FINANSTILSYNET

Credit institutions

Market developments in 2019

FINANSTILSYNET

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1. Summary

Danish credit institutions are well-capitalised and have had moderate lending growth since 2016. This provides a good starting point for extending credit to households and companies, which need temporary liquidity because of the COVID-19 crisis.

The macroeconomic outlook has deteriorated significantly with the drastic anti-infection measures introduced in Denmark as well as the rest of the world. Indicators such as car sales and payment transactions show that the economy is currently in sharp decline, and the published scenarios for the Danish economy from Danmarks Nationalbank, the Ministry of Finance and the Danish Economic Councils include a fall in GDP of 3% or more in 2020. The deteriorating finances for households and businesses will inevitably lead to increased impairments for credit institutions.

The DFSA's stress tests for credit institutions contains a scenario, which implies a very adverse development in GDP as well as unemployment. The severity of this scenario reflects even the most pessimistic scenarios published for the Danish economy. Therefore, at the time of writing, the macroeconomic headwinds are not expected to be any worse than what the institutions are exposed to in stress tests, and the financial stability of the credit institution sector is not threatened. However, based on experience, reservations must be made for the uncertainty inherent in stress testing.

This article is based on financial statements of credit institutions for 2019. The effects of the COVID-19 crisis are therefore apparent in the data. The following sections describe the starting point from which Danish credit institutions entered the crisis.

In 2019, Danish credit institutions made a pre-tax profit of DKK 38 billion compared to DKK 40 billion the previous year. The decrease is mainly due to falling net interest income resulting from the low interest rate level. Fee income related to historically large remortgaging activity has partially offset declining interest income.

An increase in impairments, from DKK 1.6 billion to DKK 3.4 billion, also contributed to declining profits. However, impairments remained at a very low level.

The solvency ratio of credit institutions increased slightly and stood at 22.2 per cent of total risk exposures by the end of 2019. By comparison, it was 12.5 per cent by the end of 2008.

Several financial players have begun to offer various products described as sustainable financing, e.g. in the form of green bonds. However, there are still no common standards or labelling schemes for sustainable financial products. Therefore, it is important that credit institutions act fairly and transparently towards their customers when selling these types of products.

Box 1: COVID-19 response in financial companies

In the period just after Denmark was locked down (12 March), financial companies set out their crisis response to ensure that critical functions would continue to operate. The crisis response entails meeting and travel restrictions as well as home workplaces or physically splitting up staff to work at various locations to avoid infection between key persons. The Danish Financial Supervisory Authority (FSA) has continuously monitored these developments and is in close dialogue with the financial companies.

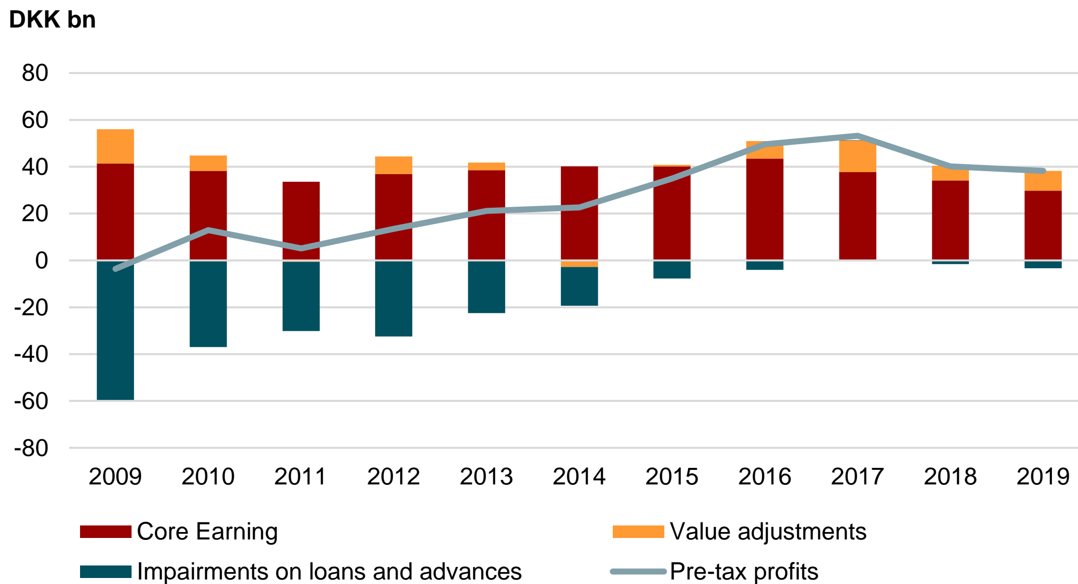
In the FSA's view, companies' response plans are working well and have the necessary focus on maintaining critical functions. Furthermore, the vast majority of financial companies will be able to continue operating core functions for a lengthy period under the current COVID-19 restrictions or if they are tightened.

Overall, the financial sector has a strong, solvency-resilient starting point for an economic downturn as a result of COVID-19. In general, at the time of writing, the sector has not suffered very large losses as a result of COVID-19. However, in Q1 2020, Danish credit institutions provided funds to cover future losses in the form of loan write-downs. But the view is that the longer society is locked down, the greater the adverse consequences it will have for individual financial companies and their customers.

2. Earnings

Danish credit institutions achieved a pre-tax profit of DKK 38 billion in 2019, see Figure 1. Core earnings, which represent the institutions' core business, continued to decline. However, this was offset by significantly higher value adjustments of DKK 8.3 billion, as opposed to DKK 6.2 billion in 2018. However, as impairments increased simultaneously in 2019, albeit from a very low level, the overall result was slightly lower in 2019 than in 2018.

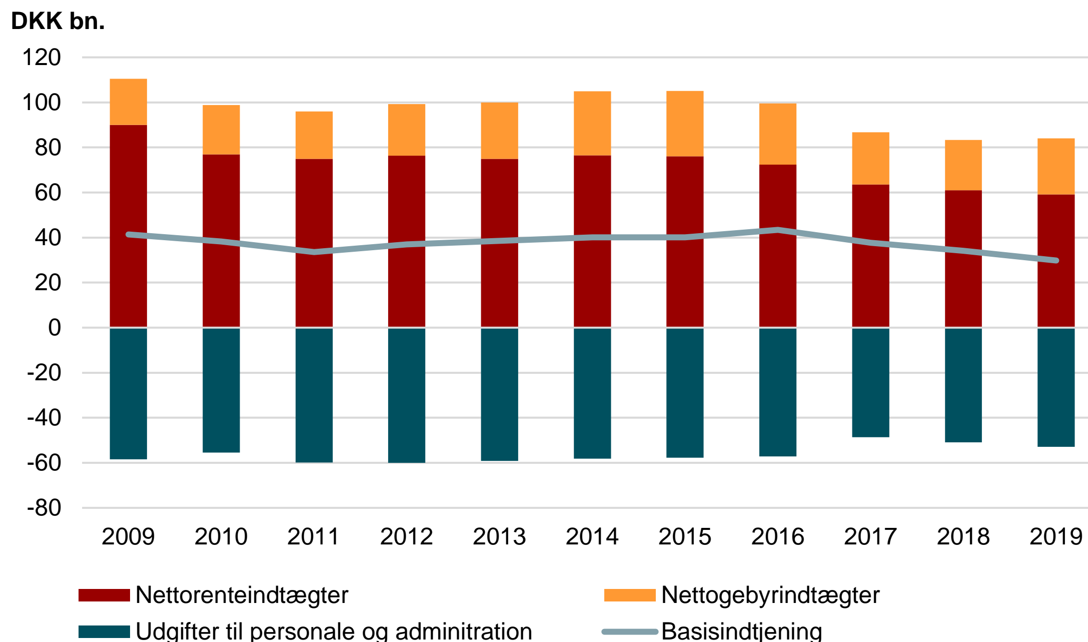
Figure 1: Largely unchanged profit



Source: Reportting to the DFSA
Note: Core earings consist of net- interest and fee income, udgifter til personell and administration expensen, and other operational income and expenses. It is an expression of he credit instition's core business. Note that the transition to IFRS9 in 2019 may have caused higher impairments

Declining core earnings are driven by declining net interest income in banks, which are under pressure from reduced interest rate margins (the difference between interest rates on deposits and loans). This is mainly due to the negative interest rates, including the fact that banks have not introduced negative interest rates fully for the deposit accounts of ordinary households. However, most credit institutions have begun to charge households negative interest rates for amounts above a certain limit. Several credit institutions have even lowered that limit in the second half of 2019 as the trend for negative interest rates for large household deposits has gained momentum in the sector.

