The Danish Financial Supervisory Authority

22 August 2019

The Danish Financial Supervisory Authority's current overview of risks and vulnerabilities

The Danish Financial Supervisory Authority (FSA) prepares an updated overview of risks and vulnerabilities every six months. This overview is based on cyclical and macrofinancial risks and assesses how and to what extent the various companies under supervision as well as consumers and investors are exposed to these risks.

In addition to the macrofinancial position, the overview assesses factors of a more structural or behavioural nature among the various financial undertakings or consumers that may affect financial stability.

The FSA pays particular attention to the responses of financial undertakings and consumers to changes in market conditions.

Current overview of risks and vulnerabilities

Macrofinancial risks are still dominated by low interest rates and low risk premiums, which are likely to remain low for quite some time. This will squeeze the ability of financial undertakings to generate returns for their customers and investors and may induce companies to take on more risk to offset the otherwise low expected returns.

On the other hand, there is also the risk of a sudden rate increase and decline in property prices – triggered, for example, by an international recession, a European debt crisis or losses in the leveraged finance market.

Obviously, sustained low interest rates cannot create problems at the same time as a sudden rate increase. However, both scenarios currently present a risk in terms of a gradual normalisation of interest rates, risk premiums and share prices that financial undertakings should consider.

The UK could leave the EU without an agreement (a 'no-deal' Brexit). The sector should be prepared to address a number of legal and practical issues for financial undertakings if this scenario materialises.

Money laundering and IT risks are also important elements of the FSA's overview of risks and vulnerabilities, and consequently the FSA has planned targeted initiatives in these areas for the coming year.

The most significant risks in the FSA's overview of risks and vulnerabilities are:

- Sustained low interest rates and risk premiums
- A sudden rate increase and decline in share prices

- Property price drops
- IT risks
- Disorderly Brexit
- Money laundering.

Table 1 describes the most significant risks in the FSA's overview of risks and vulnerabilities. Please note that the table does not provide an exhaustive list of all risks to financial stability or the companies under supervision. The FSA is constantly aware of new risks and developments in existing risks. The overall risk assessment gives rise to a number of prioritised supervisory initiatives, which are briefly reviewed on the following pages.

