

# Nykredit Capital Markets Day

## November 16, 2016

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# Agenda

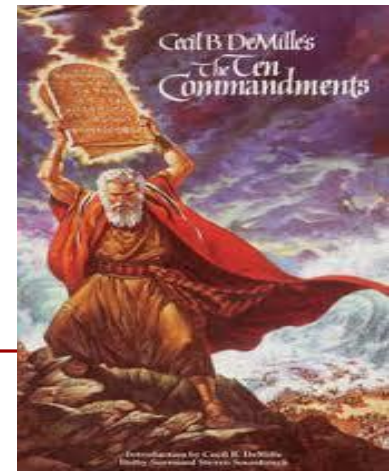
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1. State of the Union – Danish banking
  2. Developments in the housing markets
  3. New accounting standards (IFRS 9)
  4. Dividend payouts
  5. Further international regulation (Basel 4)
  6. MREL
  7. New Strategy: Justified Confidence
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## Major takeaways

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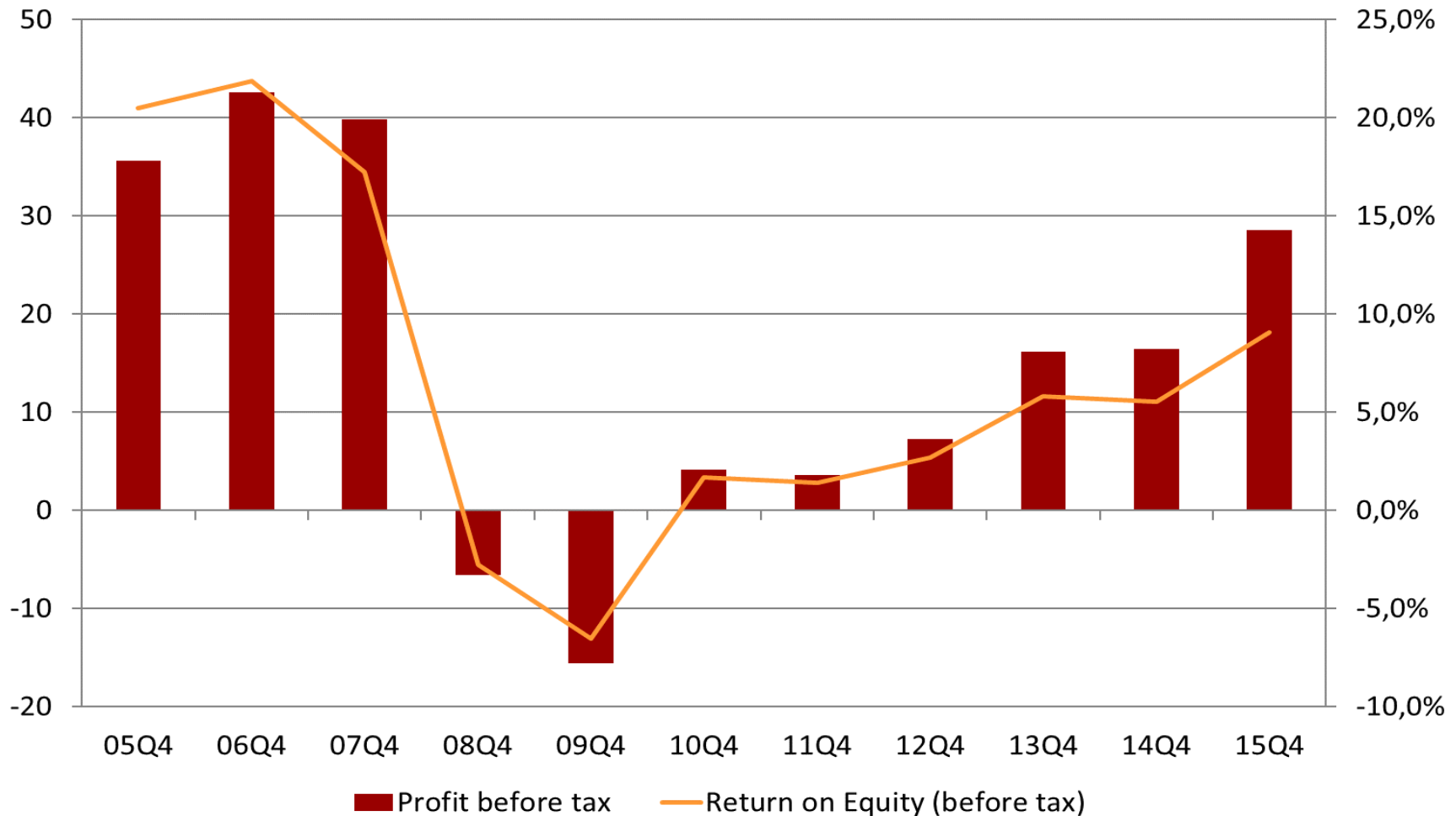
1. Negative interest rates creates challenges and temptations.
2. Pass-through mortgage credit funding is well suited for negative rates.
3. Some froth in housing markets, but already macroprudential steps.
4. New accounting standards introduces expected losses.
5. Lower ROE should mean lower dividend expectations.
6. Higher capital requirements in the horizon.
7. Finanstilsynet is taking care of Danish interests internationally, but success requires a tight ship at home.
8. Resolution and recovery is a major focus point going forward.
9. Uncertain economic and financial outlook. Negative public perception of the financial sector.
10. We have a common task in creating justified confidence