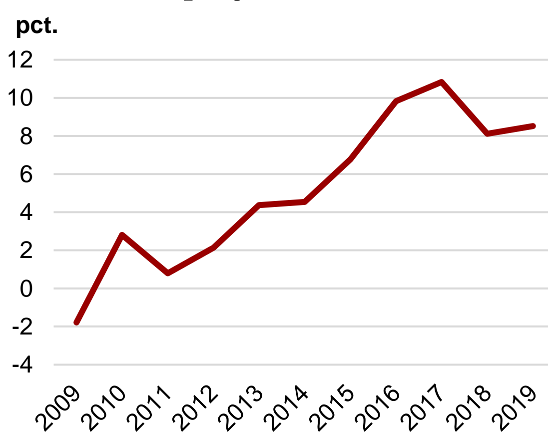
Figure 2: Continued decline in core earnings



Source: Reporting to the DFSA

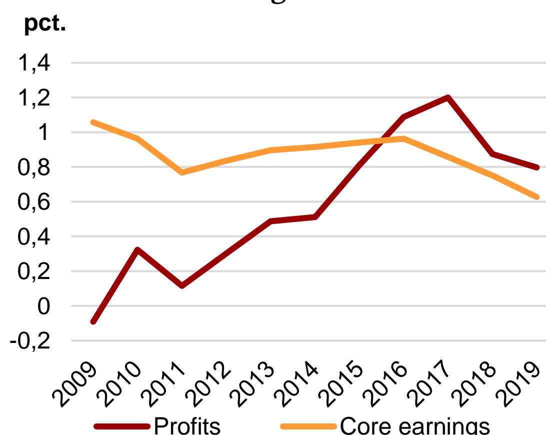
Net fee income was just under DKK 1 billion higher in 2019 than in 2018. All things being equal, it would have fallen without the historically large remortgaging in the summer, which overall contributed to the banks generating income from loan application fees of around DKK 1 billion more than in 2018. This increase in fee income, however, could only partially offset the falling net interest income.

Figur 3 (a): Small increase in return on equity



Source: Reporting to the DFSA

Figur 3 (b): Declining profits in relation to lending



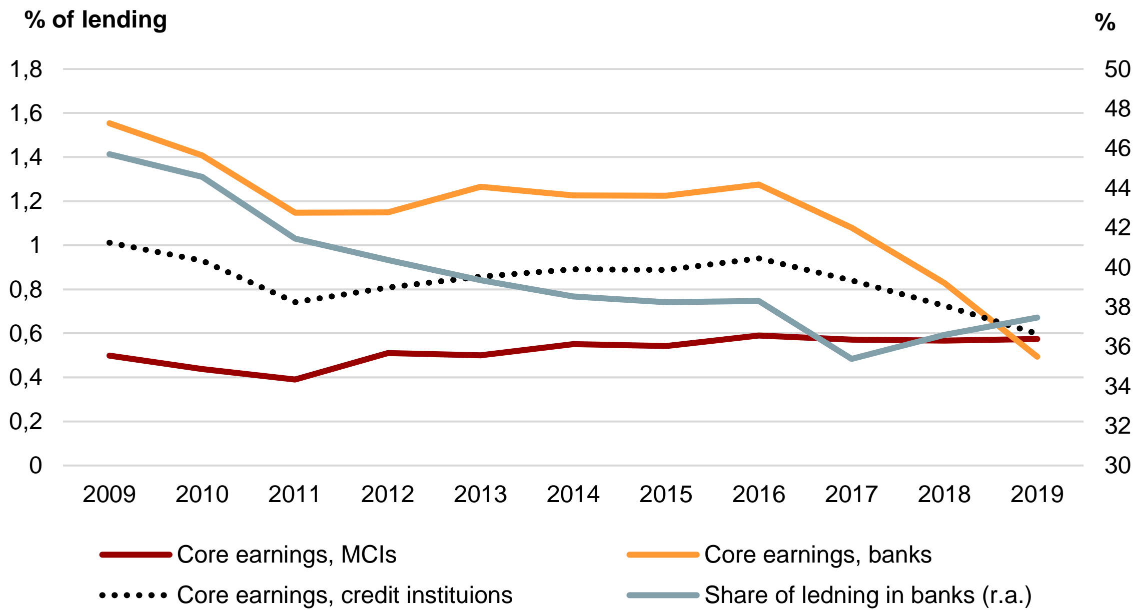
Source: Reporting to the DFSA

The decline in core earnings must also be seen in light of credit institutions' increase in business volume. Measured in relation to loans and guarantees, core earnings have been falling steadily since 2016, see Figure 2. Almost the entire decline is due to banks earning significantly less on each krone they lent in 2019 than in 2016, while the contribution per krone lent

by mortgage credit institutions is largely unchanged, see Figure 4. The reason for this is that mortgage credit institutions are not affected by negative interest rates to the same extent as banks because the core earnings of mortgage credit institutions per construction, through market financing, are affected much less by changes in interest rates.

When declining core earnings did not result in a fall in the return on equity after tax in 2019, see Figure 3 (a), this was solely due to the technical tax reasons in a single credit institution[1].

Figur n: Core earnings in baks are now on par with MCIs



Source: Reporting to the DFSA
Note: Core earnings for credit instituions is not the average of core earings for banks and MCIs, as there will also be income from foreign subsidiaries.

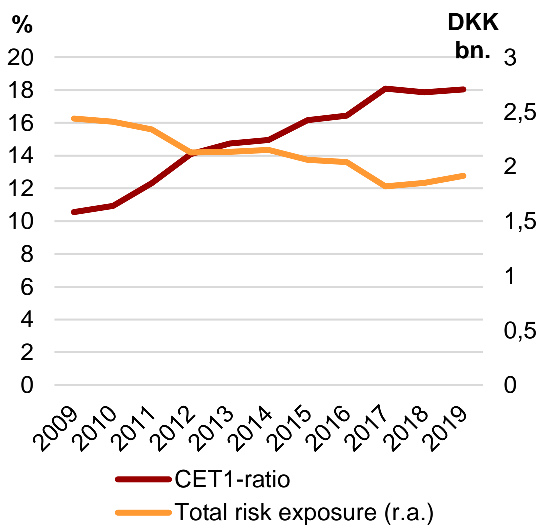
1 The reversal of tax assets at Danske Bank meant that the bank had negative tax costs in 2019.