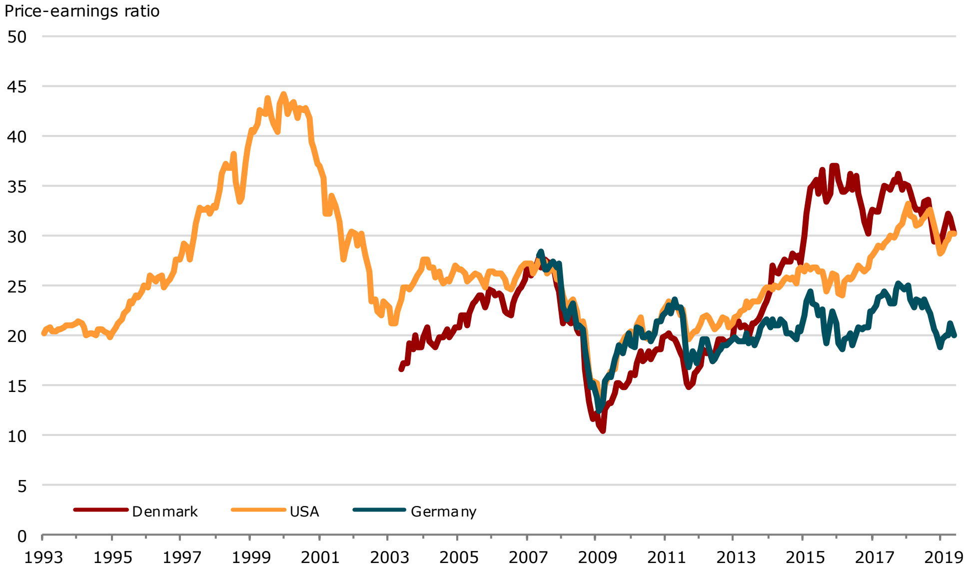
Table 1: Most significant risks

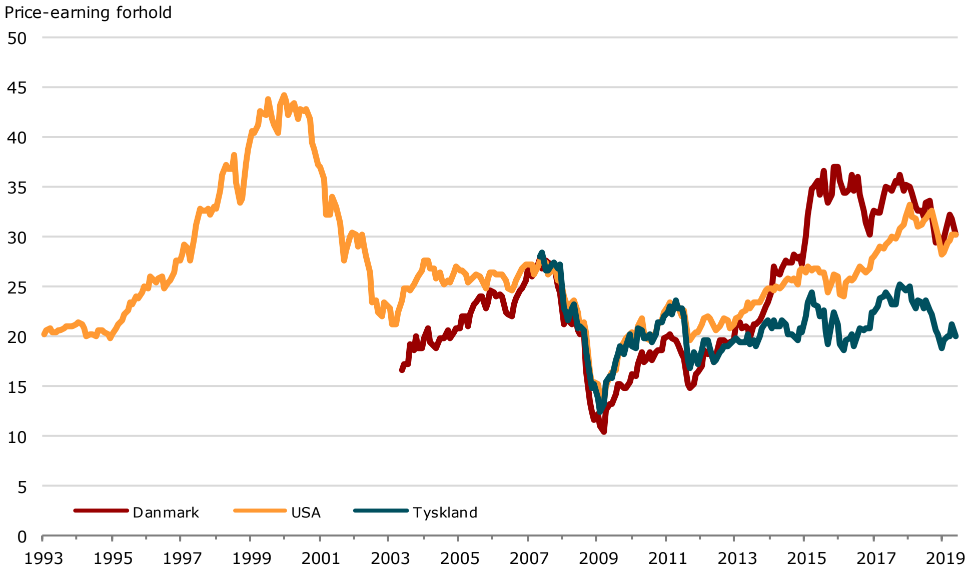
Low interest rates and risk premiums: The current low interest rates and risk premiums could be sustained (low for long). This will make it difficult for pension companies to honour the guarantees issued. Pension customers switch to market rate products and assume a risk that they may not understand. Generally, customers are increasingly faced with the risk of inadvertently buying products with negative expected returns or being advised to take greater risks to obtain positive returns. Banks' business models are challenged by an environment in which deposits earn higher returns than risk-free market rates, returns on maturity transformation are limited and fee income, especially from wealth management, is under pressure. Financial undertakings accept additional risks in search of returns.
A sudden rate increase and decline in share prices: Risk premiums are very low. An increase in risk premiums will affect consumers with variable-rate loans and non-guaranteed pension products, and access to funding will lead to higher bank losses. A risk premium increase could, for example, be triggered by a European debt crisis or losses in the leveraged finance market, where loan standards have been eased considerably over the past few years.
Property price drops: Property prices are high in certain segments. A decline in property prices will affect real estate consumers and lead to increased losses in banks, real estate funds and on pension companies' property portfolios. A decline in property prices could be triggered by a sudden rate increase.
Money laundering: Criminals from both Denmark and abroad could use Danish financial undertakings to launder money and to finance terrorism. That way, financial undertakings may become involved in criminal activities. Money laundering cases damage confidence in Danish companies and authorities.
IT risks: IT security breaches and major IT crashes could have significant social consequences and affect confidence in the financial system. Several companies have elevated IT risk exposure.
Disorderly Brexit: The UK could leave the EU without an agreement (a 'no-deal' Brexit).

A sudden rate increase and decline in share prices
Interest rates and risk premiums have been low for a long time, and although global equity markets have been declining over the summer, share prices are relatively high, cf. Figure 1.

An impending downturn in the global economy or geopolitical events could trigger higher risk premiums and interest rates, coinciding with a decline in share prices. Examples of such events include a global trade war, Brexit, a European debt crisis or other international events affecting market participants' risk perception. Theoretically, these events should, to some extent, already be factored into risk premiums, but the impacts could turn out to be greater than anticipated by the markets.

