 2020, cf. the Danish Financial Supervisory Authority's press release of 20 November 2017.

<sup>6</sup> In addition to the countercyclical capital buffer, the combined capital buffer requirement comprises the capital conservation buffer and the systemic buffer, cf. Executive Order no. 1349 of 12 December 2014 on calculation of the combined buffer requirement, the maximum distributable amount and the content of a capital conservation plan for certain financial enterprises and the Danish Financial Supervisory Authority's memo, "Bestemmelser om kapitalbevaringsplan og opgørelse af det maksimale udlodningsbeløb" (Provisions on a capital conservation plan and calculation of the maximum distributable amount) at the Danish Financial Supervisory Authority's website.

<sup>7</sup> EU legislation includes mandatory reciprocity of countercyclical buffer rates of up to 2.5 per cent. The same applies to countries with which the EU has concluded agreements in the financial area.

## **Statements from the representatives of the ministries on the Council**

"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 CCyB is one of the capital instruments that was introduced in Danish legislation following the recent financial crisis. The government will now look into the recommendation. In the coming period, the government will assess whether the economic conditions are present for the activation of the buffer, including in light of the work with resolution plans and the latest capital requirements of the Basel Committee. In this context, the government will decide in the next three months whether to activate the buffer."

## Appendix A: Information basis

### Risks are building up in the financial system

The Council's assessment that risks are building up in the financial system is supported by several factors. The indicators included by the Council in the information basis for assessing the countercyclical buffer rate are described below. The indicators have been divided into relevant categories.<sup>8</sup>

#### *Risk perception*

Developments in the financial markets have been characterised by a very low level of stress in recent years. At the same time, risk perception is currently low and risk appetite high. This is reflected in for example very low implied volatility in the bond and equity markets and narrow credit spreads.

#### *Real estate market*

In the housing market, prices and activity are rising all over Denmark. Especially the rate of price increase for owner-occupied flats in the Copenhagen area is very high – and a little higher than warranted by disposable income and the level of interest rates according to Danmarks Nationalbank's house price relation. There are indications that growth in the housing market has spread to all of Denmark and is no longer driven primarily by Copenhagen.

Prices and activity in the commercial property market have risen strongly in recent years. The required rates of return on rental properties have generally fallen, driven by the low level of interest rates and high demand from investors seeking alternative investment opportunities.

#### *Lending and credit standards*

Growth in total lending by credit institutions to households and firms has risen since 2015, but nevertheless remains modest. Growth is driven by bank lending to the corporate sector, which has outpaced GDP growth since 2016. At the same time, the banks have eased credit standards for the corporate sector in response to increased competition.

Although lending growth is modest, total lending is at a high level. Build-up of debt from an already high level amplifies risks associated with future credit growth in connection with an upswing in the real estate market and in the economy.

Every quarter, all EU member states must calculate and publish a credit-to-GDP gap and a buffer guide calculated on the basis of the credit-to-GDP gap.<sup>9</sup> The credit-to-GDP gap is defined as the difference between actual lending as a ratio of GDP and an estimated trend. In retrospective analyses, the credit-to-GDP gap has been good at predicting systemic bank crises across a number of countries. However, several member states, including Denmark, have experienced challenges in relation to the credit-to-GDP gap as an indicator of current credit developments. One of the weaknesses of the indicator is that it relies on a statistically calculated trend that does not necessarily reflect the current economic and financial situation. The credit-to-GDP gap is very negative in Denmark and does not provide a fair view of credit developments.<sup>10</sup> Consequently, the Council finds it important to include different credit development indicators in its assessment.

<sup>8</sup> The categories are described in the Council's method paper on the countercyclical capital buffer, which can be found at the Council's website, [www.risikoraad.dk](http://www.risikoraad.dk).