3. Capital

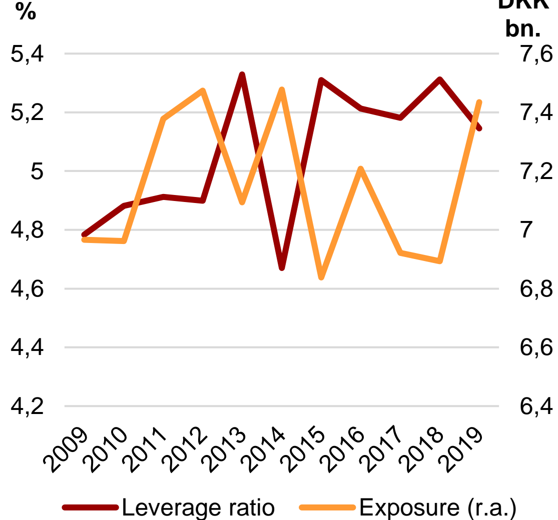
The CET1 ratio of Danish credit institutions has remained largely unchanged at 18 per cent over the last three years, see Figure 5 (a).

At the end of 2019, Danish credit institutions had an excess capital ratio of 5.4 per cent of risk exposures. However, this year the Danish countercyclical capital buffer was released by the Minister for Industry, Business and Financial Affairs in response to the COVID-19 crisis. The same action has also been taken by the authorities in several of the countries where Danish credit institutions have large exposures. The excess capital ratio in 2020 has therefore increased by 1.1 percentage points, see Box 2.

Figur 5 (a): Stagnating capital ratio



Figur 5(b): Constant leverage ratio



Note: The graph on the left shows the Danish credit institutions' actual core capital (CET1) in relation to total risk exposures (REA). The graph on the right shows the institutions' core capital (Tier 1) in relation to loans and certain off-balance sheet items, called the *leverage ratio*.
Source: Reports to the FSA.

The leverage ratio, which views tier 1 capital relation to the unweighted exposure, has remained largely constant since 2015, see Figure 5 (b). However, there has been a slight decrease from 5.3 per cent to 5.1 per cent in 2019. This remains well above the regulatory minimum requirement of 3 per cent.

Profit after tax increased slightly in 2019[2]. Considering lower share buybacks and dividends, this means that the retained earnings increased in 2019. However, this did not have a significant effect on the capital ratio as risk exposures also increased, see Figure 5 (a).

Since the financial crisis, the requirements own funds requirements for credit institutions have increased significantly, see Figure 6. This has happened particularly through requirements for capital buffers. They consist of a SIFI buffer of between 0.5 per cent and 3.0 per cent for the largest institutions and a capital conservation buffer of 2.5 per cent for all institutions. In addition, credit institutions also had to build a countercyclical capital buffer, which at the end

2 The increase is mainly due to the reversal of tax assets at Danske Bank, which meant that the bank had negative tax costs in 2019.

of 2019 was 1.0 per cent and was set to increase to 2.0 per cent by the end of 2020 before being released by the Minister for Industry, Business and Financial Affairs on 13 March 2020.

Box 2: Release of the countercyclical capital buffer

On 13 March 2020, the Minister for Industry, Business and Financial Affairs released the entire Danish countercyclical capital buffer of 1 per cent of the risk-weighted exposures. This buffer applies only to the Danish exposures of credit institutions, which account for just over 74 per cent of total risk exposures. It reduced the capital requirement by DKK 14 billion, see Table 1.

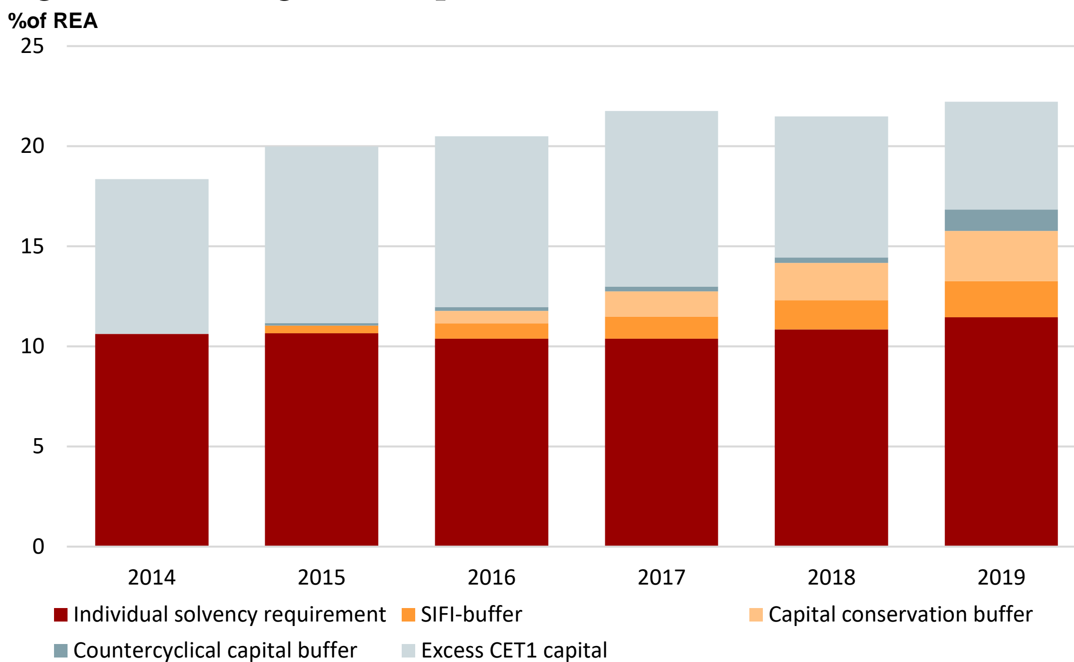
Table 1: Release of countercyclical buffers

			Effect of release	
	Share of REA	**Released buffer**	**% of REA**	**DKK bn**
Denmark	73.53	1.0	0.74	14.1
Sweden	9.19	2.5	0.23	4.4
Norway	5.29	1.5	0.08	1.5
Finland	4.84	-	-	-
UK	2.57	1.0	0.03	0.5
Germany	0.82	0.25	0.002	0.04
Total	**96.4**	-	**1.08**	**20.5**

Source: Reports to the FSA.

At the same time, the authorities in Norway (partially), Sweden, the UK and Germany also released their countercyclical capital buffers, see Table 1. Together with Finland, which has not activated a countercyclical capital buffer, these four countries account for 95 per cent of Danish credit institutions' exposures, and therefore, in apart from the Norwegian buffer of 1.0 per cent (corresponding to 0.06 per cent of total risk exposures), there are no significant countercyclical capital buffer requirements for Danish credit institutions.

Note that Finland has released parts of its SIFI and systemic buffers, but in contrast to the countercyclical buffer, they only apply to Finnish institutions and will therefore not release capital in Danish credit institutions. The relief for Finnish institutions is equivalent to 1 per cent of the Finnish credit institutions' risk-weighted exposures.



Note: The figure shows the credit institutions' total solvency percentage (whole bar) as well as the institutions' individual solvency requirements and capital buffers.
Source: Reports to the DFSA.

Therefore, credit institutions entered the current COVID-19 crisis in a significantly better position in terms of own funds than was the case at the beginning of the financial crisis.

However, an increase in lending in the wake of the COVID-19 crisis will, lead to an increase in the institutions' risk exposures from the new loans, which would, however, fully or partially offset by an expected decrease in credit demand in the long term as a result of an expected lower investment appetite in the Danish business sector. At the same time, customers who are experiencing financial problems as a result of the crisis will cause increased credit risks for the credit institutions. Both of these conditions point towards increased impairments. In this regard, it is important that major impairments are handled and booked immediately, see Box 3. A lesson learnt from previous crises is that nothing is gained by postponing impairments or dealing with breaches of capital requirements. The outside world will lose confidence in the finances and financial resilience of financial companies and the risk will be shifted from shareholders to creditors. The later an intervention is made when a reduction in capitalisation occurs, the greater the difficulties in recapitalising the companies.

