

# Nykredit Capital Markets Day 2018

## Status of the Danish banking sector

November 14, 2018

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Director General, Danish FSA

# Agenda

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1. State of the Union – Danish banking
2. Macroprudential measures
3. MREL approach
4. Principle of balance
5. Anti Money Laundering



## Major takeaways

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1. Negative interest rates create challenges and temptations.
2. Danish credit institutions are well capitalized.
3. Focus on capital building in good times.
4. Housing prices keep rising, but macroprudential steps has been taken.
5. Danish set-up – 3 models for strategies and MREL.
6. Mortgage credit and the principle of balance – the Danish FSA will encourage best practice.
7. Several initiatives to strengthen AML and lessons learned.

# State of the Union – Danish banking

The traditional business model is challenged  
by low interest rate environment

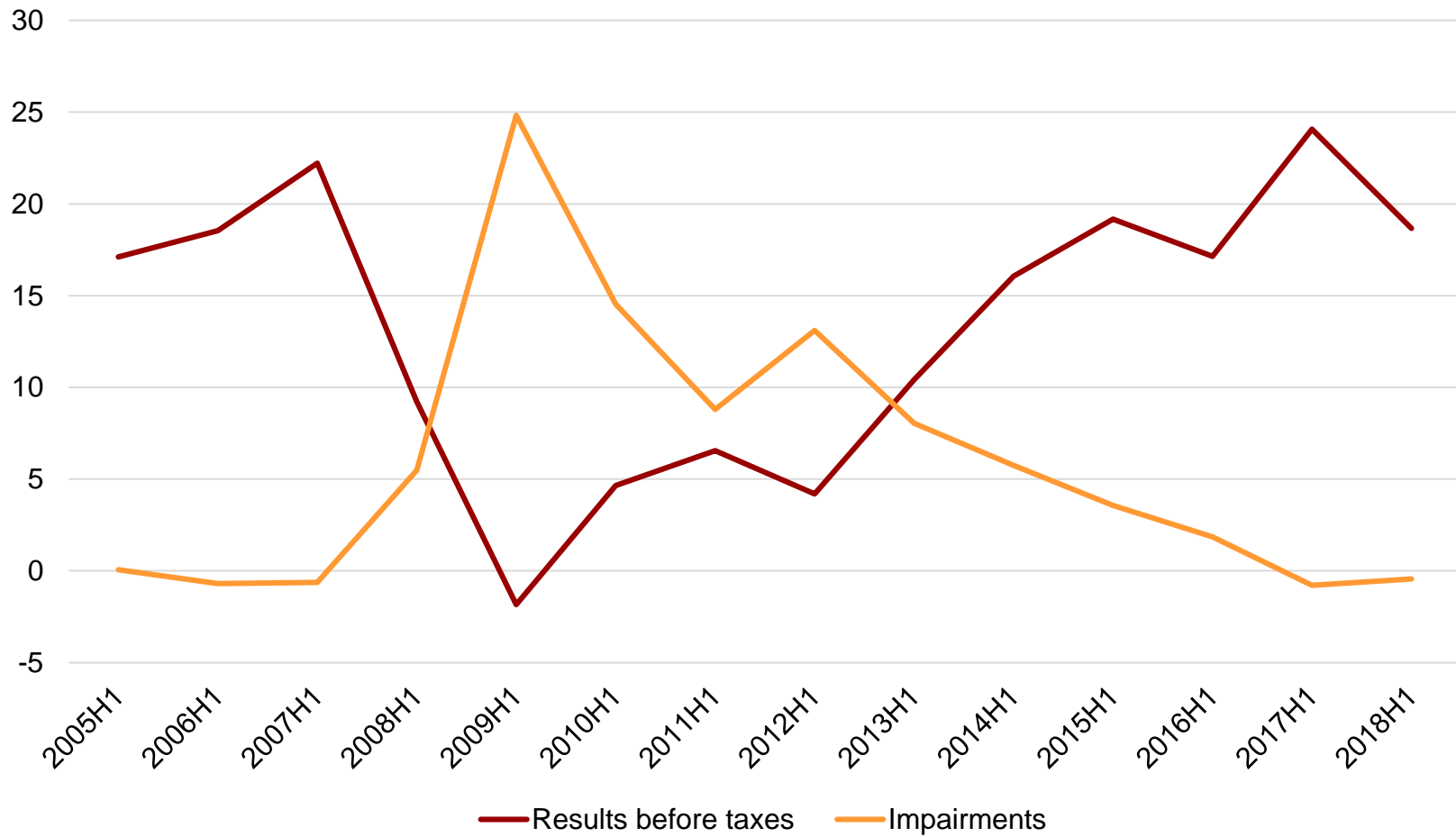
## Key risks to the Danish Economy

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- Low interest rates
  - Low price of risk.
  - Concerns regarding sudden reappraisal of risk and thereof rising interest rates.
- Bank earnings
  - Strong results, though driven by positive impairments and value adjustments.  
Core earnings under pressure.
- Loan growth
  - Moderate, but high at some smaller and medium sized institutions.
- Rising real estate prices
  - Prices are above pre-crisis levels and particularly high in Copenhagen.

## Good results for the Danish banks

Billion DKK



Source: Reports to the Danish FSA

However partly because of positive impairments 6

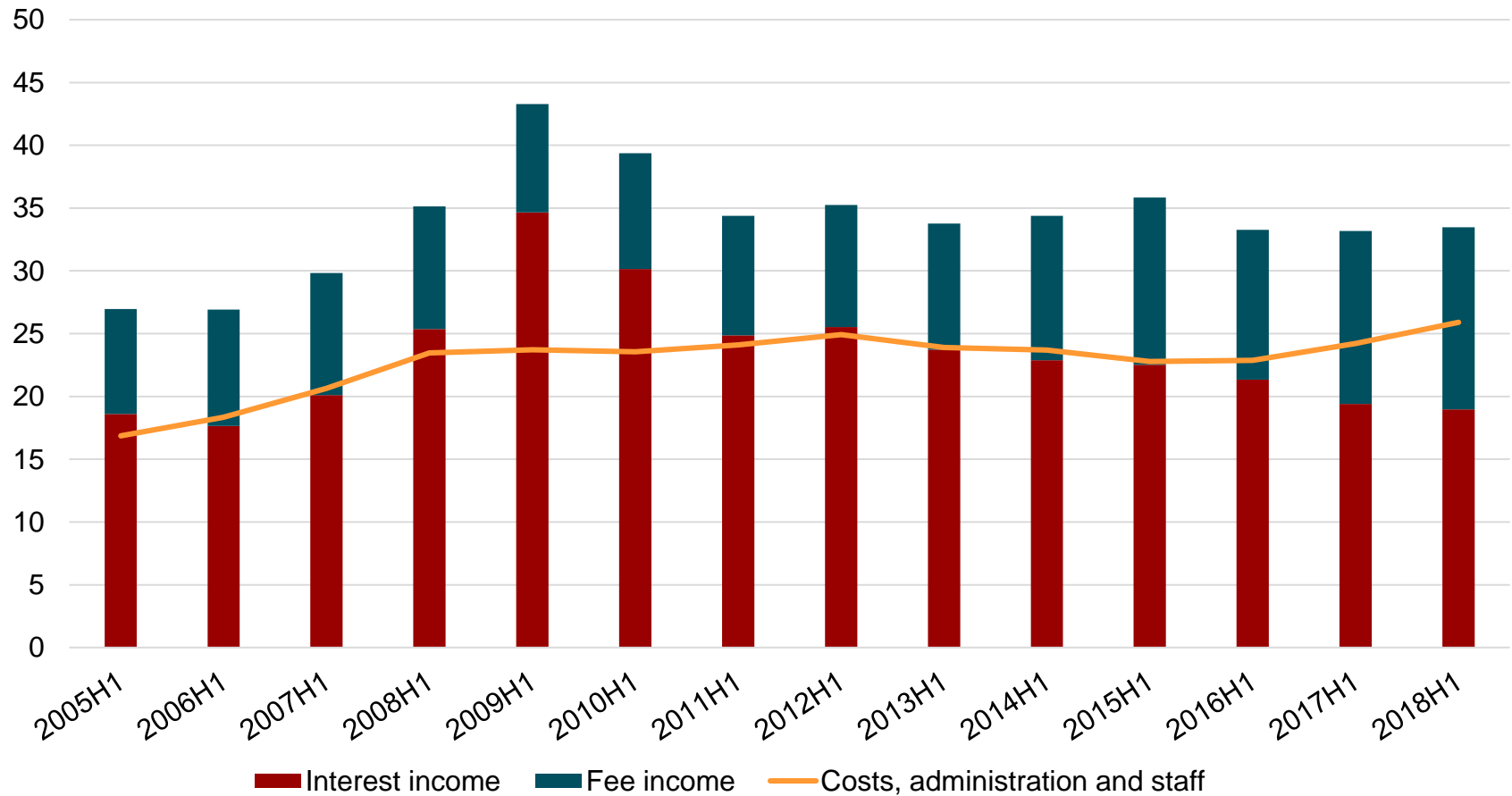
# Interest rates on mortgage loans are historically low