Figure 1: Pricing of share prices – CAPE index





Note: The figure shows the CAPE index (Cyclical Adjusted Price Earnings). CAPE is calculated as the ratio of share prices to last 10 years of earnings. OMX C20 has been used for Denmark, DAX 30 for Germany and S&P 500 for the US.
Source: Danmarks Nationalbank.

In a scenario of rising interest rates and slowing economic growth, financially vulnerable borrowers with variable-rate loans will be at particular risk of being unable to repay their debt. Rate increases could also lead to falling house prices. This will affect homeowners, especially those who do not service their debt.

The vast majority of bank loans and deposits are at variable rates or with short fixed-interest periods, entailing that banks have limited exposure to interest rate risk. At the same time, their equity exposure is generally modest, and even significant share price falls will not directly affect their solvency. However, their customers will generally be adversely affected by higher interest rates, which will lead to losses.

Pension companies and their customers will be directly affected by capital losses on shares, spread products and illiquid investments, which could be reflected in lower pension benefits. However, based on current statements, pension companies are generally regarded as well-capitalised and able to withstand even large price drops on both the equity portfolio and the bond portfolio.

Compared with market rate products, very large price drops have not been seen after these products really gained momentum. Consequently, pension company customers may only discover the consequences of their pension choices when prices begin to fall.

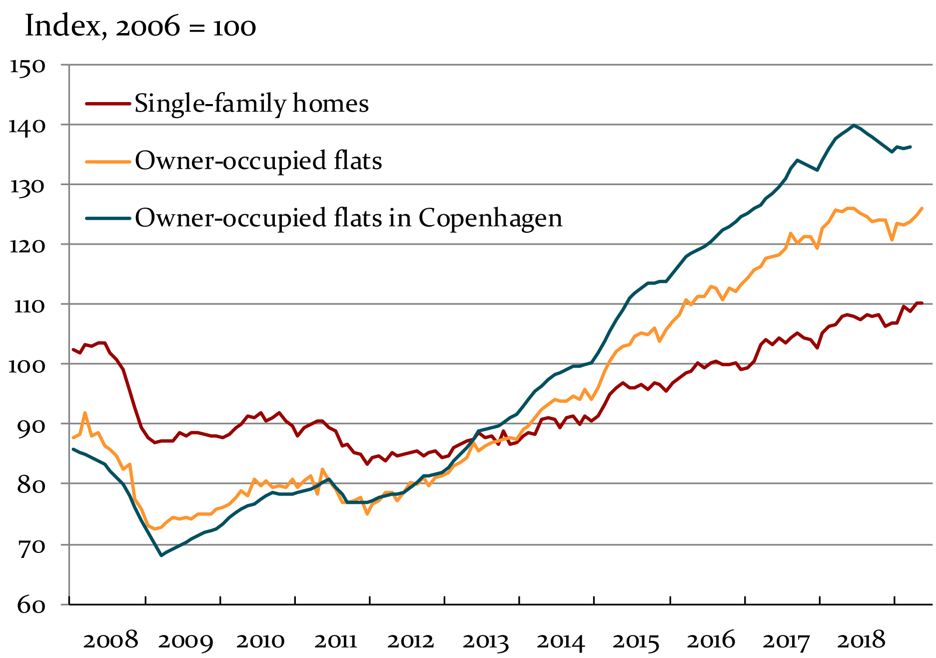
Initiatives
The FSA has initiated a study of pension companies' marketing, customer communications, contract terms and pension commitments for market rate products. The FSA is also conducting a thematic study to gain a better overview of the market for market rate products, the aim being to assess whether increased supervisory attention or new regulation is needed.