Box 3: The need for timely impairments

Financial accounts must reflect all information available about a company's value. Therefore, it is important that expected losses are posted as soon as it is clear that the risks have increased. This ensures a fair and faithful representation of a credit institution's financial situation and allows the company's management and the authorities to make a decision on a correct basis.

Under the international accounting rules for financial instruments, IFRS-9, credit institutions are required to make loan impairments for future expected losses and not only when losses actually materialise. This is known as a precautionary principle. Consequently, sudden changes in macroeconomic circumstances will result in impairments for expected future losses, simply because the risk of losses has increased.

These impairments mean that funds will be set aside to cover future expected losses. Therefore, there is nothing wrong with sudden changes in the economy, such as the COVID-19 crisis, leading to sudden increases impairments.

Customers who are in temporary difficulties will not necessarily lead to increased impairments if the institution considers that the customer's finances are fundamentally sound. Therefore, temporary easing of the customer's loan terms does not automatically have to result in increased impairments, this will depend on the specific credit rating of the customer.

Credit institutions have previously made significant distributions

CET1 capital consists of paid-up share capital and retained earnings. As a result, the credit institutions' capital position is largely determined by the accumulated, after tax, profit and the volume of previous distributions. In recent years, credit institutions have distributed an increasing proportion of decreasing profits, see Figure 7. This has hindered any improvement in the capital ratio. However, dividend payments and share buybacks have been significantly reduced in 2019. Dividend payments fell from 0.9 per cent to 0.7 per cent of REA, while share buybacks decreased from 0.6 per cent to 0.03 per cent of REA.

Credit institutions must be authorised by the DFSA to carry out share buybacks. This authorisation is conditional upon the institutions having sufficient cover to prevent them from coming into conflict with their capital requirements under severe stress.

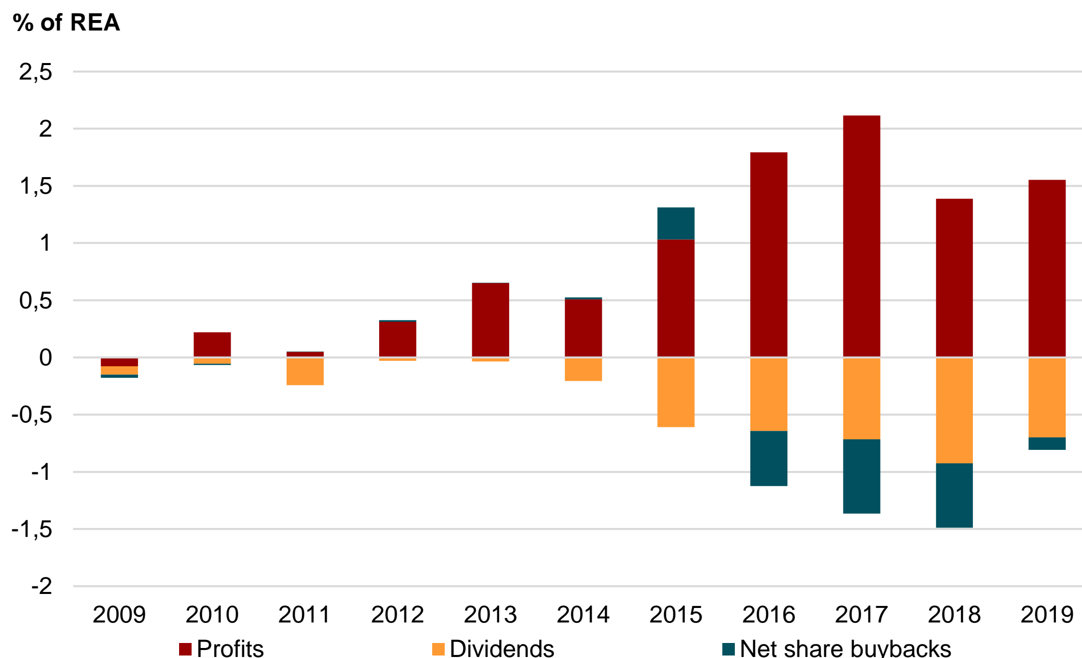
In the annual accounts for 2019, Danish credit institutions had planned dividend payments totalling DKK 13.8 billion, corresponding to 0.7 per cent of the total risk exposures. This is roughly equivalent to the amount of capital released by the countercyclical capital buffer.

Finance Denmark and the Ministry of Industry, Business and Financial Affairs announced in a joint statement on 23 March 2020 that Danish credit institutions would, as a result of the COVID-19 crisis, reconsider any dividend payments already planned. The DFSA believes that the banking sector should currently avoid reducing own funds by paying dividends or carrying out share buybacks. This is in light of the great uncertainty associated with economic

development as a result of the COVID-19 crisis. The DFSA has therefore recommended that credit institutions currently postpone distribution decisions until they have a clearer picture of the financial consequences of the crisis in both the short and long term.

Most credit institutions have chosen to follow this recommendation. The DFSA is involved in ongoing discussions with the individual credit institutions about their capital plans in order to ensure that the credit institutions' capital situation does not limit the possibility of them conducting their business, including the provision of credit. Dividends are part of these discussions.

Figur 7: Dividend payments and share buybacks were reduced



Source: Reporting to the DFSA

Requirement for own funds and eligible liabilities

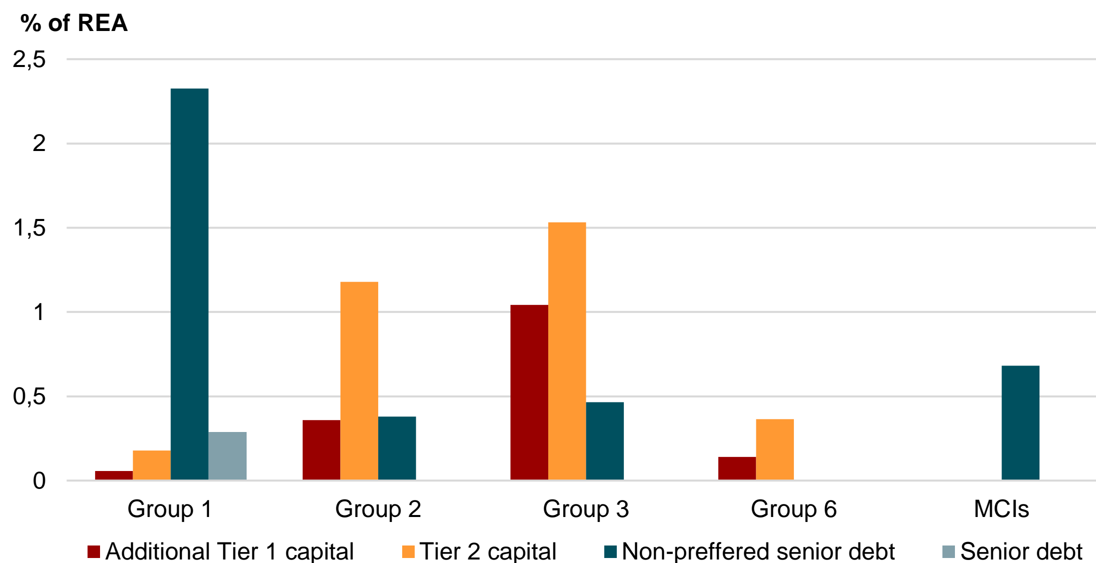
The requirement for own funds and eligible liabilities (MREL) and, in the case of mortgage credit institutions, the debt buffer has been partially phased in during 2019. These requirements are intended to ensure that systemic credit institutions can be recapitalised in a crisis without ordinary creditors suffering losses.