Source: Finance Denmark

## The Danish banks are challenged by the low interest rates

Billion DKK



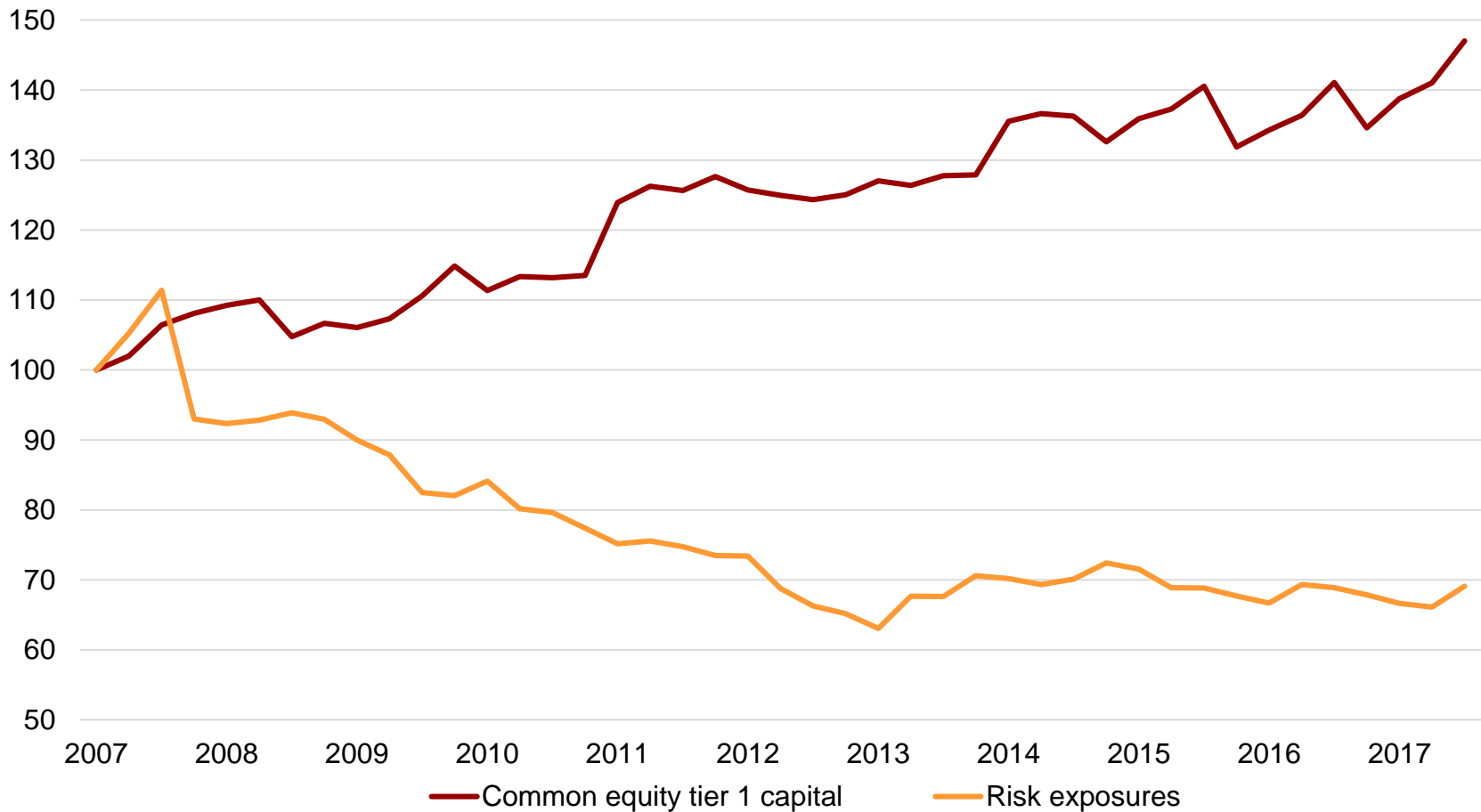
Source: Reports to the Danish FSA

While costs are rising, the banks are only partly compensated by fees 8



## Rising capitalization in the credit institutions

Index, 2007Q2=100

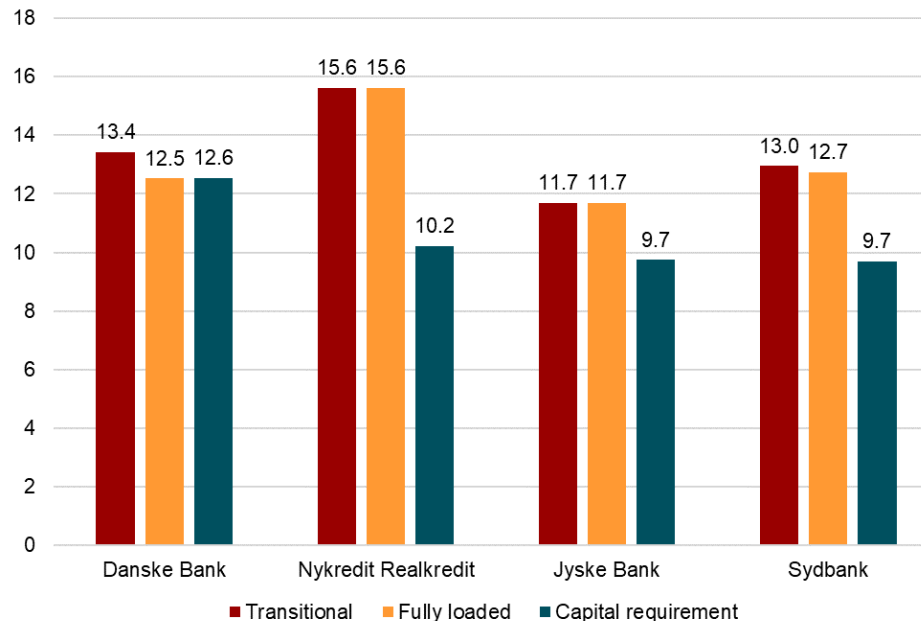


Source: Reports to the Danish FSA

## EBA EU-wide stress test results

- The EU-wide stress test shows that the four Danish banks will maintain excess capital relative to capital requirements even in the event of a severe economic downturn.
- Danske Bank, Nykredit, Jyske Bank and Sydbank will maintain Common Equity Tier 1 capital ratios between 11.7 and 15.6 percent by the end of 2020 in the adverse scenario.

Common Equity Tier 1 capital (CET1) and CET1 capital requirements in the worst year (in terms of excess capital) of the adverse scenario, percent of risk exposure amount.



## The adverse scenario

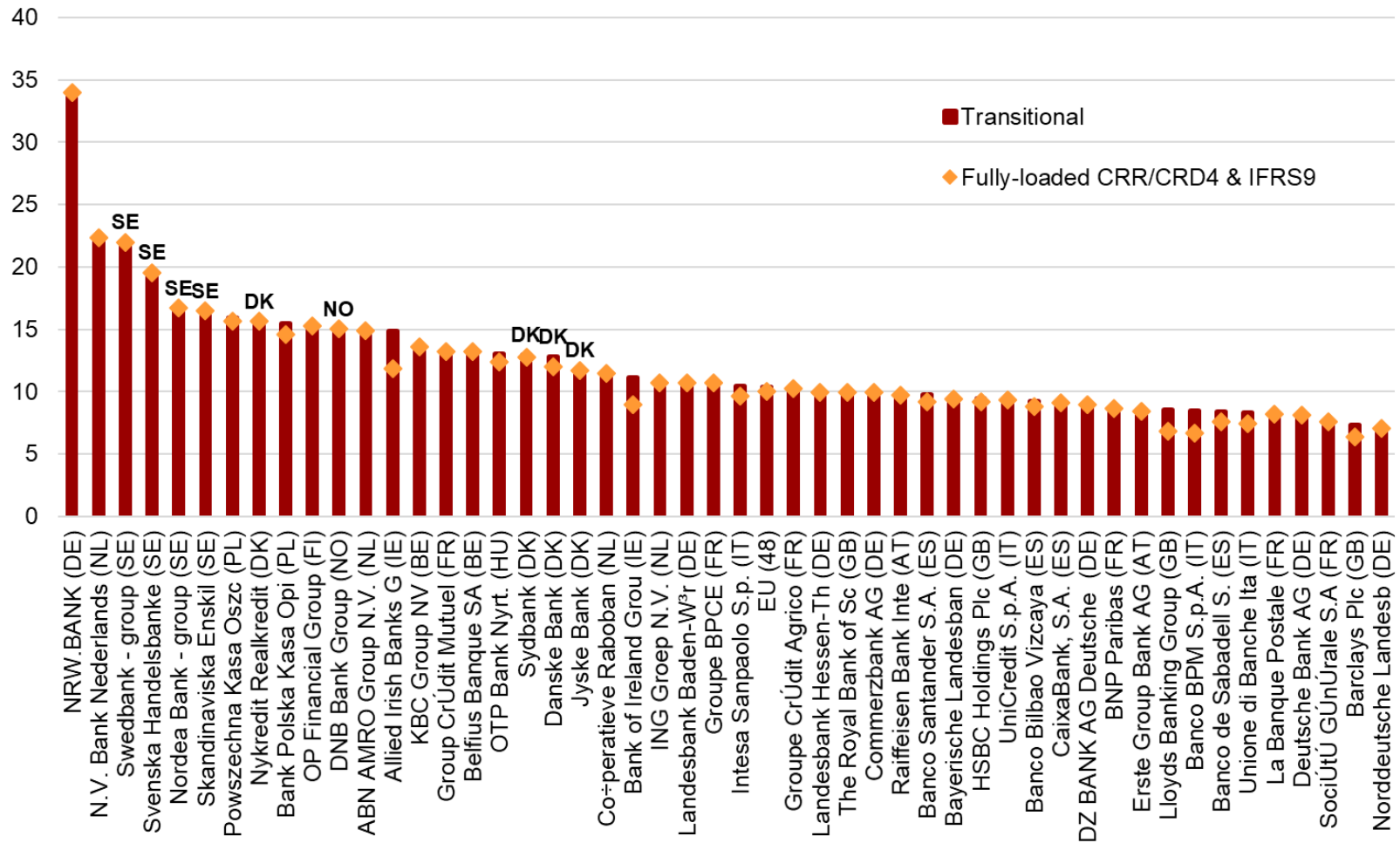
- For Denmark, the adverse scenario reflects a severe economic downturn with negative GDP growth, a significant decline in residential and commercial property prices and rising unemployment.
- More severe than for the EU/Eurozone.
- The Nordic countries are in general severely hit – Sweden stands out.

