Danish Financial Supervisory Authority

Credit institutions

Market developments in 2018

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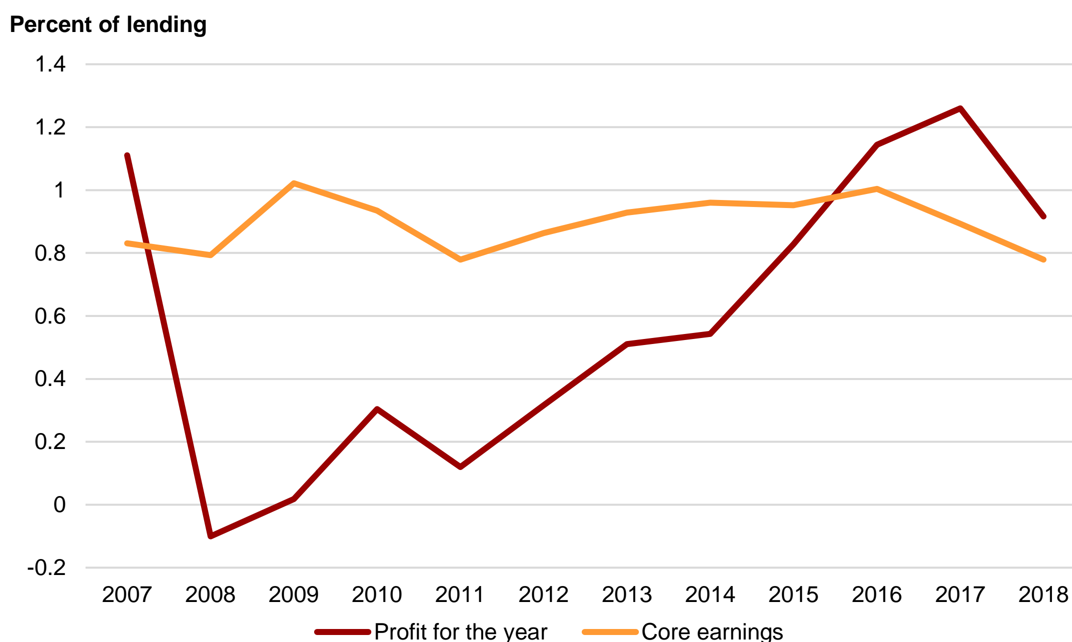
1. Summary

Credit institution profits fell in 2018. Overall profit before tax was DKK 40.3 billion, which is DKK 13.1 billion less than in 2017. However, profits continue to be at a high level in relation to lending. The drop is due to lower earnings from net interest and fee earnings, and especially from value adjustments.

Banks have found it harder to earn money from their core business. The reason for this can be found in falling net interest earnings due to very low interest rates, and the move towards more mortgage credit businesses with lower profit margins. Credit institutions have countered this effect since the financial crisis by increasing fee earnings. However, these did fall overall in 2017 and 2018, and basic earnings were therefore under pressure, cf. Figure 1.

Figure 1: Earnings in relation to lending



Note: The figure shows profit and basic earnings for credit institutions as a proportion of total lending, e.g. Repo.
Source: Reports to the FSA.

Once again, there were very few impairments in 2018. They did increase a little compared to 2017, which is primarily due to higher impairments on farming exposures[1].

The institutions increased their lending. Total lending reached DKK 4,397 billion by the end of 2018, compared to DKK 4,235 billion the preceding year. The increase is partly due to growth in mortgage credit lending of DKK 64.3 billion, but activities abroad and bank lending in Denmark also contributed to growth.

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1 As of 1 January 2018, credit institutions will perform write-downs according to the new IFRS9 accounting rules.

Own funds have steadily increased over a number of years. They did so in line with the increase in capital requirements for the institutions. But the actual core capital percentage at the end of 2018 remained largely unchanged compared to the preceding year, at 17.9%.

The credit institutions used a large part of their profit as dividends for their owners and for share buy-backs, with a total pay-out of DKK 27.6 billion, compared to DKK 24.9 billion in 2017[2]. This contributed to the lack of significant improvement in own funds.

A number of capital buffers were phased-in during 2018 as a result of regulation already adopted. The overall capital requirement for the credit institutions thus rose, and excess capital adequacy fell.

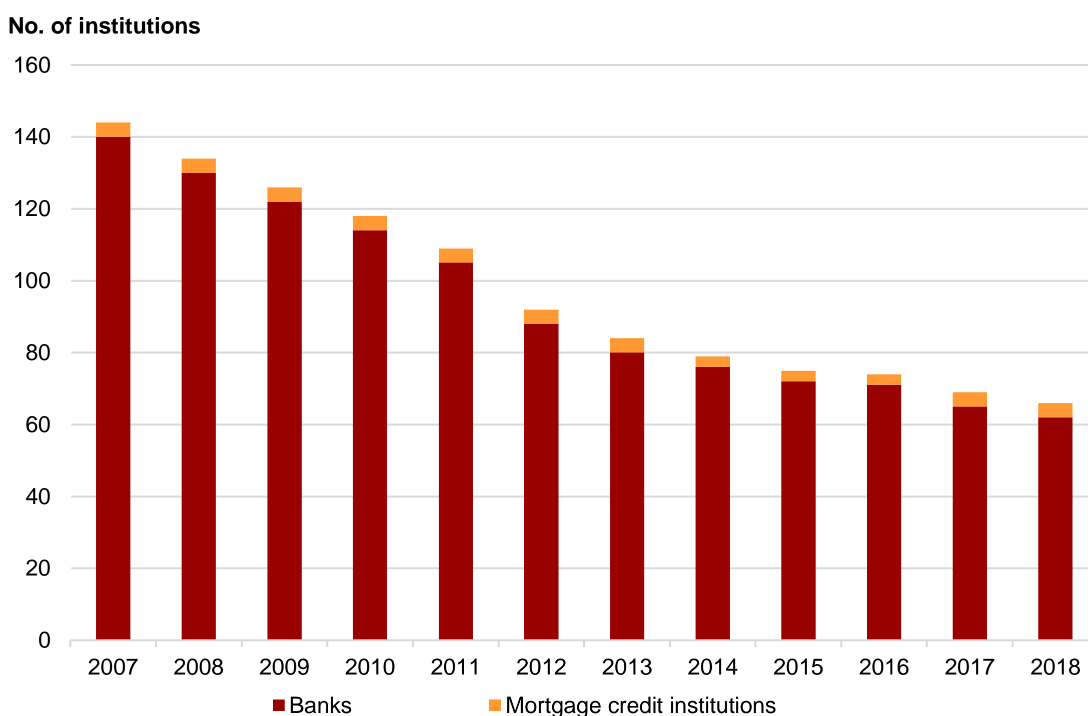
2 Total amount disbursed is the sum of dividends and buy-back of own shares, minus sale of own shares.