<sup>9</sup> In principle, the buffer guide should function as a common point of departure for when to activate the buffer and the level of the buffer rate. In order to avoid "inaction bias", the credit-to-GDP gap and buffer guide played a key role in international recommendations and legislation on the countercyclical capital buffer. The recommendations and legislation also state that decisions on the buffer rate should not be based only on the buffer guide, but that other quantitative and qualitative information must be included and published. For sources for recommendations and legislation, see the Council's method paper on the countercyclical capital buffer at [www.risikoraad.dk](http://www.risikoraad.dk).

<sup>10</sup> The buffer guide is currently 0 per cent. According to the mechanical calculation, the buffer guide will not be positive until the credit-to-GDP gap exceeds 2 percentage points. The credit-to-GDP gap is seen in Chart B.4 (right).

### ***Risk build-up in credit institutions***

The credit institutions are well capitalised and earnings are high. Growth in earnings is attributable to extraordinarily high value adjustments and very low loan impairment charges. The large banks' return on equity has increased in recent years and is now at more or less the same level as in the pre-crisis years. A large share of the institutions' earnings is distributed to shareholders in the form of dividends and share buy-backs instead of being used for building up Common Equity Tier 1 capital.

### ***Model-based indicators***

The Council uses two different estimates of the financial cycle in Denmark as input for its overall assessment of the current financial situation. Analyses of the financial cycle in Denmark show that it is driven primarily by fluctuations in house prices and lending and that house prices have a tendency to move ahead of lending.<sup>11</sup> One of the estimates of the financial cycle shows that it has turned and is now on the upswing. Another estimate shows that the cycle has not yet reached its turning point. It should be noted that the estimates do not provide an accurate picture of the current financial cycle due to estimation uncertainty at the end of the reference period (end-point problems).

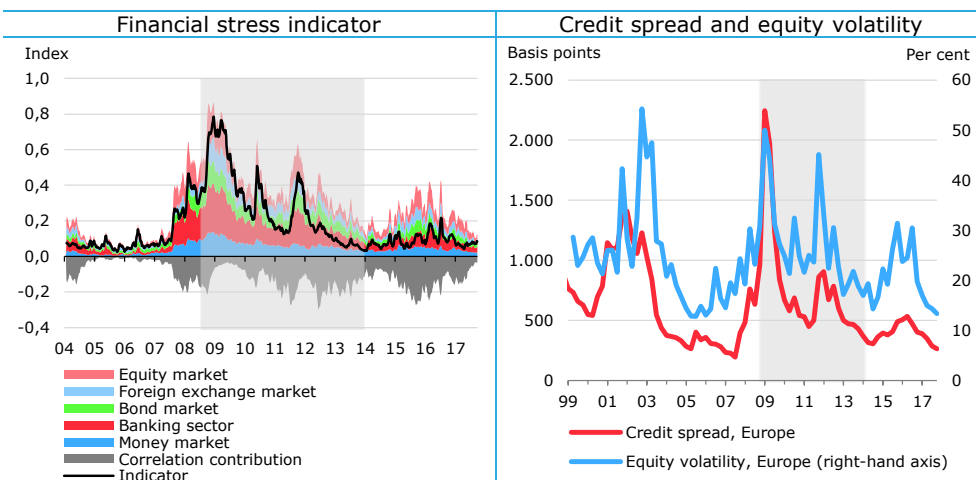
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<sup>11</sup> See Grinderslev et al. (2017), *Financial Cycles: What are they and what do they look like in Denmark?*, Danmarks Nationalbank, *Working Papers*, No. 115.