Scenario variables	EBA EU-wide stress test 2018									
	Denmark		Sweden		Norway		EU		Eurozone	
	over 2 years	over 3 years	over 2 years	over 3 years	over 2 years	over 3 years	over 2 years	over 3 years	over 2 years	over 3 years
<b>Accumulated growth in per cent</b>										
Real GDP	-5.4	-4.1	-8.9	-10.4	-2.1	-1.4	-3.4	-2.7	-2.9	-2.4
Residential property prices	-24.6	-28.1	-47.8	-49.4	-41.1	-38.7	-18.5	-19.1	-16.1	-16.5
Commercial property prices	-27.5	-31.0	-38.0	-42.8	-37.3	-35.0	-17.8	-20.0	-15.7	-17.7
<b>Per cent/percentage points</b>										
Unemployment - level EoY	9.5	11.1	10.9	12.5	5.7	6.3	9.0	9.7	9.7	10.3
Unemployment - change (2017-)	3.8	5.4	4.2	5.8	1.6	2.2	1.5	2.2	0.8	1.4
10Y government bond yields - level EoY	1.4	1.7	2.4	2.9	2.4	2.7	2.4	2.6	2.2	2.5
10Y government bond yields - change (2017-)	0.9	1.2	1.8	2.2	0.8	1.1	1.2	1.4	1.2	1.4

Note: The adverse scenario covers the period 2018-20. Eurostat's definition of unemployment rate. Over two years refer to 2018-19, over three years to 2018-20.

Source: ESRB and own calculations.

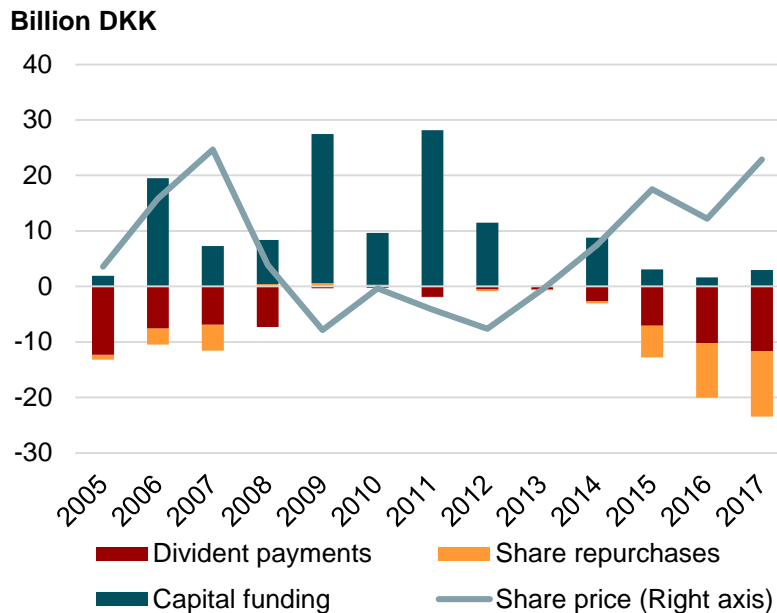
## EU-wide CET<sub>1</sub> capital ratios in the adverse scenario, end 2020



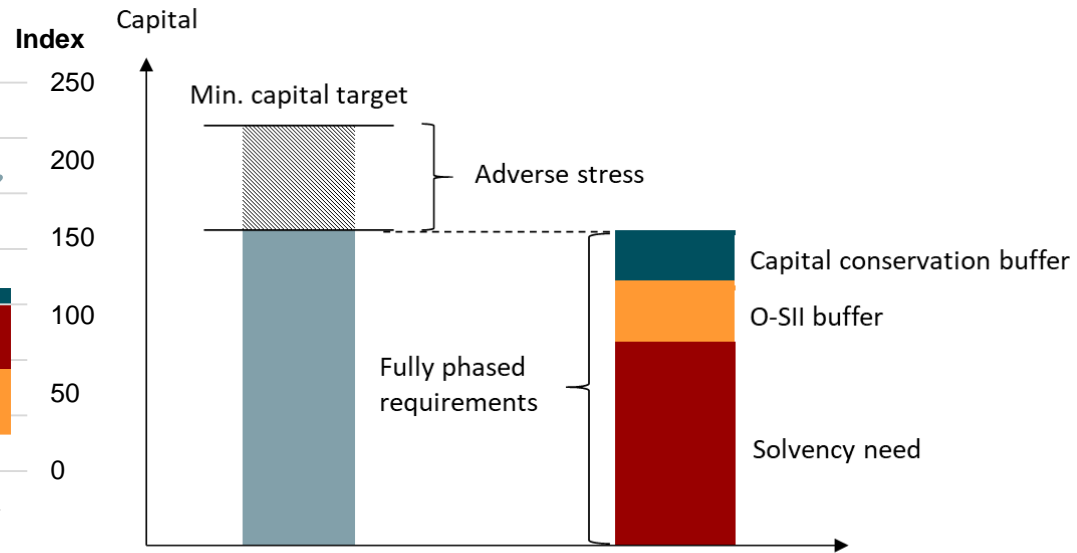
Note: EU(48) is calculated as a weighted average of the 48 participating banks in the exercise

# Supervisory dialogue with banks on capital targets and distribution policies

## Rising dividend payments and share repurchases



## High capitalization and capital target



Most banks have capital positions well above their announced capital target in order to mitigate unforeseen events

## High capitalization and capital target

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- There has to be a sound connection between capital, capital requirements and capital targets.
  - Capital targets should be well above the requirements to address a risk of conflict with requirements in case of unforeseen events.
- This rationale is also based on the fact that Denmark has chosen a model with lower total capital requirements than our Nordic neighbors.
  - Norway has gearing requirements and a hard Basel floor.
  - Sweden has a higher O-SII buffer.
- We therefore expect banks to have a higher capital target margin than their Nordic peers.
- The capital target also depends on new regulation, capital flexibility, dividend policy etc.

## Capital target must incorporate dividend policy

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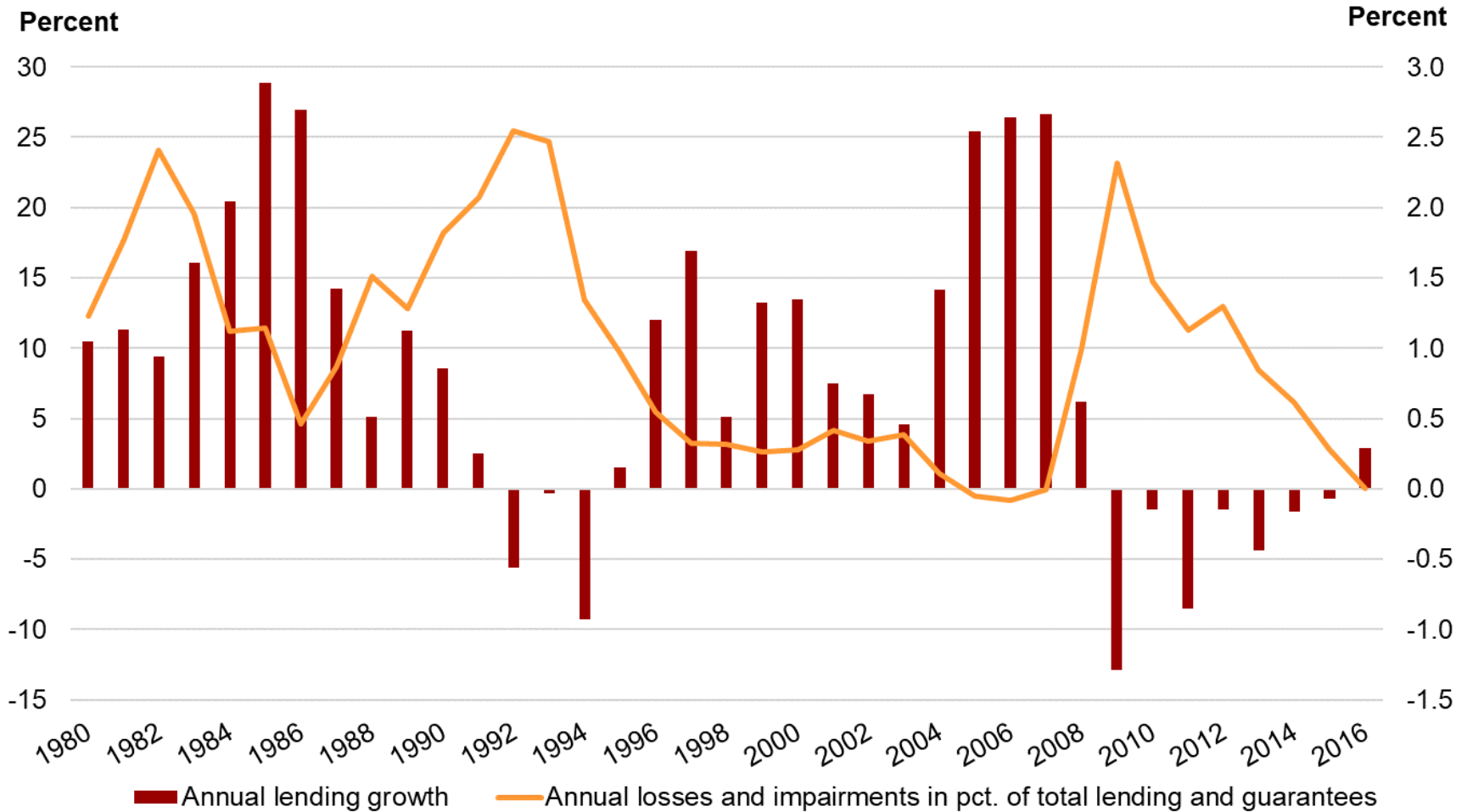
Recently we have seen increasing dividend payouts and share buy back programs.