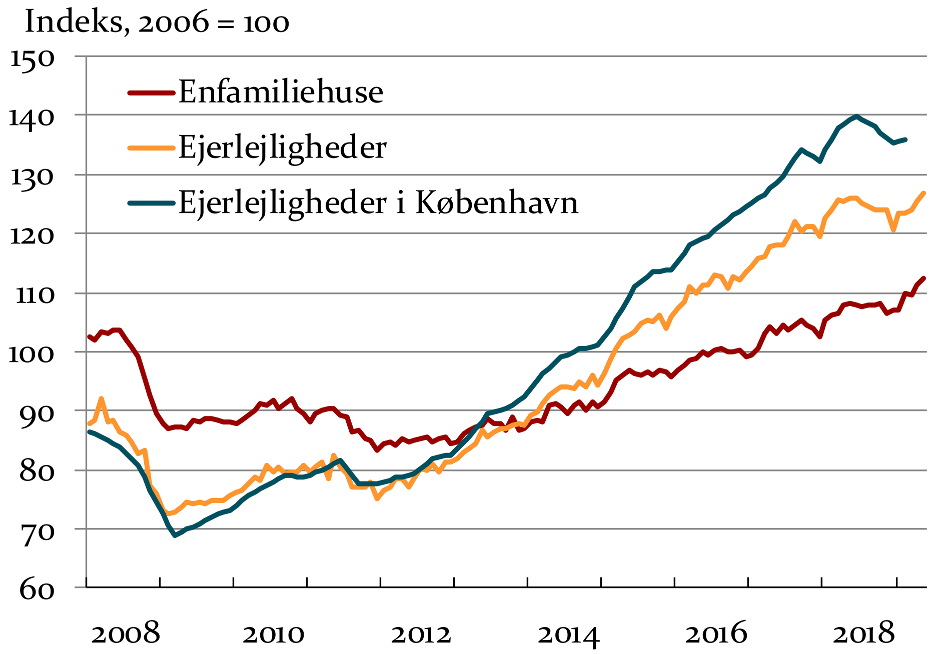
The FSA has asked the major banks (IRB institutions) to perform a specific interest rate stress test to establish whether they can be expected to have sufficient capital in a surging interest rate environment.

In 2019, the FSA completed a study of banks' credit assessment and lending to financially vulnerable customers. The study found that several consumer loan banks had inadequate credit assessments, failed to assess customers' disposable amounts and did not ask for documentation. In the course of 2020, the FSA will follow up on this study.

Property price drops
Property prices have been surging in several segments over recent years. Copenhagen has seen particular increases in prices of owner-occupied flats, see Figure 2, but recently prices in Copenhagen have been showing a declining trend and, at the same time, time on market has increased. This could be a sign of impending stagnation and a possible reversal in the Copenhagen housing market.

Figure 2: Residential property price developments





Source: Statistics Denmark.

In the FSA's assessment, the low interest rate level has contributed to the price increases seen in recent years. Financing costs are low, and any alternative investment opportunities offer low returns. Rate increases could have significantly adverse impacts on property price developments, and the abolition of the existing tax freeze from 2021 could also contribute to a drop in house prices.

In the short term, house prices are underpinned by Danish mortgage rates, which are expected to remain low over the coming year. The probability of large price falls in the market for project properties is deemed to be somewhat higher. Due to the nature of the market for project properties, prices are more sensitive to changes in demand and risk premiums than in other segments of the housing market.

The FSA estimates that a property price drop will have significant implications for consumers, given that a property price drop will affect most homeowners. First-time buyers, who typically finance most of their home purchase by loans, are particularly at risk of becoming technically insolvent following even minor house price falls if they have not begun to repay their housing debt. Homeowners who have to sell their home may suffer significant losses.

Initiatives

The FSA is conducting a study of new types of home loans such as 30-year mortgage credit loans with deferred amortisation.

When conducting its planned inspections, the FSA will continue to focus on banks' new loans for property financing, including, in particular, the financing of commercial properties and project properties. The FSA will have particular focus on the basis on which loans are granted, risk assessment and management. The FSA is also considering establishing best practice guidelines for project finance lending.

The FSA is also planning a study of lending to properties with no real alternative uses, since the property value of such properties is more uncertain if the borrower experiences payment difficulties.

The FSA will map property managers with AIFM registration or authorisation. Moreover, the FSA will examine property funds offered by players that hold neither registration nor authorisation.