2. Fewer credit institutions in Denmark

By the end of 2018, there were 71 credit institutions in Denmark, of which 64 were banks and 7 were mortgage credit institutions. Adjusted for group structures, there were 66 credit institutions, of which 62 were banks and 4 were mortgage credit institutions. Adjustment for group structures is done by removing subsidiaries, as they are already included in the parent company's consolidated accounts. There were thus two banks fewer than in 2017, cf. Figure 2. One bank merged with another, and one was taken over by Finansiel Stabilitet[3].

The number of institutions has dropped significantly since the financial crisis. There were 144 in Denmark in 2007. The number has therefore halved during the last ten years.

Figure 2: The development in the number of credit institutions in Denmark



Note: The figure shows the total number of credit institutions in Denmark adjusted for group ownership. E.g., a mortgage credit institution owned by a bank will not be counted.
Source: Reports to the FSA.

3 Københavns Andelskasse was transferred to Finansiel Stabilitet on 13 September 2019. Nordjysk Bank was taken over by Ringkjøbing Landbobank.

Box 1: Credit institutions, banks and mortgage credit institutions

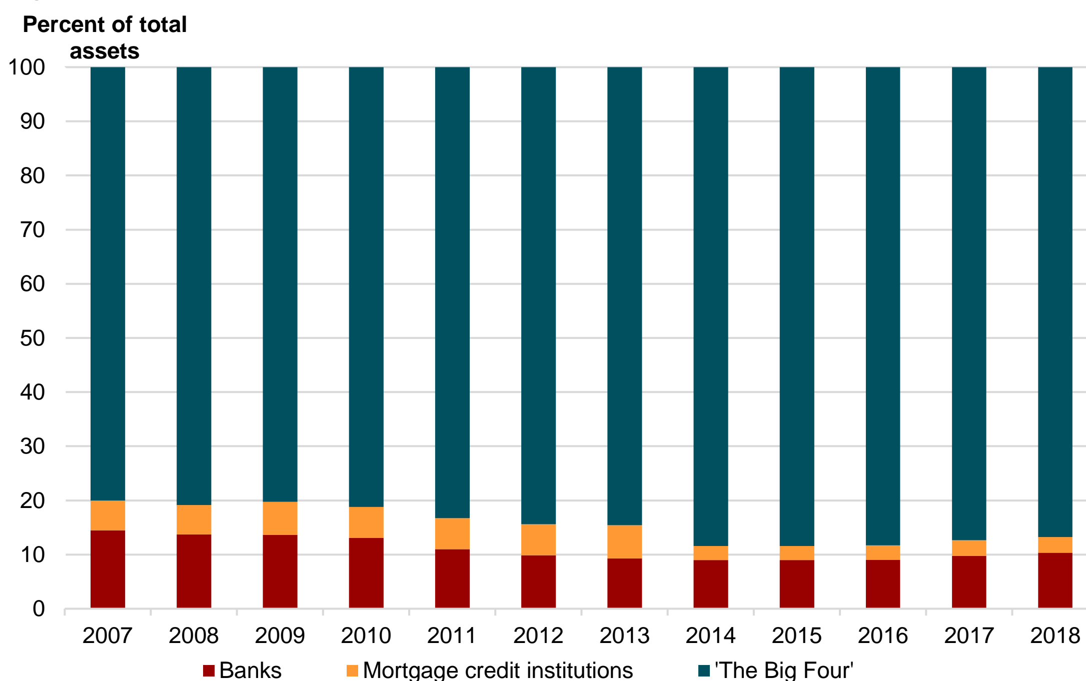
This article looks at Danish credit institutions, covering banks and mortgage credit institutions consolidated at the highest corporate level. This definition is based on the European standard, which does not differentiate between banks and mortgage credit institutions. The article only concerns Danish credit institutions. As such, it does not cover the whole of the Danish market, as branches of foreign credit institutions are also active here.

Due to the special structure of mortgage credit institutions in Denmark, we differentiate between banks and mortgage credit institutions, in contrast to the rest of Europe. Banks accept deposits and lend money. Mortgage credit institutions lend money against property and finance their lending by issuing bonds.

Credit institutions include mortgage credit institutions and banks, where possible, they are presented in the article with data at the highest consolidation level. Mortgage credit institutions that are owned by banks (or vice versa) are only included in the data once.

Credit institution assets are highly concentrated in Denmark, despite the large number of institutions. The big four (the three biggest groups: Danske Bank, Jyske Bank and Nykredit, along with Nordea Kredit) account for around 87% of total assets held by institutions, cf. Figure 3.