- Timing is important.
  - Capital should be build up in good times, not in bad times.
- High dividend pay outs must not be on the expense of economic robustness.
- Dividend policy should be set within capital objectives.

# Macroprudential measures



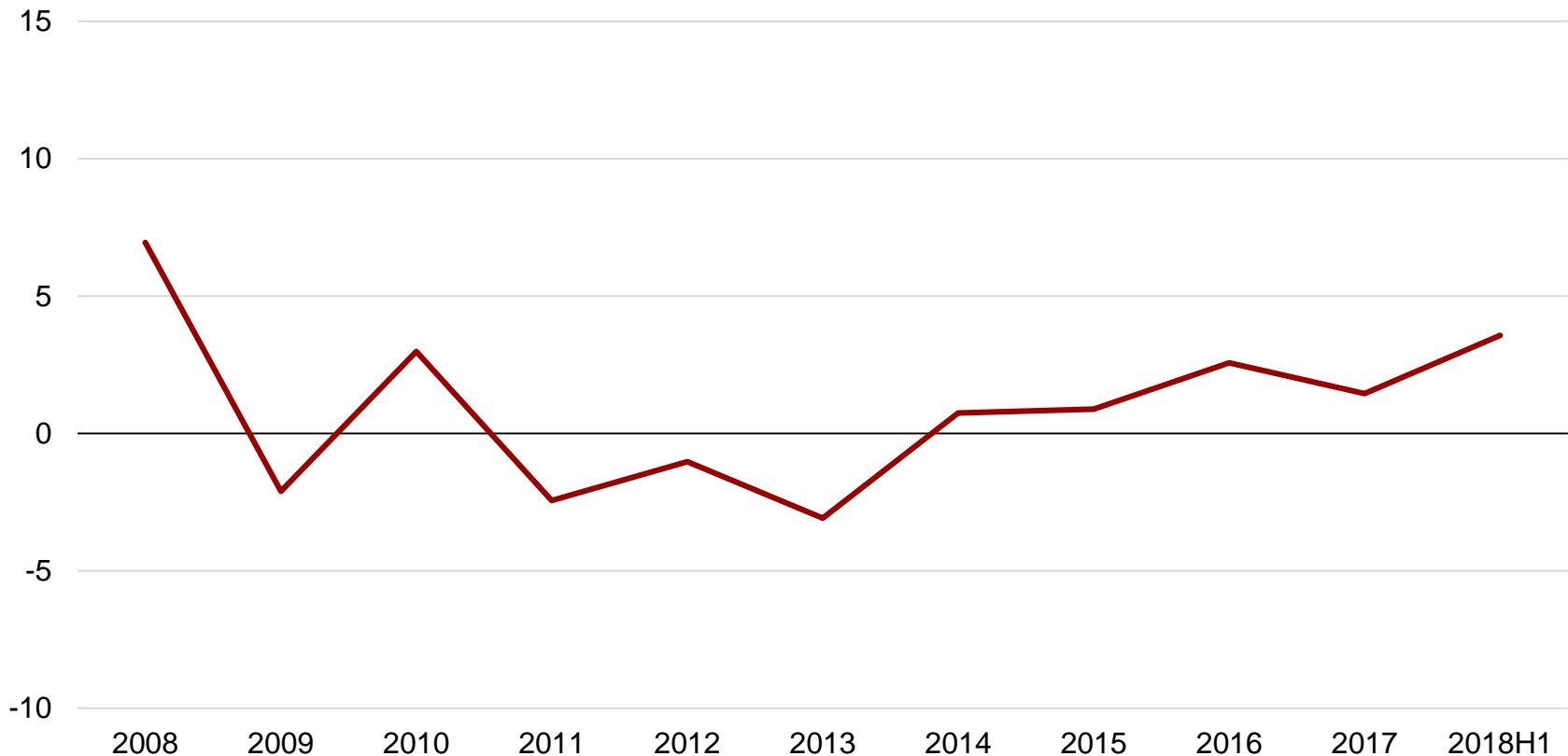
## Foundation for losses in times of crisis...



Note: Growth in lending and following losses and impairments in percentage of lending and guarantees.  
 Source: Reports to the Danish FSA.

## Moderate overall lending growth

Percent

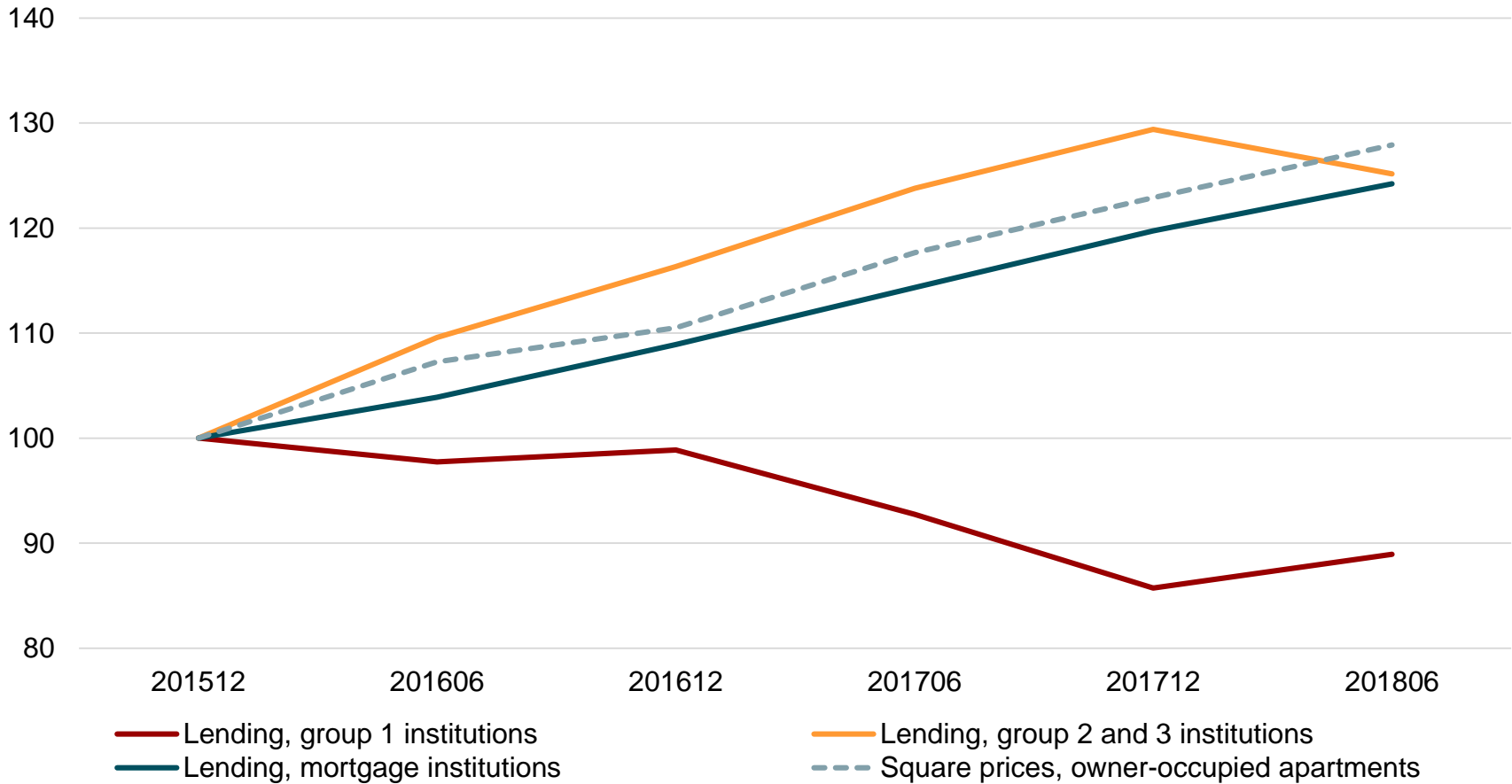


Note: The figure shows growth in lending ex repo. Nordea Bank Danmark is excluded from the numbers. The Finnish activities of Danske Bank are excluded from the data.

Source: Reports to the Danish FSA.