Disorderly Brexit

The risk of a no-deal Brexit remains substantial. Brexit could particularly affect the EU financial system, as the UK (London) is a key player in the EU financial system. However, several issues have recently been resolved by the authorities and the financial sector, and, overall, the FSA assesses that – other things being equal – the consequences of a disorderly Brexit have decreased due to greater predictability in key capital market issues.

Initiatives
The FSA is in ongoing dialogue with both Danish and foreign players on how to deal with the challenges arising from Brexit. The FSA also regularly processes Brexit-related inquiries and investment applications.

In case of a no-deal Brexit, the FSA will continuously monitor the conditional and temporary authorisations granted to UK credit institutions and investment firms to provide investment services to approved counterparties and professional investors.

The FSA is in the process of clarifying which Danish companies want to continue their activities in the UK post-Brexit. It must be clarified which companies have joined the "*Temporary Permission Regime*"[1] and the legality of Danish companies' activities in the UK post-Brexit.

Low interest rates and low risk premiums
Risk premiums are currently low, and equity pricing is high. Low interest rates are squeezing the sector's earnings and resulting in riskier activities such as riskier loans and investments.

The current low interest rates and risk premiums could be sustained. Due to relatively slow economic growth and low inflation in the euro area, the European Central Bank (ECB) is expected to maintain low monetary policy rates for an extended period of time. Low interest rates and high asset prices could also be the result of a higher global propensity to save, which could also be sustained.

Low interest rates could increase banks' incentive to seek to attract customers to investment products. Consumers investing their assets in an investment product rather than placing the assets in a deposit account are exposed to a risk that they may not be aware of – and for which they are not adequately compensated compared with earning zero per cent interest on a deposit account.

Due to low interest rates, alternative investment funds, investing in real estate, infrastructure or the like, may also gain momentum. In these areas, it may be particularly difficult for retail investors to assess whether the risk/return ratio is reasonable.

Low interest rates give the pension sector an incentive to make higher-risk investments to achieve higher expected returns. A continued decline in interest rates may increase pressure on the sector's solvency although guaranteed liabilities are mostly hedged, while the funds of market-rate customers are increasingly invested in new alternative asset classes. These alternative investments are more illiquid and riskier than conventional bonds and can present valuation challenges.

Obviously, sustained low interest rates and low risk premiums cannot create problems at the same time as a sudden rate increase and a decline in share prices.

1 Temporary regime enabling firms to operate in the UK for a limited period while seeking permanent authorisation when the UK leaves the EU.

However, both scenarios currently present a risk in terms of a gradual normalisation of interest rates, risk premiums and share prices that financial undertakings should consider.

Initiatives

A core task of the FSA is to continuously supervise that companies do not take on too much risk, and this is a constant focus area in inspections and investigations.

The FSA has emphasised that banks are obliged only to advise customers on products that are in the customer's best interests. The risk of poor advice is particularly high when it comes to customers with a low risk preference, a short savings horizon or both. As a general rule, moving further along the risk curve is no solution for these customers. Generally speaking, recommendations to customers should include only financial products that are within their preferences and financial means.

The FSA has also requested the largest banks to account for their advice and sales of low risk, short horizon investment products.

The FSA has particular focus on certain alternative investment funds targeting retail investors, for instance in terms of their marketing material.

The FSA is conducting a number of thematic studies of the pension sector's alternative investments, including an infrastructure investment study, which was completed in January.

IT risks

In IT, the primary risk is associated with IT security. Operations that are not adequately secure and stable may affect financial stability and confidence in the sector.

Both authorities and financial undertakings are paying increasing attention to cyber risks. In the FSA's 2019 questionnaire survey aimed at the financial sector, companies highlight cyber-attacks as a significant threat to financial stability.

According to the Centre for Cyber Security, the threat from cyber criminals is becoming more sophisticated and complex, and the overall threat is increasing. Cyber-attacks could potentially disrupt the availability of the Danish financial sector's services and, at worst, threaten financial stability.

Moreover, continued digitisation of the financial sector means that basic IT security management is also becoming increasingly important.