Figure 3: Development in the assets of credit institutions

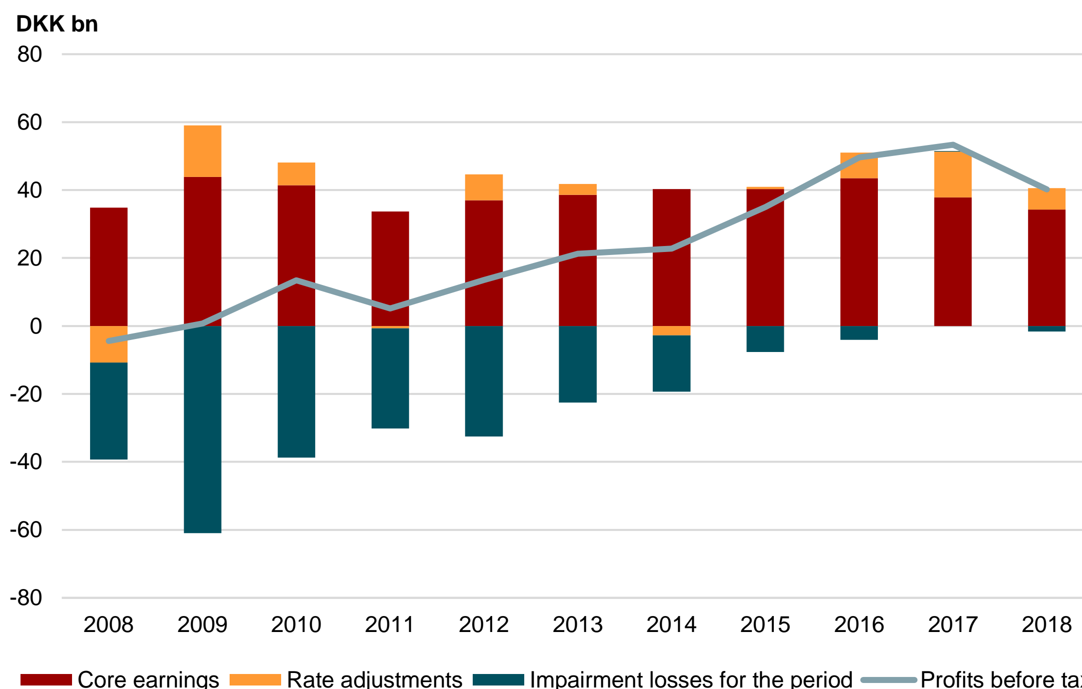


Note: 'Groups' are defined as businesses in which a bank or mortgage credit institution are part of the same group. 'The Big Four' are Danske Bank, Nykredit and Jyske Bank (all three publishing consolidated financial statements) plus Nordea Kredit.
Source: Reports to the FSA.

3. Earnings

Credit institutions experienced a drop in total pre-tax profits in 2018. The profit of DKK 40.2 billion was DKK 13.1 billion less than in 2017, cf. Figure 4. The drop is due to lower net interest earnings and, in particular, value adjustments, which more than halved, from DKK 13.5 billion to 6.3 billion. Basic earnings fell from DKK 37.8 billion to 34.3 billion.

Figure 4: Earnings of credit institutions

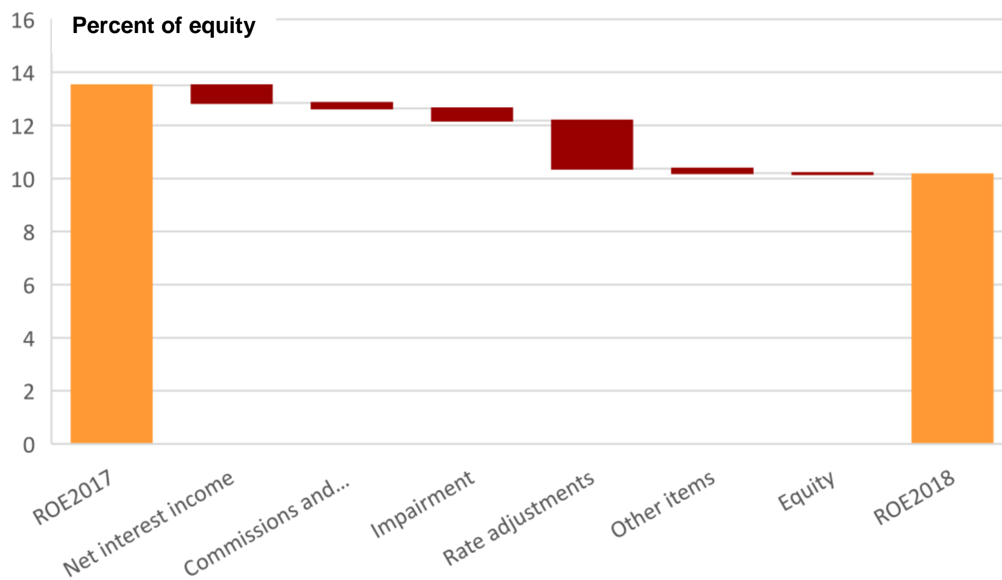


Note: Basic earnings are net income before price adjustments, write-downs and earnings in subsidiaries. Thus, basic earnings are the institutions' net interest and fee income as well as other operating income, minus staff and administrative expenses, depreciation and impairment losses on intangible and tangible assets and other operating expenses. Basic earnings are thus a measure of whether institutions are able to earn money on their core business, lending and deposits. Source: Reports to the FSA.

Net interest income, which comprises a large part of core earnings, fell from DKK 63.8 billion in 2017 to 61.2 billion in 2018. This is a historically low level. It is primarily due to the very low interest rates, making it hard for banks to earn money on the difference between deposit and lending interest rates. The switch from bank loan to mortgage credit loan also contributed to the low core earnings.

Net fee earnings fell from DKK 23.3 billion to 22.4 billion. Credit institutions used to be able to partially counteract falling revenues from net interest earnings with higher fees. But in recent years, fee revenues have also been falling, resulting in an overall drop in core earnings. Core earnings represent the first buffer against high credit loss and price fluctuations on the financial markets before the institutions have to fall back on their capital reserves. It is therefore important that they take expectations of future earnings, including projected future core earnings, into account when setting their capital targets.

Figure 5: Return on equity before tax



Note: The figure shows the factors that have influenced return on equity before tax from 2017 to 2018.
Source: Reports to the FSA and own calculations.

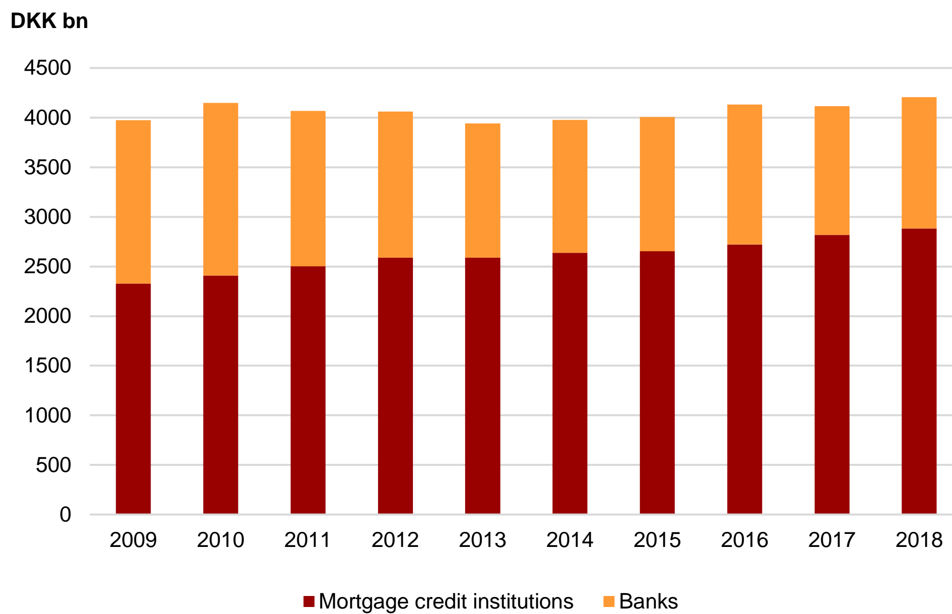
Lower earnings also mean that returns on equity before tax fell from 13.5% in 2017 to 10.2%, cf. Figure 5. As mentioned above, this is primarily due to lower value adjustments.