# Loan growth in Copenhagen municipality

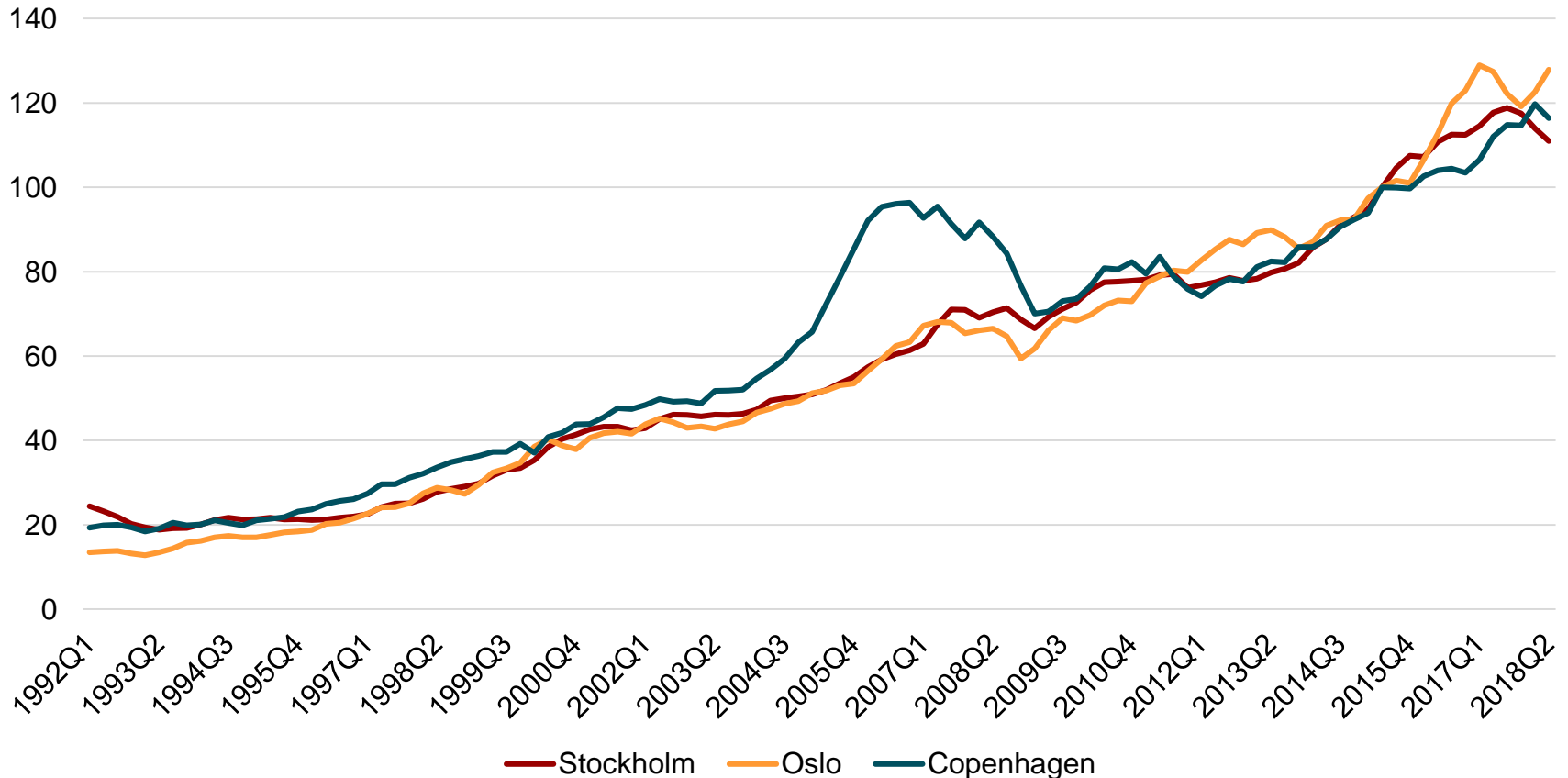
Index (2015Q4 =100)



Note: Lending to owner-occupied housing and flat prices in Copenhagen municipality.  
 Source: Reports to the Danish FSA and Finance Denmark.

## While housing prices has risen sharply in Copenhagen..

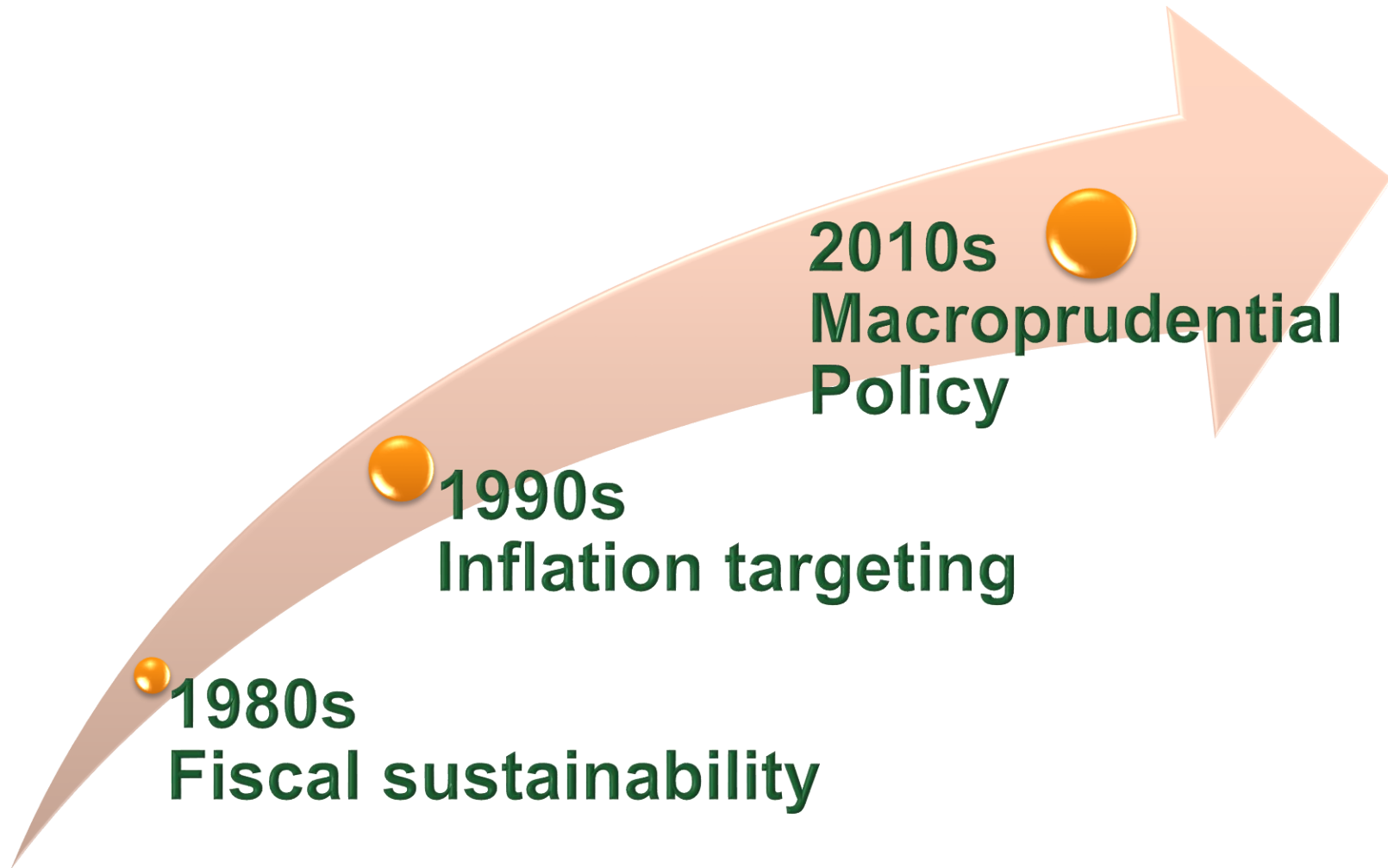
Index (2015Q2=100)