With the growing threats and continued digitisation, demands on financial undertakings to sharpen their attention on IT security are increasing. In its supervision, the FSA has identified a number of weaknesses in corporate IT security management. For instance, in several respects, management focus has not kept abreast of development in threats. This applies both in relation to companies' overview of the IT risks facing them and in relation to general IT controls in the form of access management, backups and emergency planning, which must serve as a defence against both internal errors and cyber-attacks.

Initiatives
The FSA has strengthened its IT supervision through initiatives such as:

- increased focus on IT security in the FSA's dialogue with corporate top management
- increased supervision initiatives to ensure that companies adequately address IT risks.

The financial sector has already made headway in terms of cyber and information security. Danmarks Nationalbank has set up the Financial Sector Forum for Operational Resilience (FSOR), consisting of major financial sector participants, including financial undertakings, shared data centres, industry associations and a number of authorities (such as Centre for Cyber Security, the Ministry of Industry, Business and Financial Affairs and the FSA). The aim is to increase operational resilience, including cyber resilience, in the financial sector.

The sector has also established Nordic sectoral collaboration with the participation of banks, insurance companies and pension companies, among others. This collaboration contributes to the operational task of protecting Nordic financial institutions from cyber-attacks through operational capacity to defend against and combat cyber threats.

As far as cyber risk is concerned, the Minister for Industry, Business and Financial Affairs has designated the FSA as the financial sector's decentralised cyber and information security unit. This means that the FSA is responsible for the cross-sector initiatives to support cyber and information security in the financial sector.

The FSA will support the strengthening of joint activities for cyber and information security through initiatives along three main lines of action:

- Threat, vulnerability and risk assessment
- Sector emergency preparedness
- Knowledge sharing.

Money laundering
Money laundering and terrorist financing are major risks to society as a whole. This also applies to financial undertakings that may inadvertently contribute to money laundering and terrorist financing if their measures are inadequate. Financial undertakings are at risk of substantial fines, and of customers and business partners losing confidence and no longer wanting to continue the customer relationship/partnership. Recent cases of money laundering, including that involving Danske Bank's Estonian branch, highlight the importance of effective monitoring and control systems and international cooperation.

Initiatives

On 27 March 2019, in a bid to step up anti-money laundering and counter-terrorist financing efforts, the financial conciliation agreement parties, comprising a broad majority of the Danish Parliament (Folketing), signed the latest agreement to increase the efforts against financial crime.

This agreement is designed to ensure that the FSA further strengthens its AML/CTF supervision and obtains stronger control authority. This is to be effected through measures such as increased resources to the area, along with more control and intervention tools. Longer limitation periods, higher maximum penalties, requirements for companies to provide essential information on their own initiative, and further protection of whistleblowers will also help to facilitate increased enforcement of the rules.

There are also increased requirements on the individual companies to check and follow up on indications that they are not complying with the requirements of anti-money laundering legislation. Key function holders and the day-to-day management are now subject to a reporting obligation under which warnings ('red-flag indicators) about money laundering risks or terrorist financing must be reported to the company's supreme governing body. Moreover, management must be able to document how it has followed up on such warnings.

Background

This memo is based on the FSA's participation in national and international meeting forums, including DSRR (The Systemic Risk Council), the ESRB (The European Systemic Risk Board), colleges of supervisors and the ESAs (European Supervisory Authorities) etc. The overview of risks and vulnerabilities is also based on observations and information from inspection activities, investigations and the FSA's own analyses. The overview contributes to the ongoing prioritisation of the FSA's activities.

Experience from previous crises, most recently the financial crisis, indicates that the greatest problems are caused, in particular, by unidentified or underestimated risks and the interaction of various risk factors. Unidentified and underestimated risks will always exist, and the interaction of risk factors is notoriously complicated. Nevertheless, identification of risks and considering how to address these provides a good basis for risk assessment and management. This reduces the scope of unidentified risks and is a good point of departure for analysing the interaction of risk factors.

Please note that the FSA's overview of risks and vulnerabilities is published twice a year and that the work of the FSA and its prioritised initiatives for identified risks cover both current and new activities. Where considered relevant, the conclusion on completed initiatives is mentioned in the overview of risks and vulnerabilities.