4. Loans

The credit institutions increased lending in 2018. This was due in particular to the continuing stability of lending growth in mortgage credit institutions, but banks also increased their lending, cf. Figure 6.

The growth in bank lending is currently more subdued. The growth in lending has been affected by considerable fluctuations over the year, primarily from changes in group activities in branches and subsidiaries.

Figure 6: Increase in lending in Danish credit institutions



Note: The figure shows total lending excl. repo between 2009 and 2018 for banks and mortgage credit institutions. The large drop in 2017 can be primarily attributed to Nordea, which branched its banking business in 2017, and is thus excluded from the figures from 2017.
Source: Reports to the FSA.

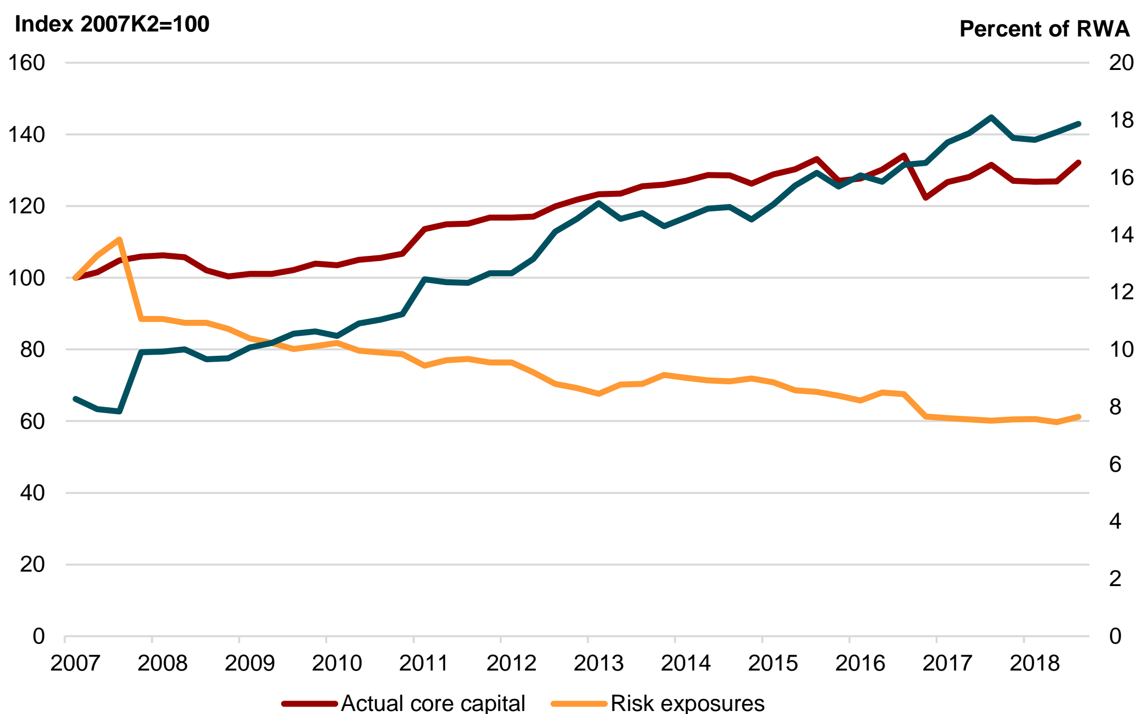
5. Own funds remain largely unchanged

The actual own fund capital ratio fell slightly. It stood at 17.9% in 2018, compared to 18.1% the preceding year, while the total ratio fell from 22.1% to 21.7%.

The capital ratios of credit institutions show how much capital they have in relation to the risks they have taken on. When the ratio rises, it can be due to two things: Own funds (the numerator) increases and/or risk exposures (the denominator) falls. Since the financial crisis, the trend has been a fall in risk exposure, while actual core capital and own funds in general have risen[4]. Capital ratios have therefore grown considerably since the financial crisis, cf. Figure 7.

However, this trend failed to continue into 2018. The actual core capital ratio remained largely unchanged compared to 2017, with a slight drop. Risk exposures and actual equity rose slightly, which resulted in the unchanged capital ratio.

Figure 7: Largely unchanged capital ratio



Note: The drop from 2016 to 2017 was due to the branching of Nordea Bank Danmark, which was thus excluded from the Danish data.
Source: Reports to the FSA.

Mandatory capital requirements have been on the rise since the financial crisis. The credit institutions have strengthened their own funds in parallel and are therefore better equipped with capital than before the financial crisis. However, going forward, capital requirements will continue to increase, cf. the phasing-in of the new Basel agreement (Basel III revision, also