The MREL requirement can be met with the same type of capital that institutions can use to meet the capital requirement. The MREL requirement can also be met with non-preferred senior debt, which is a type of debt instrument for which it has been clearly defined that, in a crisis situation, it can be written down and converted into equity. In particular, it is the major credit institutions that issued this type of debt instrument. The smaller credit institutions meet their MREL requirements, to a greater extent, with CET1 capital.

Market issuances
Credit institutions primarily issued capital and debt instruments in order to either optimise their capital composition or meet the MREL requirement. Secondarily, institutions replaced existing capital.

Throughout 2019, capital and debt markets operated well and attracted great investor interest both in Denmark and abroad. It was also evident that even the smallest institutions were able to obtain capital and perform debt issuance transactions on the Danish market, while larger institutions also had access to international markets.

Figur 8: Large issuance of non-preffered senior debt



Source: Reporting to the DFSA.

The SIFIs primarily issued non-preferred senior debt in order to be able to meet MREL and debt buffer requirements. This meant that the total number of capital and debt issuance transactions among the credit institutions in 2019 was higher than in 2018. Several of the medium-sized Group 2 and Group 3 banks also issued more supplementary capital than the Group 1 banks relative to their risk exposures, see Figure 8.

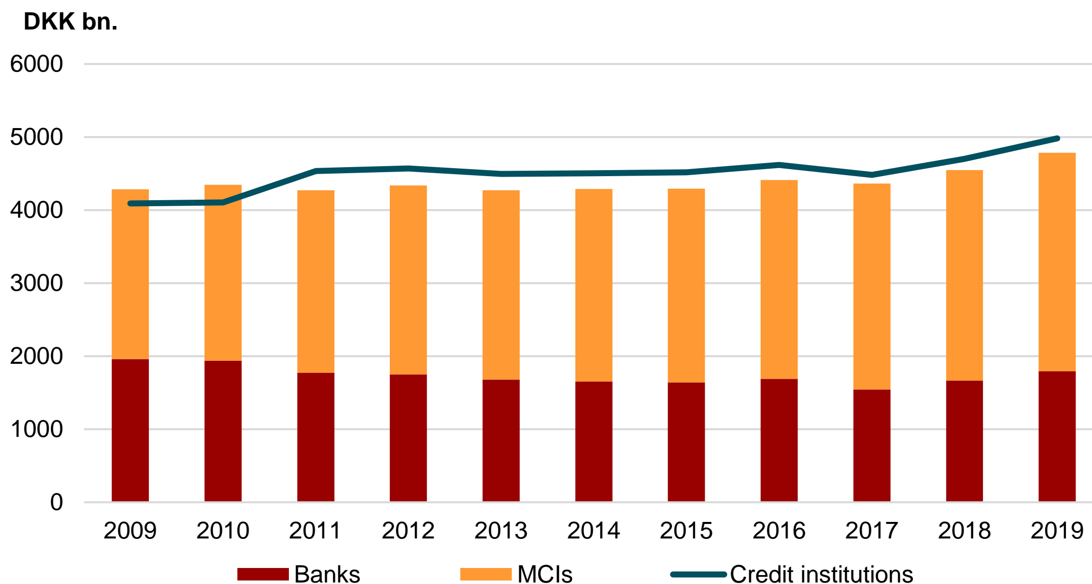
Total capital and debt issuance transactions in the form of AT1 and T2 capital, non-preferred senior debt and senior debt reached roughly DKK 28.6 billion in 2019. The majority covers issuance transactions for non-preferred senior debt among SIFIs.

Since the beginning of the COVID-19 crisis, the primary market for MREL instruments in Denmark has been temporarily frozen, which means that Danish institutions have not had the opportunity to issue new MREL instruments. Danish institutions have not needed to issue new MREL instruments, but market conditions highlight the need for the institutions to have sufficient excess capital so that they can carry out issuances at the most favourable time. For smaller institutions, it will generally be even more difficult to issue non-preferred senior debt. Therefore, it must be expected that they will mainly fulfil the MREL supplement with own funds.

4. Lending

Lending by Danish credit institutions increased moderately during 2019. It increased from DKK 4,700 billion to DKK 4,982 billion, corresponding to an annual rise of 6 per cent. Forty-five per cent of this increase came from banks and 38 per cent from mortgage credit institutions, with the rest coming from subsidiaries which are not Danish banks or mortgage credit institutions. Bank lending has increased slightly since 2017. Mortgage credit institutions' lending has grown throughout the period since the financial crisis, see Figure 9.

Figur 9: Increase in lending from banks and MCIs



Source: Reporting to the DFSA
Note: The sum of lending in banks and MCIs is not equal to the consolidated lending fror credit instituions, this is due to some activities only being included in the consolidated number, f.x. lending at from foreign subsidiaries.

Lending by Danish credit institutions has been declining since the financial crisis, when measured in relation to the size of the Danish economy. Based on experience, high lending growth is associated with increased risk because a substantial expansion of the loan portfolio will happen at the expense of credit quality. Therefore, based on this parameter, Danish credit institutions are also assessed as being well-equipped to deal with the COVID-19 crisis.

Box 4: Potential lending capacity of released capital

Newly released countercyclical capital buffers and the suspension of dividend payments can all contribute to increased lending and loss capacity. The following calculation example illustrates only the extra lending and loss capacity the credit institutions have gained, not whether they actually use it.

The release of the countercyclical capital buffers resulted in a total of DKK 20.5 billion. In the calculation in the table below, it is assumed that the institutions maintain the same total capital adequacy ratio measured as a percentage of risk exposures. As a result, the release allows for an increase in the total risk exposure of DKK 95 billion or an increased loss capacity totalling 0.39 per cent of lending. The amount of extra lending capacity it provides depends on how risky the loans are – i.e. their risk weight. Of course, if credit institutions use the borrowed capital to increase lending, it cannot simultaneously be used to absorb increased losses as a result of the COVID-19 crisis.

Table 2: Impact of various measures on lending and loss capacity

	Impact (DKK billion)		Lending capacity (DKK billion)		Loss capacity
	Capital	REA increase	Avg. risk weight	75% risk weight	(% of lending)
Buffer, Denmark	14.1	65.6	204	88	0.28
Buffer, Sweden	4.4	20.0	62	27	0.09
Buffer, Norway	1.5	6.8	21	9	0.03
Buffer, UK	0.5	2.3	7	3	0.01
Buffers in total	**20.5**	**94.7**	**295**	**126**	**0.41**
Planned dividend	**13.8**	**64.2**	**200**	**86**	**0.28**

Note: The "REA increase" column shows how much credit institutions can increase risk exposures by using released capital. In the case of the buffers, the released capital is used to increase risk exposures so that coverage for the combined buffer requirement is constant. For the "Planned dividend" row, the capital that the institutions had planned to distribute in the form of dividends is used to increase risk exposures while keeping the overall capital ratio constant. The "Lending capacity" columns indicate how much lending this increased risk exposure could contribute, assuming that the new lending has the same risk weight as the credit institutions' existing loan book, i.e. 32 per cent, while the next column assumes a more conservative risk weight of 75 per cent. The last column "Loss capacity" indicates how much losses the various amounts of capital will be able to absorb as a proportion of total lending.
Source: Reports to the FSA.

At the end of 2019, the average risk weight for credit institutions' credit risk was 32 per cent. If this weight is used for the new lending capacity, the institutions will be able to increase lending by DKK 295 billion, corresponding to an increase of 6.0 per cent. However, it is not plausible that new loans will have such a low risk weight. A more cautious risk weight of 75 per cent would generate an increased lending capacity of DKK 126 billion.