## Chart pack: Key indicators

### Risk perception

Chart A.1

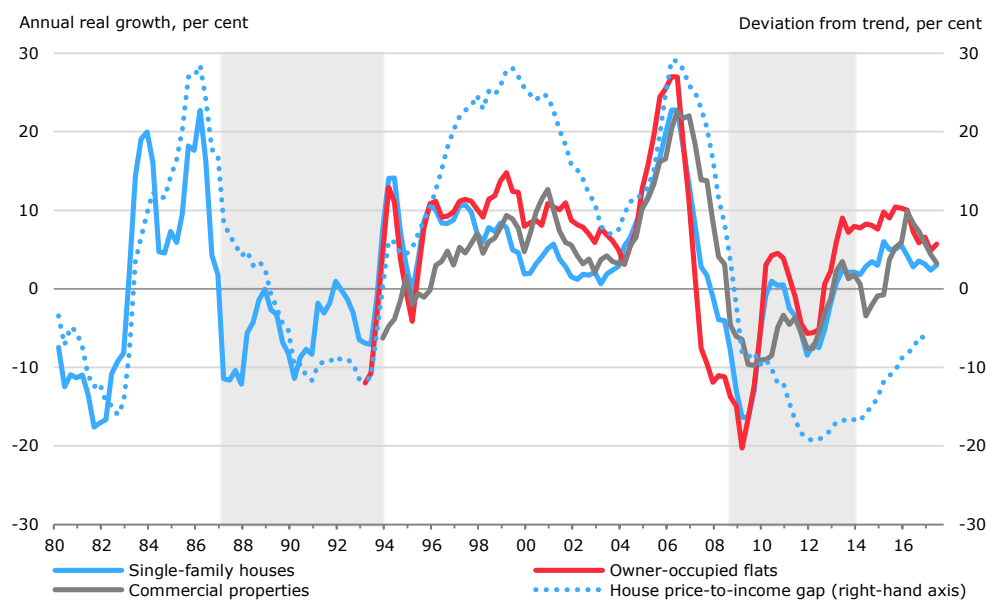


Note: 4-week moving averages. The financial stress indicator aggregates the level of stress in five key submarkets/sectors, taking into account that simultaneous stress in several submarkets is a greater challenge to the financial system. A value of 0 indicates very low volatility and strong confidence in the financial system, while a value of 1 indicates that the five submarkets are all extremely dysfunctional and at the same time market participants are nervous. For further details, see the Council's method paper on the countercyclical capital buffer at [www.risikoraad.dk](http://www.risikoraad.dk). The most recent observations are from 3 December for the financial stress indicator and the 3rd quarter for credit spreads and equity volatility.

Source: Bloomberg, Nordea Analytics, Thomson Reuters and Danmarks Nationalbank.

### Property prices

Chart A.2

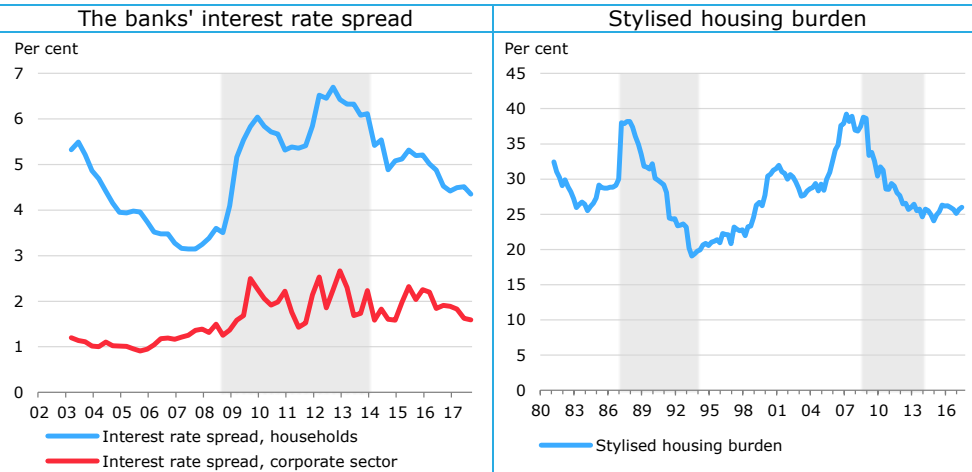


Note: The house price-to-income gap is defined as deviations of the house price-to-income ratio from its long-term trend (estimated by means of a recursive HP filter,  $\lambda=400,000$ ), the house price being the cash price for a single-family house and income the household disposable income. For further details, see the Council's method paper on the countercyclical capital buffer at [www.risikoraad.dk](http://www.risikoraad.dk). The most recent observations are from the 2nd quarter of 2017.