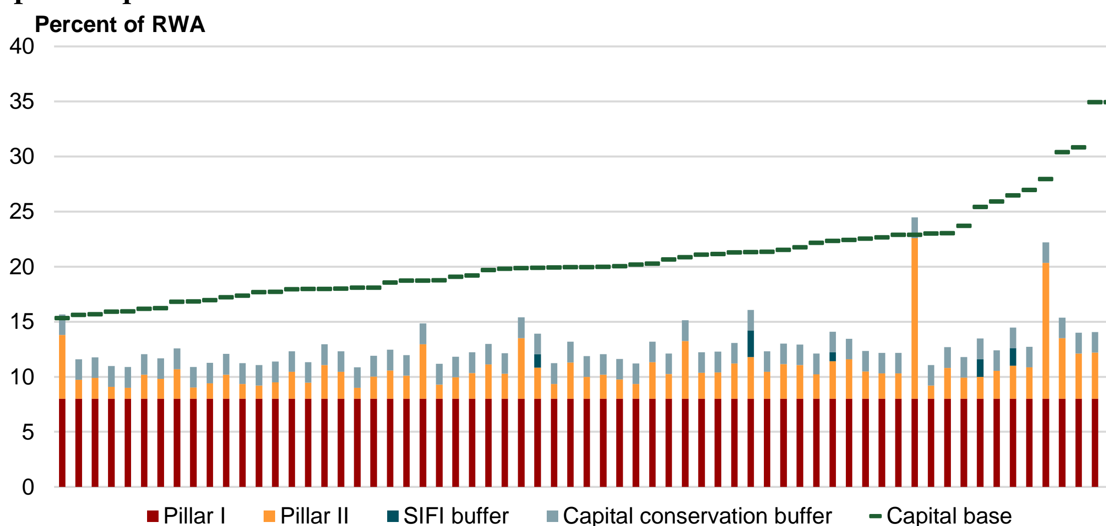
4 Falling risk exposures can be due to the institutions taking less risk, but also due to pro-cyclic risk-weighting, according to which they evaluate their activities as less risky in good times.

known as Basel IV), the Minimum Requirement for own funds and Eligible Liabilities (MREL) for banks, and debt buffer requirements for mortgage credit institutions. It is therefore important that the credit institutions are aware of the need to maintain a robust level of own funds that can absorb the new requirements and unforeseen incidents, such as an economic downturn.

The total capital requirement for an institution consists of a number of requirements. The capital base requirement is a minimum capital requirement (pillar I) of 8% for all institutions. The institution-specific capital supplement (pillar II) is for risks that are not covered or are insufficiently covered by the pillar I requirement. The pillar II requirement was on average 2.9% at the end of 2018, though with considerable variation between institutions, cf. Figure 9. The capital requirement sum from pillars 1 and 2 comprises the solvency requirement. In addition to this, there are a number of capital buffers, cf. Box 2, which comprise 3.4% on average. Altogether, these requirements are referred to as the 'mandatory capital requirement'.

Excess capital adequacy dropped. The reason was mainly due to higher buffer requirements, cf. Figure 8. Excess capital adequacy was 7.5% in 2018, compared to 9.4% in 2017. Additional buffers will be phased in during 2019 and 2020, cf. Box 2. The new countercyclical capital buffer is therefore under construction, and will rise by 1 percentage point during 2019. It can be expected to rise further in 2020, providing the Minister for Industry, Business and Financial Affairs decides to pursue the recommendations of the Systemic Risk Council[5]. Revision of the European capital requirement regulation (Box 3) can also give rise to an increased capital requirement.

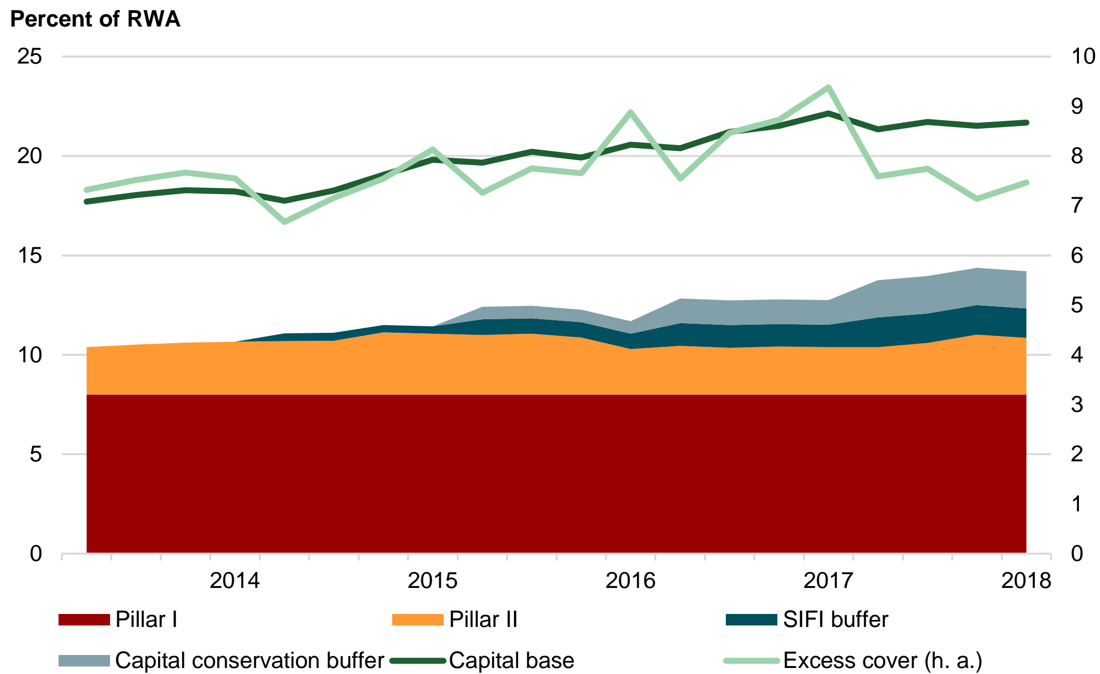
Figure 8: Range of bank capital positions and composition of the mandatory capital requirement



Note: The figure shows the capital ratios of Danish credit institutions as a percentage of risk exposures. The institutions are sorted according to their total capital percentage (solvency ratio), which is the sum of actual core capital, supplementary core capital and hybrid core capital over the total risk exposures. The capital cover is the difference between total mandatory capital requirements (the sum of pillar I requirements, pillar II requirements and the buffer requirement) and the solvency ratio.
Source: Reports to the FSA and own calculations.

5 On 26 March 2019, the Systemic Risk Council recommended to the Minister of Industry, Business and Financial Affairs an increase in the buffer level from 1.0% to 1.5% as of 30 June 2020.

Figure 9: Unchanged solvency ratio means lower capital adequacy



Note: Own funds include all subordinated capital. I.e., actual core capital, supplementary core capital and hybrid core capital. Please note that the stated capital requirement only covers the Danish requirements. Institutions with activities abroad can also be subject to buffer requirements in those countries. The actual capital requirement can therefore be higher than shown.
Source: Reports to the FSA.