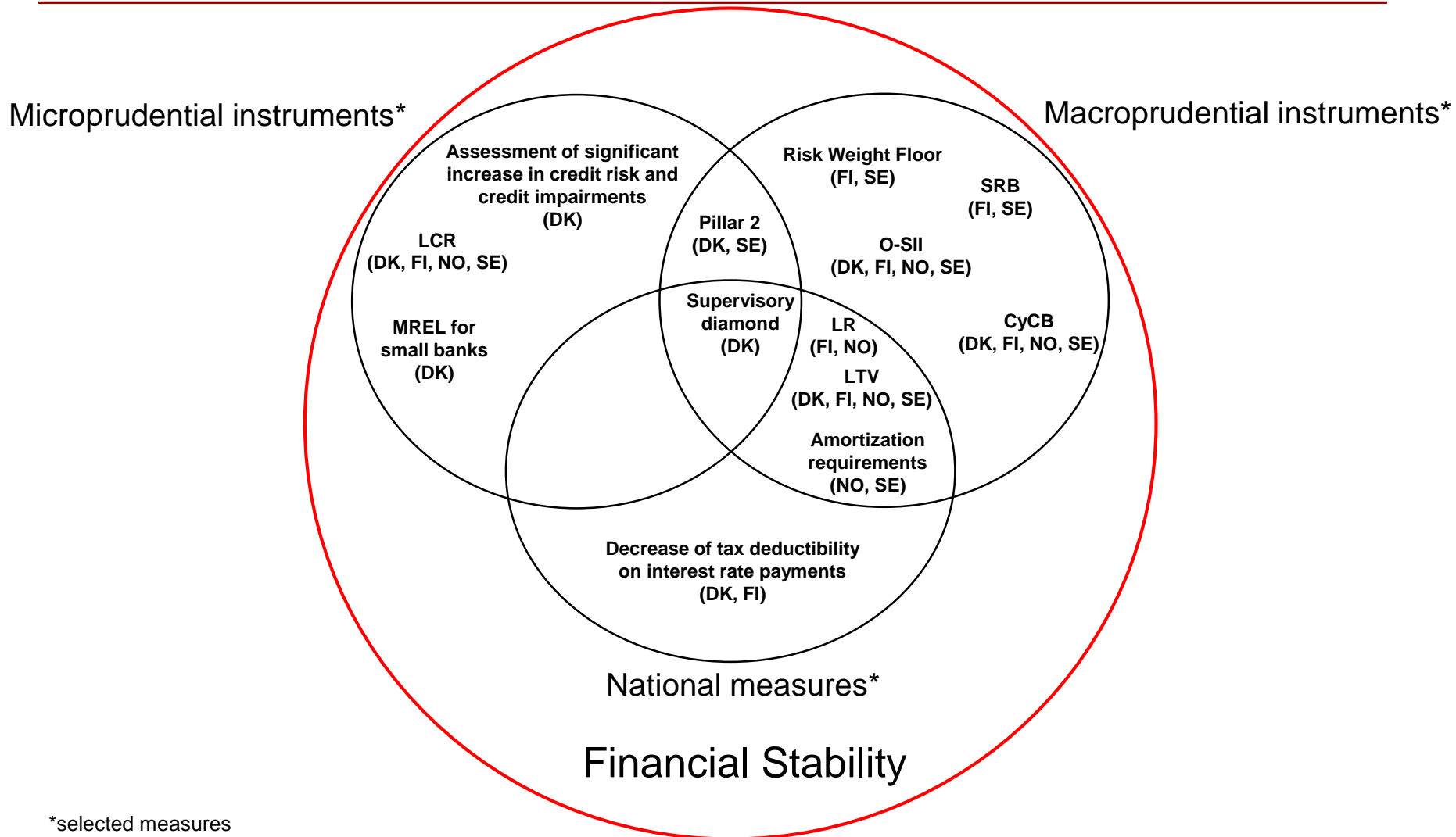
Note: Stockholm housing prices covers Greater Stockholm, one- and two-dwelling buildings for permanent. Oslo housing prices covers Oslo (city) including Bærum (city), existing dwellings. Copenhagen housing prices covers District of Copenhagen city, detached- and terraced houses. Source: Statistics Norway (SSB), Statistics Sweden (SCB) and Finance Denmark.

## Limited fiscal and monetary space

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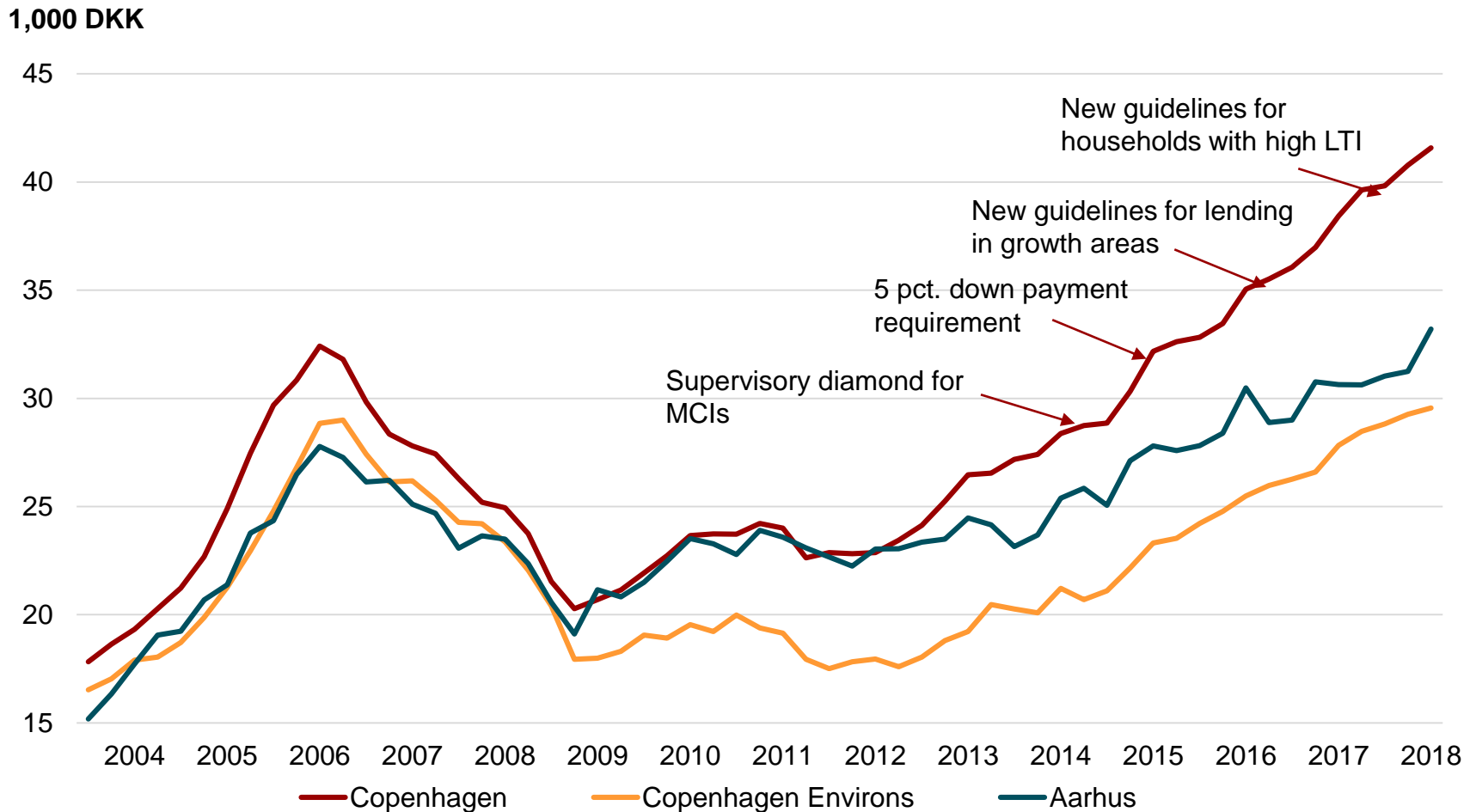


# The Nordics - live experiment for micro- and macroprudential instruments



\*selected measures

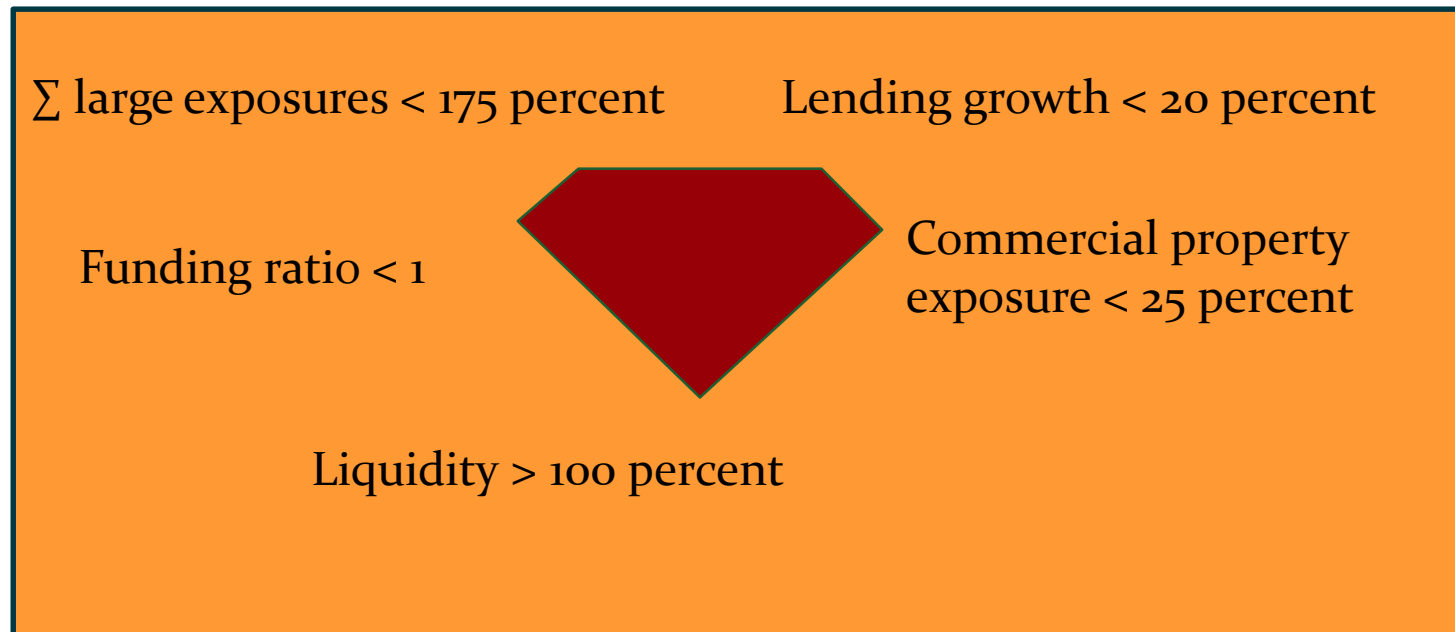
## Several macroprudential measures taken...



Note: Price pr. square metre.  
Source: Finance Denmark.