5. Regulation

Change to the Danish Financial Supervisory Authority's solvency guide
A credit institution must calculate its individual solvency requirement. The individual solvency requirement is a measure of the capital which the credit institution needs in order to be able legally to continue its operations, taking into account the institution's individual risk profile. The solvency requirement is calculated as the sufficient amount of own funds as a percentage of the total risk exposure. The solvency requirement must be at least 8 per cent of the overall risk exposure (Pillar 1 requirement). There is also a separate Pillar 2 add-on.

The credit institution's management is responsible for identifying the risks which the institution is exposed to in order to assess the institution's risk profile. Once risks have been identified, management must assess how the institution should tackle them and how much capital it should allocate. This enables management to determine the credit institution's individual solvency requirements. The higher the solvency requirement, the greater the risks the institution has assumed.

"Guidance on adequate own funds and solvency requirements for credit institutions" makes the DFSA's practice for calculating the solvency requirement more transparent. The guidance is published on the DFSA's website and was revised last year with updates being added in a number of areas. One of the key changes is a clarification of the management of Pillar 2 add-ons in the case of management and governance deficiencies. The deficiencies can lead to an increased risk for the institution and should therefore be covered through a provision in the solvency requirement. As a rule, the institution should remedy the shortcomings, thereby reducing the solvency add-on for inadequate management and control, as the institution makes improvements.

The guidance is also clarified with a more forward-looking approach to calculating credit risk for large customers with financial problems. In this regard, the FSA has observed, in connection with inspections, that the estimated credit risk of some large customers does not take into account that a cyclical downturn can adversely affect customers' accounts and financial situation. The guidance clarifies how the institutions should calculate the credit risk for these customers based on a classification which reflects a full business cycle and should exercise caution in those areas where a customer is not resilient in the event of a recession.

Governance and corporate culture
The financial sector is of central social importance. This is partly due to the fact that a healthy, stable and well-functioning financial sector is a prerequisite for growth and employment in Denmark. Confidence in the Danish economy is strengthened by a stable financial sector, which can offer financing to companies and households on competitive terms. Due to this vital social importance, financial companies are subject to extensive rules, including rules on good company management (*corporate governance*), which should help secure and maintain confidence in the financial sector.

Good corporate governance is therefore crucial to society's confidence in the financial sector. The DFSA supervises that financial companies comply with the rules of good corporate governance. This is partly due to the fact that society has strong interests in the functioning of the financial sector and that these interests do not always coincide with those of shareholders. It is therefore important that the DFSA safeguards the Danish population's interests by overseeing corporate governance in the financial companies.

In addition, there are rules on the composition of special employees' remuneration. Among other things, the remuneration rules aim to limit the incentive for covered employees to perform riskier transactions than they would otherwise have done. Legislation also requires members of the management team to allocate sufficient time to the function they are performing. This applies, for example, to limits on how many board positions and executive positions board member of Denmark's largest credit institutions can hold..

Corporate governance rules are not in themselves sufficient to ensure the maintenance of trust in the company and a good reputation. Legislation therefore also requires the credit institution to have a written policy which safeguards and promotes a healthy corporate culture[3]. One of the purposes of the policy is to express the company's expectations in terms of the behaviour of all the employees. It may, for instance, include examples of acceptable and unacceptable behaviour and of how employees can actively contribute to preventing, among other things, money laundering and other financial crimes.

As another example, the company must establish methods setting out how it creates a culture which can promote open communication about suspected breaches of relevant legislation by the company, its employees or members of its management. Experience shows that it is crucial that companies have a healthy corporate culture. The policy must therefore contribute to the employees' behaviour supporting good corporate governance.

3 This is pursuant to section 70 a of the Financial Business Act.

Box 5: The three lines of defence

Part of good governance for a credit institution is that it is structured with clear lines of responsibility and reporting and that the way in which it manages its risks is organised around three lines of defence:

- The first line of defence consists of the institution's operational functions, where the institution assumes risks, these risks must be identified, managed, measured and reported. As a result, there must be sufficient independent inspection of compliance with rules, etc.
- The second line of defence consists of the risk management and compliance functions. These functions are responsible for monitoring, controlling and assessing risks and compliance with the law. The functions must prepare an assessment of whether the work in the first line of defence is sufficient according to the management's instructions and matches the chosen risk profile.
- The third line of defence is an internal audit, which is responsible, among other things, for assessing whether the institution's internal control system is appropriate and reassuring.

Later this year the *Executive Order on a Healthy Corporate Culture Policy in Banks and Others* will take effect. It will also include guidance on what the bank's policy should contain.

Fit and proper

The management and key function holders in financial companies have obligations and take on tasks which, require a high level of expertise and considerable experience. As a result, financial legislation sets out requirements for the skills and experience that this group of people must have, including requirements in terms of suitability and integrity (fit and proper). The overall purpose of the requirements is to ensure that financial companies are managed

Box 6: New fit and proper rules

The fit and proper rules have been tightened through a legislative amendment, which came into force on 1 July 2018. This legislative amendment meant that when assessing whether a person is proper, emphasis should be placed on people's understanding of the financial sector's special social responsibility in terms of preventing money laundering and terrorist financing.

On 1 July 2019, key function holders in all banks were also covered by the rules for being fit and proper. Under the Financial Business Act, key function holders are defined as employees who are part of the actual day-to-day management, along with employees responsible for a key function. Previously, these rules only applied to SIFIs.

properly so that society can have justified confidence in the financial sector. The FSA assesses whether a person complies with the fit and proper rules at the time when they join the financial company and on an ongoing basis while they are performing their job. However, it is ultimately the responsibility of financial companies to ensure that relevant management executives are suitable and reputable.

For some of the rules, proportionality is a key part of assessing whether the requirements are met. This is especially true when assessing a candidate's suitability for a given position in a company. The assessment of a candidate's skills and experience will have to be considered here in relation to the relevant company, including its size, scope and business model.

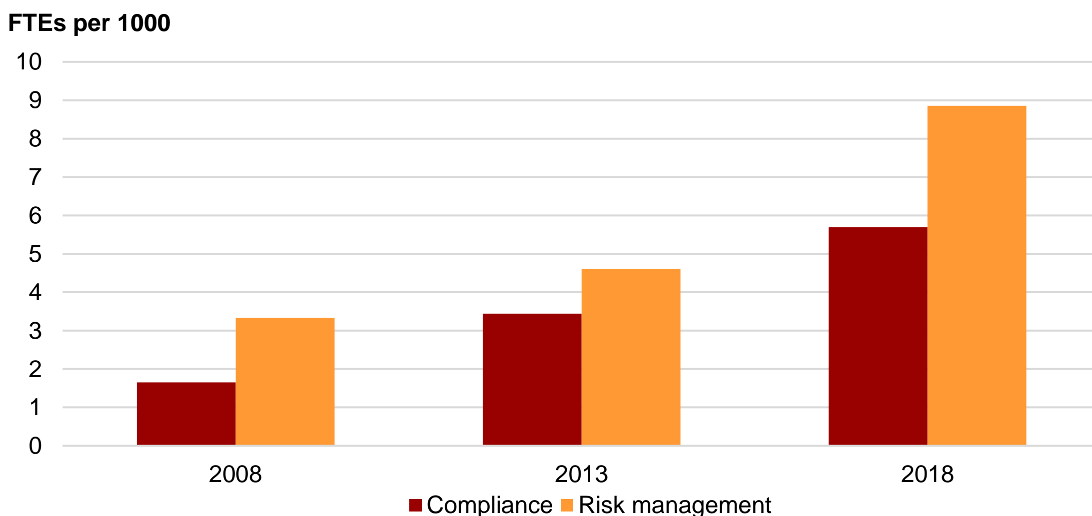
Since the financial crisis, the FSA has been focusing more on the fit and proper rules, with the legislation in this area having been continuously developed and tightened. As a natural consequence, this has increased financial companies' focus on this area.