The mandatory capital requirement is intended to ensure that an institution can always meet its liabilities. The institutions must be able to absorb losses that cannot be covered by earnings without breaking with the mandatory capital requirement. The FSA expects the institutions to set a robust capital target with sufficient adequacy above the mandatory capital requirement[6]. The capital target must take into account stress scenarios, so that it can absorb losses caused by unforeseen incidents.

6 See notification letter on the expectations of the FSA for capital targets. https://finanstilsynet.dk/Nyheder-ogPresse/Pressemeddelelser/2018/kapitalplaner_og_kapitalmaalsetninger071118

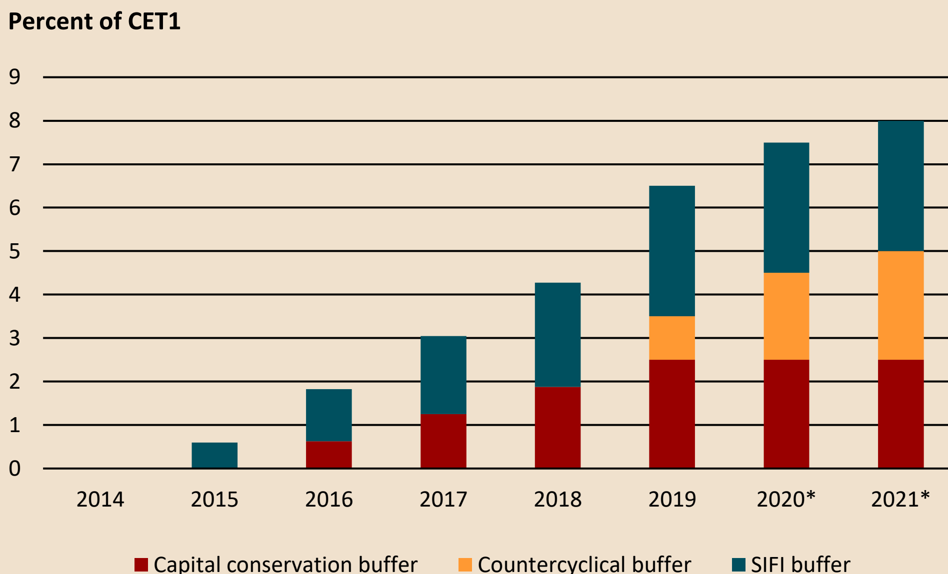
Box 2: Capital buffers

To ensure that the credit institutions can absorb loss without exceeding their solvency requirements, a series of capital buffers have been introduced. These buffers extend beyond the solvency requirements of the institutions, and must be composed of actual core capital. The consequences for an institutions of violating those buffers is less than violating the solvency requirement. Violating the buffers will therefore usually not mean the revoking of a banking licence, but will incur constraints on the payment of dividends and a requirement that the institution draw up capital restitution plans. Three such buffers are in use in Denmark:

- The capital retention buffer is the same for all institutions, and it is there to ensure they can absorb losses. It will be fully phased-in during 2019 at 2.5%.
- The countercyclical buffer is also the same for all institutions, but it can vary through the economic cycle. It is set by the Minister for Industry, Business and Financial Affairs based on recommendations from the Systemic Risk Council. The purpose of the buffer is to build up capital in good times, which can be released during macrofinancial stress that affects their ability to distribute capital.
- The SIFI buffer only applies to institutions that are of importance to the system, i.e. those which could negatively affect the national economy if they encountered problems. Buffer size depends on the importance to the system, and can be up to 3%.

The buffers will be fully phased-in during 2019, with the exception of the countercyclical buffer, which will come into effect one year after it is announced.

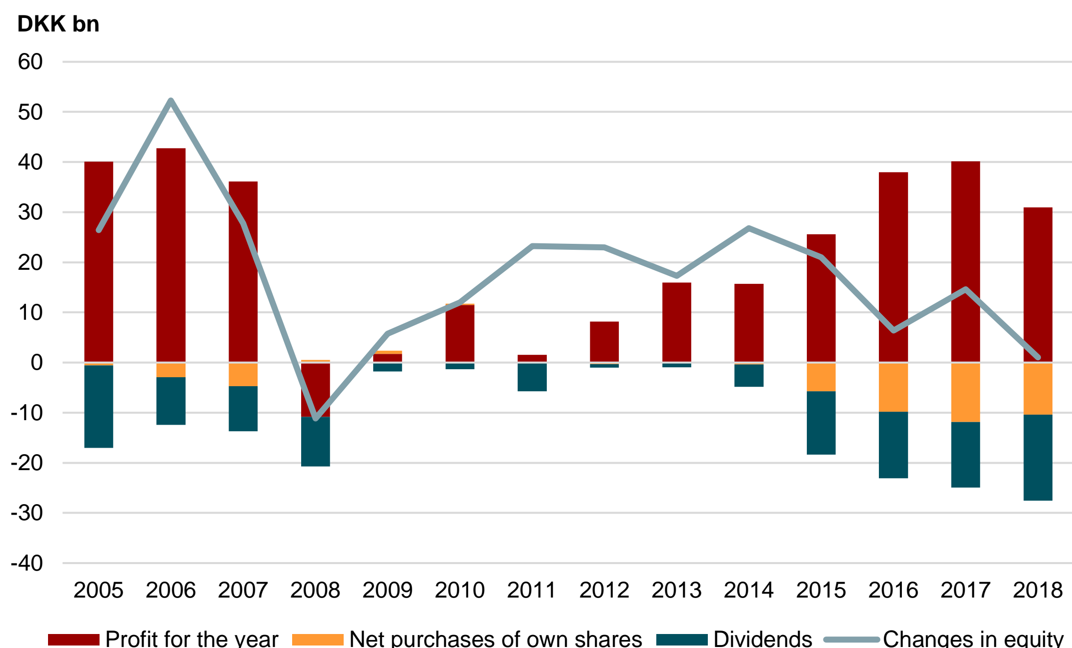
Figure 10: Phasing-in of capital buffers



Note: For the SIFI buffer, the maximum SIFI buffer is shown. The figure shows buffer levels at the end of the year in question.
* The 2020 and 2021 level for the countercyclical capital buffer is based on the expectations of the Risk Council, contingent on the economic conditions not changing significantly.
Source: The Danish Financial Supervisory Authority.