Source: Statistics Denmark, the MONA data bank and own calculations.

Credit standards

Chart A.3

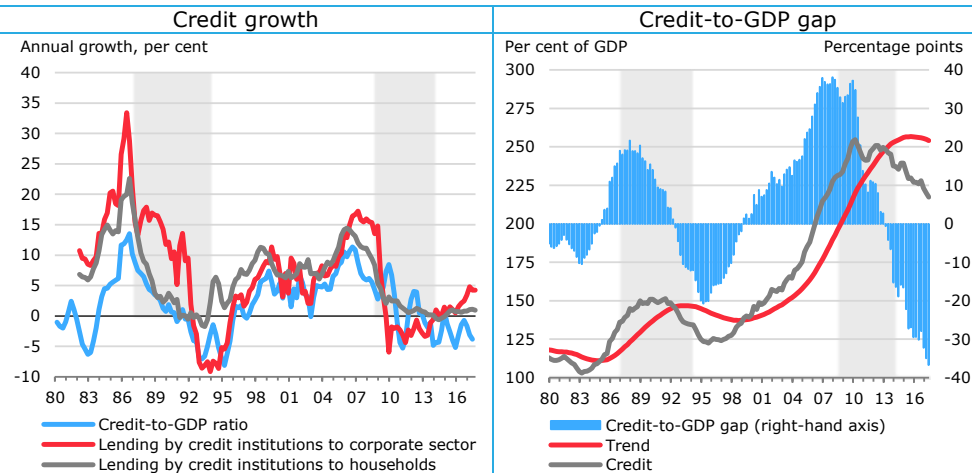


Note: *Left-hand chart:* 3-month moving averages. The interest rate spread is defined as the banks' lending rate on new lending, excluding overdrafts, relative to Danmarks Nationalbank's rate of interest on certificates of deposit (Danmarks Nationalbank's lending rate before 2009). *Right-hand chart:* The housing burden is a stylised calculation of the financing costs when buying a single-family house as a share of average disposable household income. For further details, see the Council's method paper on the countercyclical capital buffer at [www.risikoraad.dk](http://www.risikoraad.dk). The most recent observations are from the 3rd quarter of 2017 for the banks' interest rate spread and the 2nd quarter of 2017 for the stylised housing burden.

Source: Statistics Denmark, Association of Danish Mortgage Banks, Realkredit Danmark, Skat (Danish tax authorities), Danmarks Nationalbank and own calculations.