The DFSA's compliance study

Credit institutions' risk management function helps ensure that credit institutions identify and manage their risks satisfactorily. In parallel with the risk management function, credit institutions have a compliance function that looks at regulatory risks associated with the credit institution's business. Both functions must operate independently and provide the opportunity to comment on risks directly to the board of directors.

In recent years, there has been a growing focus on compliance and risk management in Danish credit institutions. The major cases both in Denmark and abroad, where credit institutions have suffered large financial and reputational losses due to non-compliance and lack of risk management, are one of the reasons why credit institutions have increased their focus in these areas. Inadequate compliance and risk management are no longer socially acceptable and can cost credit institutions dearly through business losses, loss of reputation and an exodus of customers.

Figure 10: Increase in employees in compliance and risk management



Note.: Simple average of the participants in the survey
Source: Reporting to the DFSA

For this reason, the DFSA has published a good practice paper on compliance and risk management in credit institutions. The paper was drafted on the basis of the FSA's ongoing supervision and of a questionnaire distributed among large and medium-sized credit institutions. The memorandum contains 10 specific guidelines for compliance and risk management in credit institutions, see Box 7.

Developing effective compliance and risk management functions will generate a need for increasing resources and costs for credit institutions. However, a lack of compliance and risk management will cost the credit institutions significantly more in the longer term. It is therefore important that credit institutions allocate the necessary resources. The DFSA's study shows that credit institutions have already allocated more resources for compliance and risk managementnow than they did 10 years ago, see Figure 10. However, this build up occurred from a low starting point, so credit institutions still need to focus on their resource requirements.

Box 7: Guidelines from the FSA's good practice paper on compliance and risk management

1. There is a clear division of tasks and responsibilities between, and within, the lines of defence, which ensures that all significant risks are identified and controlled. The institutions ensure that both the first and second lines of defence carry out checks in the credit area.

2. The compliance function monitors and assesses broad compliance with rules, including the rules governing the running of a financial undertaking, and whether the risk management function performs the tasks required by law.

3. The compliance and risk management functions have sufficient resources and competencies to fulfil their responsibilities properly and independently.

4. Conflicts of interest are identified and handled so that independence in the second line of defence is not compromised.

5. Reporting from the risk manager gives management an overall, comprehensive overview of the institution's risks. Reporting from the compliance officer gives management a clear picture of the institution's compliance risks and any change requirements and measures.

6. The compliance officer and risk manager prepare risk assessments, which form the basis for the functions' planning and preparation of multi-annual plans.

7. The risk manager and compliance officer have an appropriately high position assigned in the organisation. The risk manager and compliance officer in SIFIs are part of, or report directly to, the executive board. In cases where the risk manager is not part of the executive board, the executive director to whom the risk manager reports should not be responsible for significant business risks (unless this is the CEO). The risk manager and compliance officer have the opportunity to speak directly to the board of directors.

8. The compliance officer and risk manager are consulted on important decisions, but must not be responsible for business projects.

9. The compliance officer and risk manager have significant experience from working in a credit institution. In SIFIs, the compliance officer and risk manager also have experience from working in the function itself.

10. The compliance officer and risk manager have access to all relevant information.

6. Climate risks

Financial stability and confidence in the financial sector

Climate change and sustainable financing (consisting, inter alia, of green bonds[4]) affect both financial stability and confidence in the financial sector. The DFSA therefore considers it important that, to some extent, the financial sector integrates risks arising from climate change into their business model, while acting in a responsible and fair manner in relation to issuing green financial products to investors and customers. In this regard, the DFSA has identified the following focus areas for credit institutions.

Responsible management structure in managing financial risks resulting from climate change

The FSA expects credit institutions to comply with the applicable rules for good management structures in managing financial risks resulting from climate change[5]. As part of a responsible management structure, credit institutions should take sufficient account of adverse climate effects on, for example, the quality of assets, the adequacy of technical provisions and the quality of collateral provided, etc. In this context, it is also important to ensure that risks are reflected accurately. Conversely, it also implies that institutions should be reluctant to deal with green investments, etc. more casually than other investments, simply because they are green, without them being justified in a specific risk assessment.

4 "Green" bonds refer to a special type of bond where the issuer, for example, invests in renewable energy, energy efficiency and other projects which reduce CO_2 emissions.

5 See Box 9 for more information.

Box 8: Disclosure Regulation

The purpose of the Disclosure Regulation is to enhance the investors' ability to compare products and companies' approaches to sustainability in order to increase investment in sustainable products. This means that players in the financial markets, including credit institutions, which provide investment advice or produce financial products, are required to:

- publish policies on how their investment decision-making process integrates sustainability risks and whether they (credit institutions) take into account adverse effects on sustainability factors;
- describe the way in which sustainability risks are integrated into the credit institution's investment decisions and provide an assessment of the impact which risks can have on the return of a product.

The Regulation will apply from 10 March 2021.

The Disclosure Regulation is supplemented by regulatory technical standards (RTSs) which specify the content and presentation of the information that credit institutions are required to provide under the Regulation. In this context, the EBA will submit a draft to the Commission on this by 30 December 2020**.**

The credit institutions' management of financial risks resulting from climate change must be proportionate to the nature, scope and complexity of the credit institution's business model. In practice, this means that credit institutions must address all risks affecting them and that management must include the handing of these risks in their strategy, risk profile, risk appetite, policies and guidelines[6]. By extension, when assessing and managing risks, the DFSA expects that credit institutions, going forward, identify the potential current and future impacts of the transitional risks and physical risks resulting from climate change. The DFSA also expects credit institutions to improve the quality in terms of managing and handling these risks as they gain greater experience in handling financial risks associated with climate change. In addition, credit institutions must comply with the Disclosure Regulation, see Box 8.

Fair and transparent information about green bonds for investors

Credit institutions operate in a market where, at present, there is no common definition or minimum standard for assessing what can actually be termed as green bonds or sustainable investment products. This definition issue, on the one hand, increases the risk of *greenwashing* (i.e., a company presents products as green, even if they are not) and, on the other, it exposes credit institutions which issue green liabilities to an increased reputational risk.

In order to maintain trust in credit institutions and the integrity of the capital market, it is essential that institutions make efforts to ensure that their green bonds (green investment

6 See section 4 of Executive Order no. 1026 of 30 June 2016 and CRD IV Article 74

products) are sustainable or climate-friendly if marketed as such, and act transparently when it comes to issuing green bonds.

At EU level, efforts are being made to introduce legislation which addresses the definition problem.

Credit institutions are experiencing a steadily growing demand for green bonds from investors and consumers. As a result, several institutions have issued green bonds in the form of non-preferred senior debt (Tier 3) and covered bonds respectively.

In response to the increased demand, the FSA considers it vital that investors are clearly and adequately informed about sustainability issues and risks and that they receive information and advice in a fair, loyal and non-deceptive way. This reduces information asymmetry and increases transparency, which can boost the integrity of capital markets and the financial system.

The FSA recognises that the lack of common definitions and rules can lead to divergent assessments of sustainability aspects. Against this background, the DFSA recommends that credit institutions use international, recognised framework tools (e.g. TCFD[7]) to measure and report on the sustainability of their products and services until EU legislation applies. Recognised framework tools can be helpful in gaining and maintaining investor confidence. They can also help prevent misleading greenwashing and ensure that investors understand what they are buying.

7 Task Force on Climate-Related Financial Disclosures (https://www.fsb-tcfd.org/)

Box 9: Climate-related risks

There is international consensus that climate change poses two types of risks which can affect financial stability: transitional risks and physical risks.