Capital structure and dividend payments
The credit institutions paid more money back to their owners, in the form of dividends and share buy-backs, in 2018 than in 2017, despite lower earnings, cf. Figure 11. The share buy-backs and dividend payments for the institutions totalled DKK 27.6 billion, compared to 24.9 billion in 2017.

Figure 11: Higher dividends despite lower profits



Note: The figure shows selected items for movements in the equity of the credit institutions.
Source: Reports to the FSA.

Up until the financial crisis, credit institutions paid large dividends and bought-back their own shares, just as they do now. Several of those institutions had to raise new capital during the crisis, at a time when share prices were at rock bottom.

Capital should generally be built up in good times, to enable the institutions to withstand financial shocks and large losses in bad times. An excellent way to build up capital is to retain profit.

Capital raised on the market
The credit institutions primarily issued capital and debt instruments with regard to either optimising their capital structure (e.g. refinancing capital instruments that can no longer be recognised in own funds to the same extent), giving themselves extra room to manoeuvre or replacing existing capital with new capital. Some also issued capital as a result of the need to comply with statutory requirements.

The capital and debt markets were well-functioning and attracted a lot of investor interest, at home and abroad, throughout 2018, although with an increase in credit spreads towards the end of the year, which subsequently tightened up again. Even smaller institutions were able to obtain capital and perform debt issuances on the Danish market, while the larger institutions also had access to the international markets.

Box 3: Revision of CRR/CRD IV

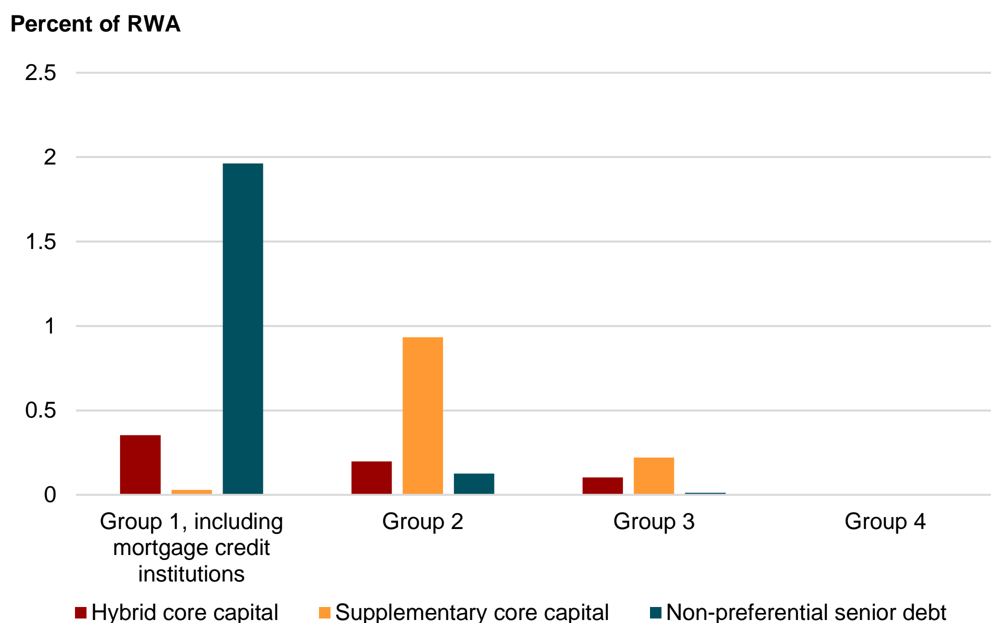
The European Council, Parliament and Commission agreed in February 2019 on revisions to the capital requirement rules (CRR/CRD IV) and the rules on winding up distressed credit institutions (BRRD/SRMR), referred to as the 'risk reduction package'. As stated below, it was not just a question of introducing measures to reduce risk in the financial system, but also measures that involve more lenient regulation.

These changes will be significant to credit institutions in several areas, the most important of which are:

- introduction of a gearing requirement to provide a solid basis under risk weighting by the institutions. The requirement was set at 3% of the non-risk weighted exposures and must consist of core capital
- a revised pillar II inflow, now divided into two: an actual pillar II capital requirement and a recommended capital level. In general terms, this has already been standard practice for the SIFI institutions in Denmark
- specification of the use of the pillar II requirement to prevent its use for macroprudential purposes. That means solely addressing the institution's individual risk which is not covered, or insufficiently covered, by the pillar I requirement
- clarification of the use of the SIFI buffer and systemic buffer, so that the latter can only be used to address general systemic risks, while the former addresses systemic risks from individual institutions. Meanwhile the parameters for buffer size have bee nchanged. The SIFI buffer can now be up to 3%, while there is a total ceiling of 5% for the two buffers together. The two buffers are also generally made to be cumulative
- clarity concerning the use of call options on non-preferential senior debt in the future EU rules. It has thereby been decided that non-preferential senior debt with a call option can be incorporated in the fulfilment of the MREL right up to the call date, usually one year before expiry, as long as a simple call structure is involved.
- introduction of a new liquidity requirement, Net Stable Funding Ratio (NFSR). This implies that the institutions must have stable sources of funding able to match their exposure within a period of one year
- revision of the winding up rules (BRRD) in connection with revision of CRR/CRD IV. The changes retain the option for exemption of mortgage credit institutions, whereby the debt buffer requirement (see Box 4) can be retained.

Primarily led by the SIFI institutions, non-preferential senior debt was issued by the institutions in addition to capital with the intention of fulfilling the MREL and debt buffer requirements[7] (see Box 4), which meant that total capital and debt issuance among the credit institutions in 2018 was somewhat higher than in previous years. Several of the medium-sized Group 2 banks also issued a certain amount of supplementary capital as part of capital optimisation. The Group 2 banks have thus issued more capital in relation to their risk exposures than Group 1, including the mortgage credit institutions, cf. Figure 12.

Figure 12: Issuances in relation to risk exposures



Source: Reports to the FSA and own calculations.