## Supervisory diamond for banks

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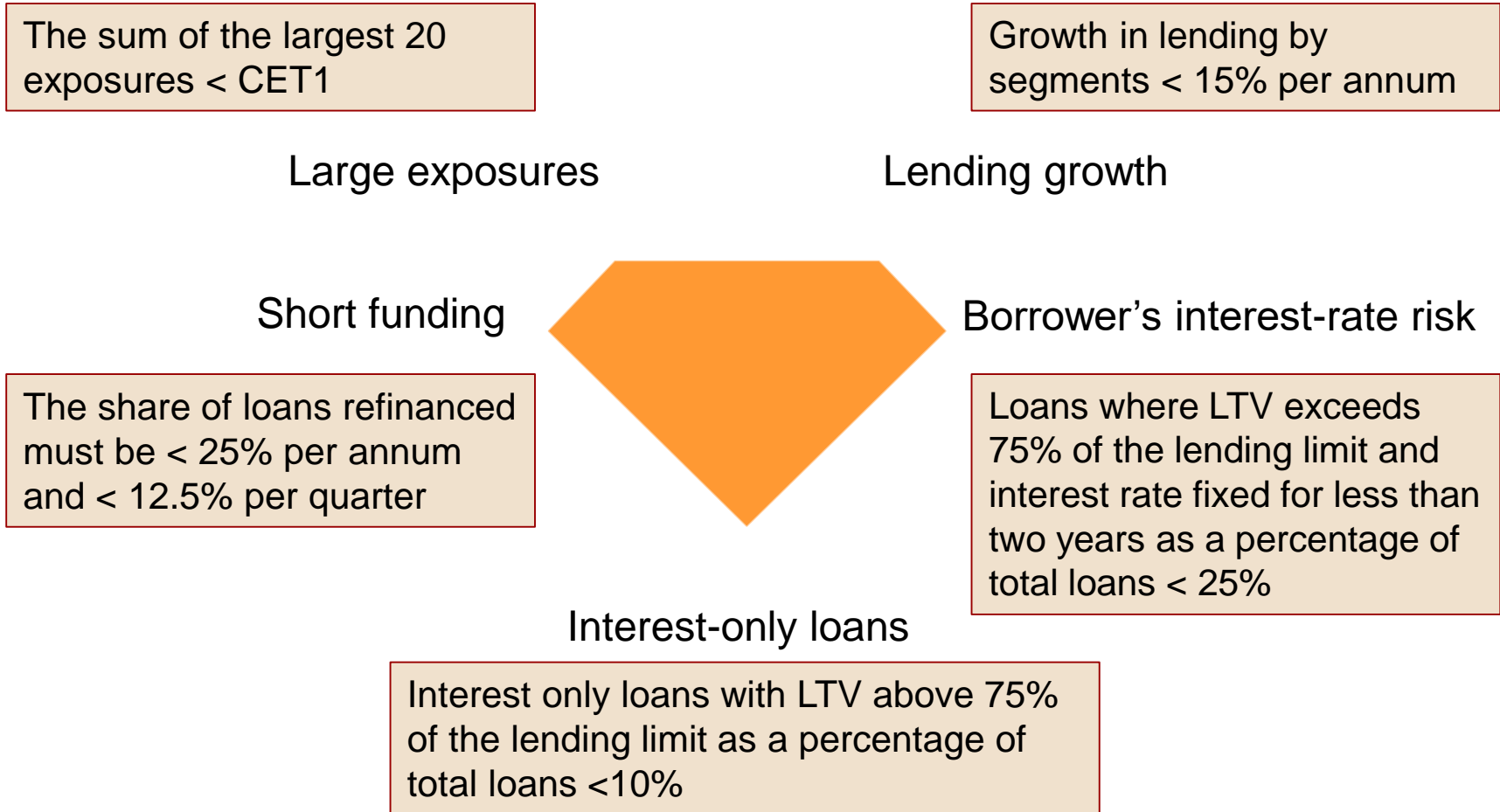


- New benchmark for large exposures – changed January 1st 2018.
- New benchmark for liquidity based on LCR – changed June 30th 2018.
- Funding benchmark expected to be revised when the EU NSFR requirement enters into force.



## Supervisory diamond for mortgage credit institutions

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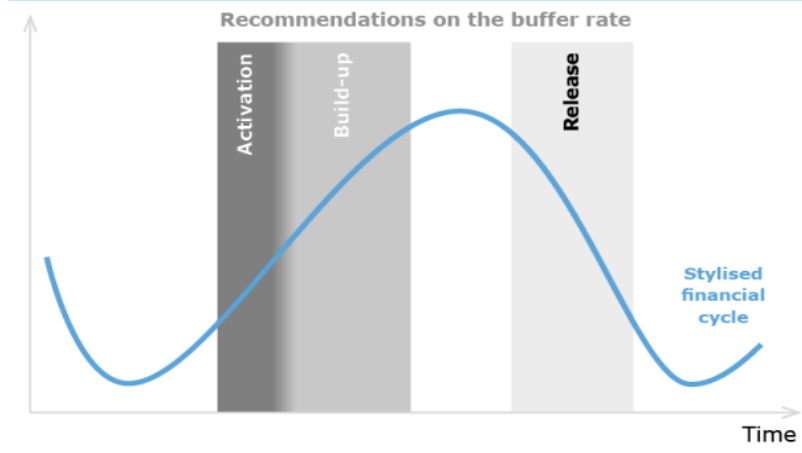


## Time to activate the CCyB

- February 2018: The Systemic Risk Council recommends to set the CCyB rate at 0.5 per cent.
  - 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.
- March 2018: The Minister complies with 0.5 percent from March 31 2019.
- September 2018: Following a recommendation from the SRC, the Minister increases the buffer rate to 1.0 percent in effect September 30 2019.

Illustration of the relationship between the Council's approach to assessing the buffer rate and a stylised financial cycle

Chart 1



## Limitations of risky loan types for lenders with high debt

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- Limitations for loan types if
  - debt > 4 times income
  - LTV > 60 percent.



- Avoid repetitions leading up to the financial crises.
- Benefits young family  
→ limits housing prices.

# MREL approach

## Overall status on setting MREL in Denmark

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**October  
2017**

FSA publishes principles for non-systemic banks.

**March  
2018**

MREL for systemic banks (consolidated level).

**October  
2018**

MREL for Nykredit.

**1 Januar  
2022**

All MREL fully subordinated.  
8 percent minimum threshold to be met.

**December  
2017**

MREL for non-systemic banks.

**1 July 2018**

New legislation, 8% of TLOF minimum threshold for all systemic groups.

**1 July 2019**

MREL to be met ('preferred senior' issued prior to 1 Jan. 2018 accepted).

## No liquidation regime in place for non-systemic banks

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- BRRD provides no resolution regime for non-systemic banks, but assumes insolvency proceedings.
- It is an illusion that banks can be resolved through ordinary (non-bank) insolvency proceedings – specialised procedures for banks are necessary.
- Also non-guaranteed depositors need access to payment systems Monday morning.

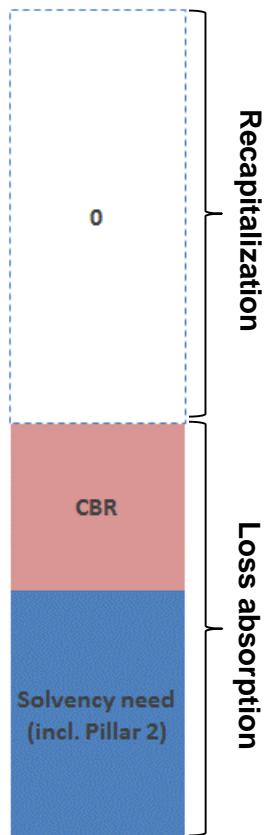
## Resolution strategy for non-systemic banks

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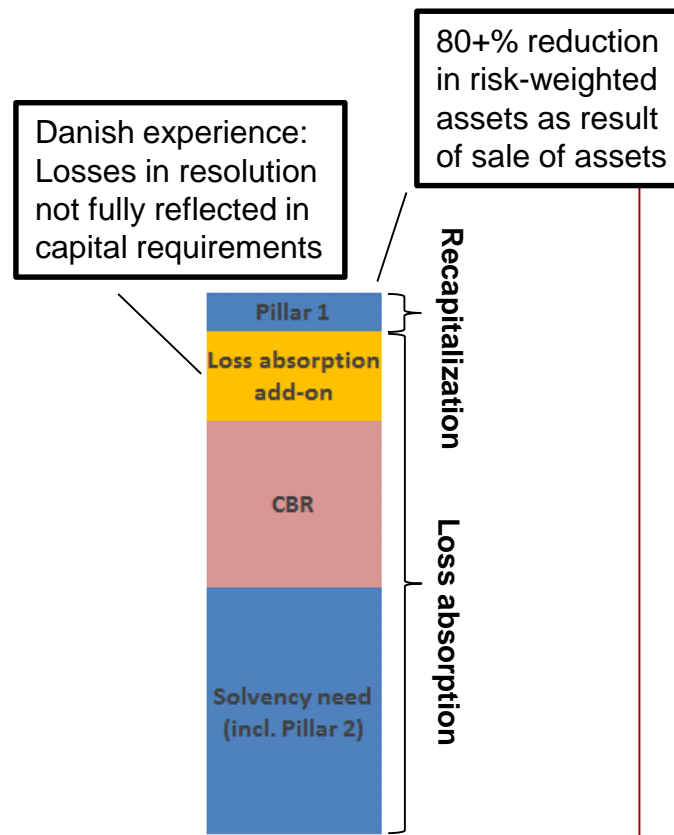
- Orderly winding-up using resolution tools instead of insolvency.
- Sale of assets, while remaining activities are wound down by Finansiell Stabilitet.
- Aim of the approach.
  - Access to payment services maintained and available on Monday morning after the resolution weekend.
  - Avoid disruptive and value destructing effects of insolvency proceeding.
  - Reduce risk that unsecured creditors (including depositors) incur losses in resolution – experience shows that losses can be large.