Transitional risks include (indirect) risks arising from the transition to a green economy - e.g. political measures, technological development or market demand.

Physical risks are risks which arise directly as a result of climate change. There may be a risk of flooding in buildings, changes in plant yield, drought, forest fires, etc.

The DFSA has identified a number of financial risks as a derived effect of transitional risks and physical risks respectively.

Liquidity risk

- *Transitional risks.* Increased demand for green bonds risks fragmenting the credit institutions' issuance transactions and reducing the liquidity of the individual series. An imbalance between the development of the sustainability agenda and the length of bond issues poses a risk that the underlying assets which were considered to be green at the time of the issue do not necessarily retain this categorisation throughout the term of the issue. It can cause losses for investors and reduce confidence in the issuing institution.

- *Physical risks.* Floods or hurricanes cause insurance companies to pay large sums in non-life insurance. Insurance companies' withdrawals in credit institutions potentially cause credit institutions to sell HQLA (High Quality Liquid Assets) to cover these outflows.

Credit risk

- *Transitional risks.* The risk of stranded assets within CO_2-heavy industries increases the likelihood that companies will default on their loans in the credit institutions.

- *Physical risks.* Severe weather events can result in lower asset values and increased volatility of commodity and foreign exchange markets, for instance.

Market risk

- *Transitional risks.* Increased costs and regulation of CO_2-heavy industries affect energy and commodity prices, corporate bonds, shares and certain derivative contracts. The financial risk of credit institutions will increase over the coming years if the institutions' portfolios are not adapted to the expected climate development.

Annex 1: Annual accounts for credit institutions 2015–2019

	2015	2016	2017	2018	2019	Change, 1 year	Change, 5 years
Income statement	*DKK millions*					*%*	
Interest income	142,997	132,269	119,240	115,063	112,714	-2.04	-21.18
Interest expenses	66,918	59,892	55,654	54,098	53,532	-1.05	-20.00
Net interest income	***76,079***	***72,377***	***63,585***	***60,965***	***59,182***	***-2.93***	***-22.21***
Dividends from assets, etc.	1,630	1,102	722	778	1,277	64.27	-21.63
Fee and commission income	37,921	37,596	35,191	34,840	37,501	7.64	-1.11
Fee expenses and commission	10,563	11,526	12,746	13,259	13,871	4.62	31.32
Net interest and fee income	***105,066***	***99,549***	***86,753***	***83,323***	***84,088***	***0.92***	***-19.97***
Expenses for staff and administration	57,695	57,138	48,671	50,844	52,859	3.96	-8.38
Other operating income	5,575	6,727	5,996	7,886	8,564	8.60	53.61
Other operating expenses	1,292	504	572	272	420	54.58	-67.45
Amortisation and write-downs of intangible and tangible assets	11,517	5,226	5,825	5,992	9,569	59.70	-16.91
Basic earnings	***40,138***	***43,407***	***37,682***	***34,102***	***29,804***	***-12.60***	***-25.75***
Value adjustments	672	7,505	13,515	6,317	8,435	33.53	1155.50
Loan write-downs and receivables, etc.	7,656	4,025	- 202	1,596	3,408	113.51	-55.49
Profit from investments in associates	1,740	2,657	1,823	1,316	3,456	162.53	98.58
Profits before tax	**34,894**	**49,544**	**53,222**	**40,139**	**38,287**	-4.61	9.72
Tax	8,556	9,880	10,533	8,003	2,746	-65.69	-67.91
Net profit for the year	**26,338**	**39,664**	**42,688**	**32,136**	**35,541**	10.60	34.94

Source: Reports to the FSA.

FINANSTILSYNET

	2015	2016	2017	2018	2019	Change, 1 year	Change, 5 years
Balance sheet items	*DKK millions*					*%*	
Cash in hand and demand deposits with central banks	114,018	83,085	118,673	70,134	152,569	117.54	33.81
Receivables from credit institutions and central banks	227,985	414,043	490,994	355,505	313,379	-11.85	37.46
Loans	4,517,989	4,616,350	4,483,441	4,700,149	4,981,763	5.99	10.27
Loans excl. repos	*4,227,147*	*4,335,669*	*4,231,830*	*4,393,576*	*4,587,677*	*4.42*	*8.53*
Bonds	938,865	937,607	805,299	766,201	842,593	9.97	-10.25
Shares etc.	48,703	50,587	46,349	32,621	38,515	18.07	-20.92
Equity investments in associates	2,968	2,153	2,021	1,908	3,461	81.44	16.62
Equity investments in affiliates	19,283	16,858	16,623	18,544	20,491	10.50	6.26
Assets linked to pool schemes	121,072	128,792	114,046	114,947	135,007	17.45	11.51
Intangible assets	12,040	12,009	10,765	12,117	13,593	12.18	12.90
Land and buildings	14,553	12,719	11,691	10,627	16,576	55.98	13.90
Other property, plant and equipment	8,639	10,529	11,313	11,939	13,886	16.32	60.74
Tax assets	3,935	3,128	3,366	4,525	4,810	6.30	22.24
Assets held temporarily	7,748	1,758	1,384	2,120	3,768	77.70	-51.37
Other assets	459,364	462,211	354,111	336,540	399,916	18.83	-12.94
Accruals and deferred income	3,885	3,765	3,357	3,727	3,787	1.63	-2.50
Total assets	**6,501,047**	**6,755,595**	**6,473,434**	**6,441,603**	**6,944,115**	7.80	6.82
Debts to credit institutions and central banks	409,750	392,286	305,841	316,985	231,340	-27.02	-43.54
Deposits	1,869,398	1,978,791	1,832,545	1,867,968	2,021,848	8.24	8.16
Deposits excl. repos	1,869,398	*1,892,935*	*1,689,821*	*1,686,788*	*1,826,733*	*8.30*	*-2.28*
Issued bonds	3,079,120	3,212,631	3,320,239	3,270,293	3,590,718	9.80	16.62
Other liabilities	11,925	20,013	20,010	6,912	5,572	-19.40	-53.28
Accruals and deferred income	1,939	2,022	1,826	1,727	1,718	-0.55	-11.40
Liabilities, total	***6,028,823***	***6,274,984***	***6,016,550***	***5,986,563***	***6,460,349***	***7.91***	***7.16***
Provisions	12,404	12,293	11,160	13,507	8,810	-34.78	-28.98
Subordinated debt	70,675	65,094	51,718	45,779	57,844	26.35	-18.16
Equity	389,145	403,224	394,006	395,753	417,112	5.40	7.19
+Total liabilities	**6,501,047**	**6,755,595**	**6,473,434**	**6,441,603**	**6,944,115**	7.80	6.82

Source: Reports to the FSA.

Annex 2: Financial ratios for credit institutions 2015–2019

	2015	2016	2017	2018	2019
%					
Total capital ratio	19.81	20.74	22.14	21.69	22.47
Tier 1 capital ratio	17.62	18.41	19.72	19.79	19.96
CET1 capital ratio	16.16	16.43	18.09	17.86	18.05
Return on equity before tax	8.97	12.29	13.51	10.14	9.18
Return on equity after tax	6.77	9.84	10.83	8.12	8.52
Ratio of op. income to op. expenses (DKK)	1.44	1.74	1.97	1.67	1.55
Accumulated write-down rate	1.79	1.52	1.21	1.15	1.07
Write-down percentage for the period	0.18	0.09	-0.01	0.04	0.08
Lending in relation to equity (ratio)	10.86	10.75	10.74	11.10	11.00
Total risk exposures (DKK billion)	2,060	2,041	1,819	1,850	1,916

Source: Reports to the DFSA.