Total capital and debt issuances in the form of hybrid core capital, supplementary capital and non-preferential senior debt reached approx. DKK 48 billion in 2018. The majority covers issuances of non-preferential senior debt, primarily among the Danish SIFI institutions. These accounted for 78.4% of total issuances in 2018. Issuances of hybrid core capital and supplementary capital represented 15.4% and 6.2% respectively of the total for 2018.

7 Go to https://finanstilsynet.dk/Nyheder-og-Presse/Sektornyt/2019/NEP-private-kunder-290319 for more details on the FSA's expectations for the issuing of MREL and debt buffer instruments.

Box 4: The debt buffer and MREL requirement

To ensure that a distressed credit institution does impose losses onsimple creditors, a requirement has been introduced for so-called 'minimum requirement for eligible liabilities' (MREL). Simple creditors are depositors (and the Guarantee Fund for Depositors), bondholders and the like. The requirement stipulates that there must be liabilities on the balance sheet, which in the event of serious difficulties, can be written-down and converted to core capital (bail-in).

The requirement for SIFI institutions is set at twice the mandatory capital requirement, so that they continue to fulfil the capital requirement after a bail-in. Non-SIFI institutions with a balance sheet worth less than EUR 3 billion of risk exposures are subject to an MREL of between 3.5% and 6% above the mandatory capital requirements, calculated on their exposures. There is a supplement for non-SIFI institutions with a balance sheet value higher than EUR 3 billion of between 1.25% and 5% of RWA, depending on their size.

The MREL requirement can be fulfilled by a number of capital and debt types, e.g. non-preferential senior debt. It must be clearly defined for both types that they incur losses before simple creditors.

There is no MREL applied to mortgage credit institutions. A debt buffer of 2% of non-weighted lending has been introduced instead. When the debt requirement is calculated for groups with a mortgage credit institution, the liabilities used to fulfil the debt buffer cannot be concurrently used to fulfil the MREL.

6. Annexes

Table 1: Annual accounts for mortgage credit institutions

DKK millions	*2014*	*2015*	*2016*	*2017*	*2018*	**Change** *2017-2018*
Income statement						
Interest income	157,777	143,204	132,470	119,455	115,289	-3.5%
Interest expenses	81,011	66,922	59,891	55,648	54,093	-2.8%
Net interest income	76,767	76,281	72,578	63,807	61,196	-4.1%
Dividends from shares, etc.	3,071	1,630	1,106	723	780	7.8%
Fee and commission income	34,820	38,004	37,682	35,279	34,921	-1.0%
Fees paid and commission expenses	9,427	10,565	11,527	12,747	13,260	4.0%
Net fee and commission income	28,463	29,069	27,260	23,255	22,441	-3.5%
Net interest and fee income	105,230	105,350	99,839	87,063	83,637	-3.9%
Core earnings	40,256	40,275	43,548	37,834	34,255	-9.5%
Rate adjustments	-2,778	661	7,492	13,509	6,315	-53.3%
Expenses for staff and administration	58,276	57,834	57,282	48,824	51,001	4.5%
Amortisation and impairment of intangible and tangible assets	15,595	11,523	5,232	5,832	5,999	2.9%
Impairment losses on loans and receivables etc.	16,513	7,676	4,039	-188	1,606	*
Result from investments in associates and affiliates	1,790	1,740	2,657	1,823	1,316	-27.8%
Profits before tax	22,785	35,001	49,657	53,354	40,281	-24.5%
Tax	5,846	8,590	9,916	10,576	8,048	-23.9%
Profit for the year	16,939	26,411	39,741	42,779	32,233	-24.7%
Balance sheet items						
Receivables from credit institutions and central banks	323,632	229,440	415,414	491,516	356,666	-27.4%
Loans	4,507,423	4,520,812	4,619,423	4,486,776	4,703,622	4.8%
lending, excl. Repo	4,193,286	4,229,970	4,338,743	4,235,165	4,397,049	3.8%
Bonds	1,097,530	939,700	938,533	806,194	767,081	-4.9%
Shares	32,889	48,788	50,673	46,438	32,706	-29.6%
Investments in associates and affiliates	24,655	22,251	19,011	18,644	20,452	9.7%
Assets linked to pool schemes	110,574	121,072	128,792	114,046	115,010	0.8%
Other assets	573,466	459,470	462,305	354,227	336,645	-5.0%
Total assets	6,790,749	6,506,893	6,761,507	6,478,789	6,447,768	-0.5%
Debt to credit institutions and central banks	544,084	409,795	392,307	305,864	317,007	3.6%
Deposits	1,974,422	1,874,140	1,983,614	1,836,757	1,872,930	2.0%
deposits, excl. Repo	1,974,422	1,874,140	1,897,758	1,694,033	1,691,750	-0.1%
Issued bonds	2,993,597	3,079,120	3,212,631	3,320,239	3,270,293	-1.5%
Liabilities, total	6,327,953	6,033,685	6,279,898	6,020,867	5,991,644	-0.5%
Subordinated debt	78,042	70,675	65,094	51,718	46,029	-11.0%
Equity	371,572	390,059	404,151	394,964	396,504	0.4%
Total liabilities	6,790,749	6,506,893	6,761,507	6,478,789	6,447,768	-0.5%

Note: The table shows only selected items. The figures are based on the institutions that existed in the individual years.
Source: Reports to the FSA.

Table 2: Key figures for mortgage credit institutions

	2014	*2015*	*2016*	*2017*	*2018*
Solvency ratio	18.2	19.8	20.7	22.1	21.7
Core capital ratio	16.2	17.6	18.4	19.7	19.8
Common Equity Tier 1 capital ratio	15.0	16.2	16.4	18.1	17.9
Return on equity before tax for the year	6.1	9.0	12.3	13.5	10.2
Return on equity after tax for the year	4.6	6.8	9.8	10.8	8.1
Income/cost ratio	1.2	1.4	1.7	2.0	1.7
Accumulated impairment ratio	2.0	1.8	1.5	1.2	1.2
This year’s impairment ratio	0.3	0.2	0.1	0.0	0.0
Lending in relation to equity	12.3	11.6	11.4	11.4	11.9

Note: The table shows only selected items. The figures are based on those institutions that existed in the individual years, except Nordea's banking operations which have been excluded. As of 1 January 2017, Nordea's banking business was branched and is now part of the parent bank of Finnish Nordea. Nordea's banking activities have been excluded for all the years to better compare the accounting figures.
Source: Reports to the FSA.