Credit developments

Chart A.4



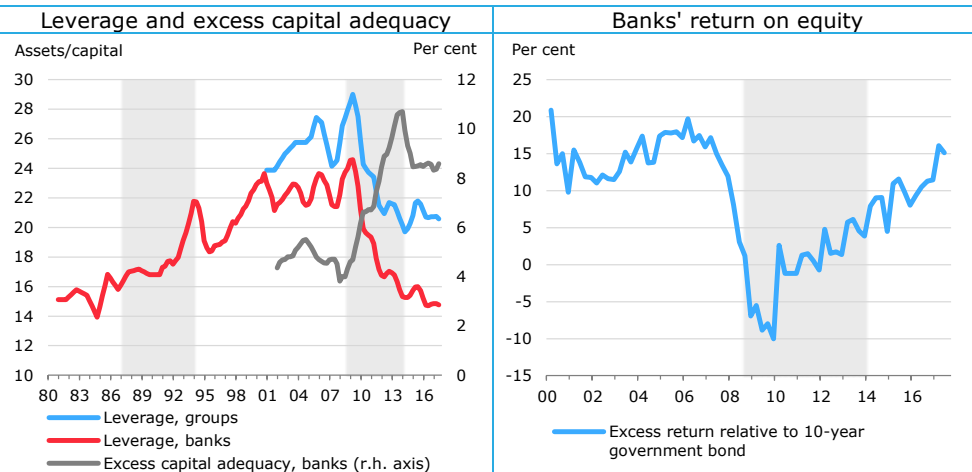
Note: *Left-hand chart:* The credit-to-GDP ratio is based on a broad definition of credit, while the other two lending series are based on a narrow definition. *Right-hand chart:* Credit is based on a broad definition of credit and the credit-to-GDP gap is defined as deviations between the credit-to-GDP ratio and a long-term trend (estimated by means of a recursive HP filter,  $\lambda=400.000$ ). For further details and sources, see the Council's method paper on the countercyclical capital buffer at [www.risikoraad.dk](http://www.risikoraad.dk). The most recent observations are from the 3rd quarter of 2017 for the credit institutions' lending to households and the corporate sector and the 2nd quarter of 2017 for the credit-to-GDP ratio and the credit-to-GDP gap.

Source: Abildgren (2007 and 2010), Statistics Denmark, Danmarks Nationalbank, the MONA data bank and own calculations.



Risk build-up in credit institutions

Chart A.5

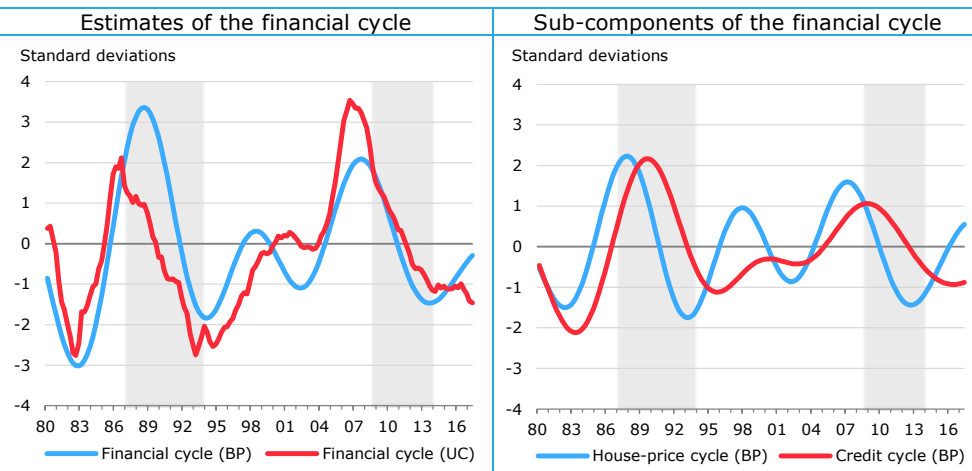


Note: *Left-hand chart:* 4-quarter moving averages. *Right-hand chart:* Annualised quarterly data for the banks' return on equity. For further details, see the Council's method paper on the countercyclical capital buffer at [www.risikoraad.dk](http://www.risikoraad.dk). The most recent observations are from the 2nd quarter for leverage, excess capital adequacy and the banks' return on equity.

Source: Danish Financial Supervisory Authority, Bloomberg and own calculations.

Model-based indicators

Chart A.6



Note: Deviations from trend. *Left-hand chart:* BP indicates that the cycle has been estimated using a band-pass filter. UC indicates that the cycle has been estimated using an unobserved components model. *Right-hand chart:* House price cycle and credit cycle where the trend has been estimated using a BP filter. For further details, see the Council's method paper on the countercyclical capital buffer at [www.risikoraad.dk](http://www.risikoraad.dk). The most recent observations are from the 2nd quarter of 2017.

Source: Danmarks Nationalbank, Statistics Denmark and own calculations.