# Danish set-up – 3 models for strategies and MREL

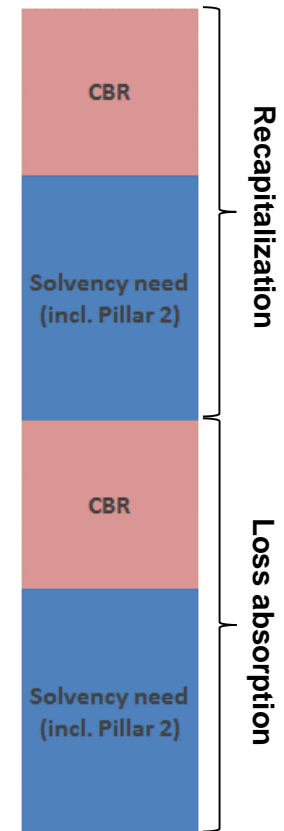
**A** Insolvency  
Investment firms



**B** Orderly wind-down  
Non-systemic banks



**C** Open bank bail-in  
Systemic banks





## Revisions in the level of debt buffer in the future

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### New legislation entered into force 1 July 2018

- Introduces a minimum threshold of 8 percent of TLOF for all systemic groups and institutions.
- Clarifies that mortgage credit institutions shall not be part of the consolidation when setting consolidated MREL.
- Allows for consolidated MREL to be met by issuance from MCI (if it is not in conflict with resolution strategy).

### Other events that could have an impact on the level of the debt buffer

- Review of the debt buffer is taking place during 2018.
- BRRD2 implementation in Denmark, e.g. internal MREL requirements are more explicit in BRRD2 and this could give input on internal buffer requirements.

# Principle of balance

## The classic principle of balance...

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- Almost one-to-one correlation between payments made on the loan and the issued bonds.
- Prevents the MCIs from essential risktaking.
  - Interest rate risk, liquidity risk, option risk, currency risk.
- The only essential risk is the credit risk.



## The principle of balance, now in two versions

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- With the introduction of SDOs in 2007, the principle of balance was changed and split into two versions.
  - The specific principle of balance (corresponding to the classic version).
  - The overall principle of balance (banking version).
- Both versions of the principle of balance have narrow limits for net imbalances.
- The overall principle of balance gives the institutions a wider framework for working with gross imbalances.

## Investigation of the principle of balance

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- Investigation of the principle of balance shows rising use of imbalances.
- Best practice on the basis of the investigation.
  - The degrees of freedom in the principle of balance should only be used in special cases.
  - Limitation of the part of the portfolio where it is necessary to use derivatives.
  - Use of tight risk management with focus on derivative counterparts and possibilities of finding new counterparts if necessary.
  - Multiple derivatives counterparts.
  - Temporal coincidence between the expiration of derivatives contracts and possible refinancing.
- The Danish FSA encourages to renewed discussion in the boards with regards to the derogation of strict matchfunding and use of derivatives.
- Going on the current regulation will be taken into account.



## The principle of balance...

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- The principle of balance continues to contribute to a strong Danish mortgage credit sector despite of the split in 2007.



- The Danish FSA will continuously monitor the sector to ensure that it stays that way!

# Anti Money Laundering

# Prevention of money laundering and financing of terrorism

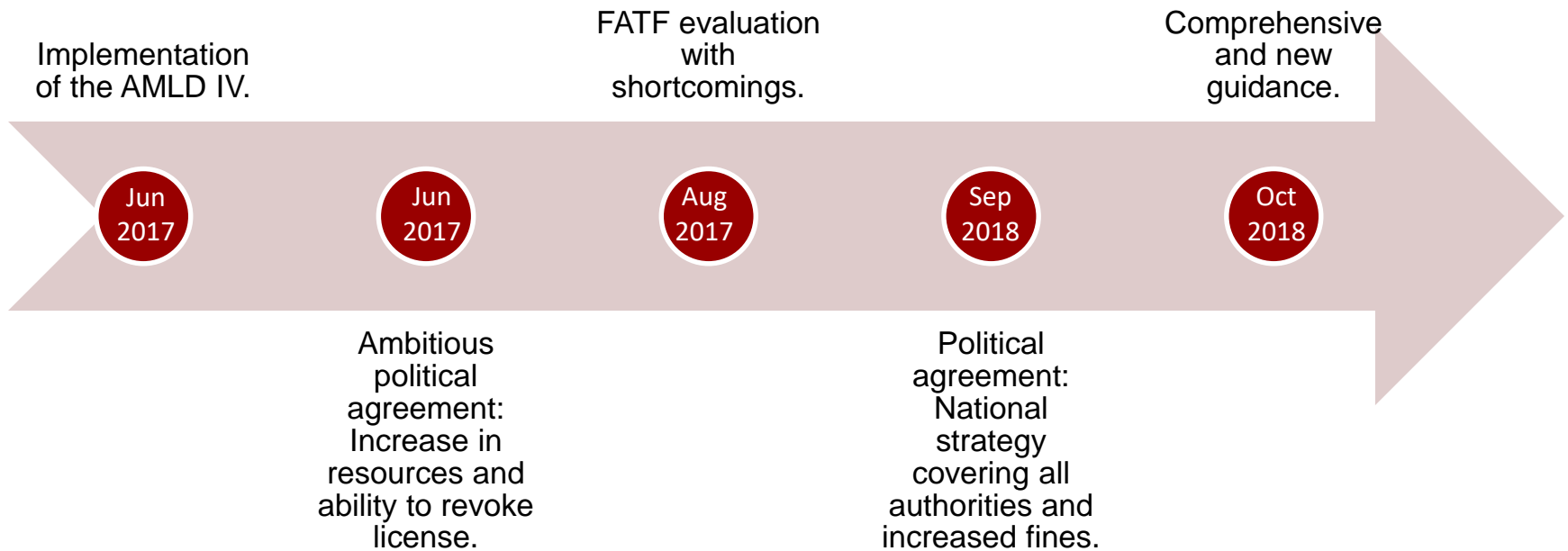
The background of the slide is a collage of 500 Euro banknotes. The notes are shown in various orientations, some overlapping, creating a textured, financial-themed backdrop. The color palette is primarily light purple and blue, with yellow stars and architectural illustrations on the notes.

1. More money laundering inspections.
2. More guidance.
3. More collaboration with other authorities.



## Several initiatives to strengthen AML

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## Danish legal quirks

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1. The Danish FSA publish orders and reprimands as well as decisions to report to the police.
2. The Danish FSA can take fit and proper decisions.
3. The Danish FSA can also take away the license to operate.
4. The Danish FSA does not have the same catalogue of enforcement actions as many other FSAs.
  - We can only issue a fixed-penalty notice.
  - Reflects basic constitutional issues on powers to impose fines.
  - More significant fines are traditionally issued by the police/courts.
  - The FSA has a responsibility to report cases to the police, if the FSA believe that a guilty verdict is likely.
  - Very difficult to get verdict for mismanagement.



## Significant strengthening of the DK FSA

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- The DK FSA now has a dedicated AML/CFT division with 15 employees (previously 3-4).
- The division was established as a separate division in June 2017 and it is responsible for
  - supervision,
  - drafting of legislation,
  - information,
  - international cooperation on AML/CFT issues.
- In 2018, the plan is to have 40-50 AML/CFT inspections (previously 2-3 yearly).
- Development of a system for risk assessment of the nearly 1,500 financial companies under supervision by the DK FSA.
- Further initiatives under consideration to strengthen the toolbox.



## Lessons learned – for supervisors

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- Be persistent and ask critical questions until there is complete (or sufficient) clarity.
- Basic model of relying on information from banks is challenged.
- Coordination and information sharing between supervisors is key. Importance of colleges.
- Combating money laundering is a joint assignment between FSA, FIU and the financial sector. Successful execution requires communication.
- Both political acceptance and understanding is limited.
- Cross-border activities increases the complexity and risk of money-laundering.



## Lessons learned – for financial institutions

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- A central IT platform makes it easier to monitor and report to management, contrary to a stand alone-system.
- Be alert not just to loss-making business areas, but also where profit is abnormally high. Ask why this is the case?
- Functional separation is of decisive importance, separating business responsibility and control/reporting risks. Otherwise risk of creating information bias and -pollution.
- Common sense and healthy scepticism towards management and dispositions is key – should be incorporated in the institutional culture.
- Important to clean up and correct mistakes immediately without letting too much time pass.
- All of the above is in the long term interest of shareholders. Experience shows that there is no real shareholder value in doing the opposite.

## The role of a supervisor

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- A Golden retriever?
  - Cute family dog without teeth.
- A Pitbull?
  - Aggressive attack dog.
- A Border collie!
  - Smart and intelligent.
  - Attentive to its surroundings.
  - Steering the herd in the right direction.
- "... we dribble and tackle with a firm regard to our legal basis."  
David Lando (Chairman of the Board) and Jesper Berg (Director General).