The traditional business model is challenged  
by low interest rates

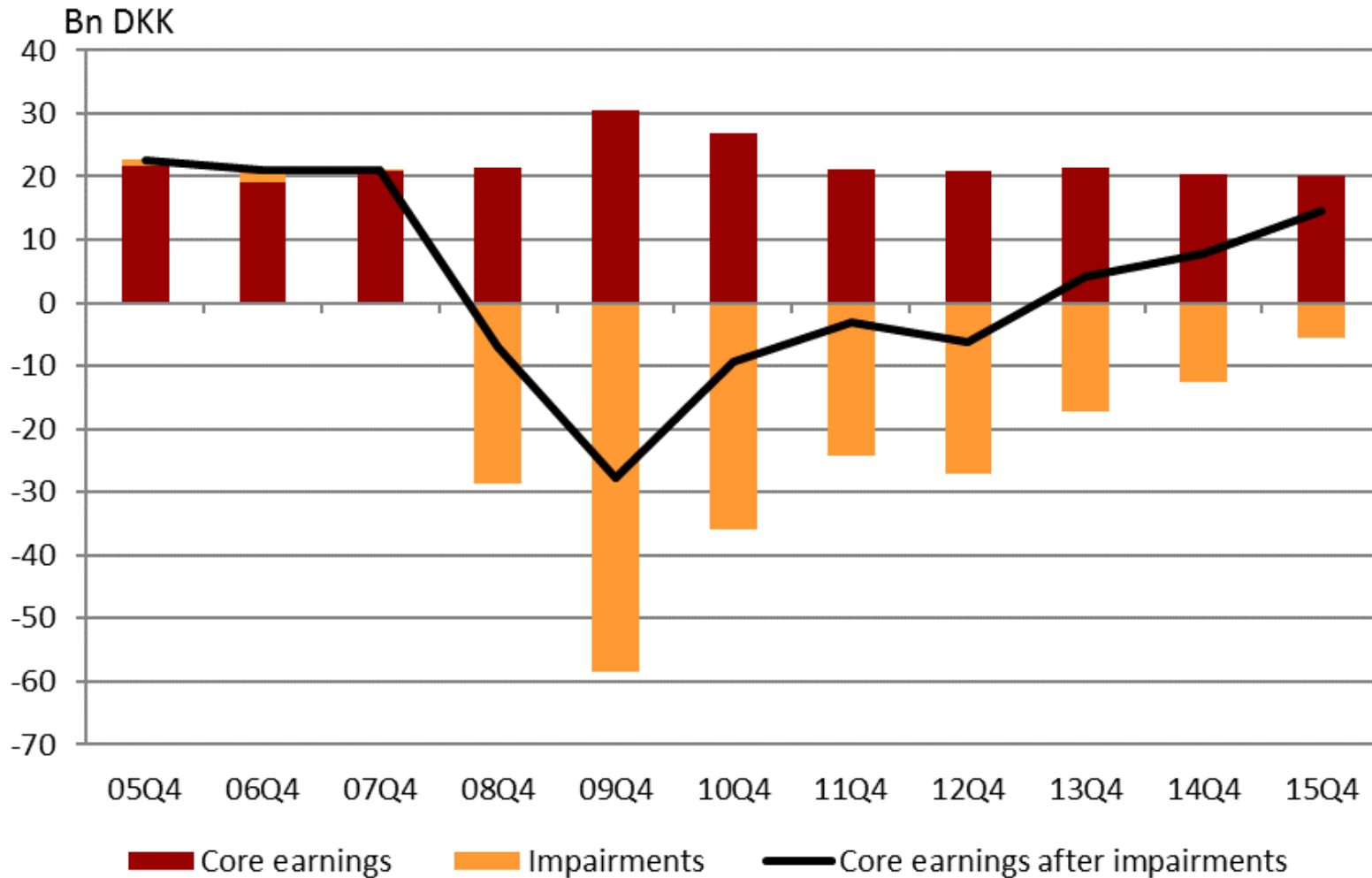
## Positive results for credit institutions

Bn. DKK



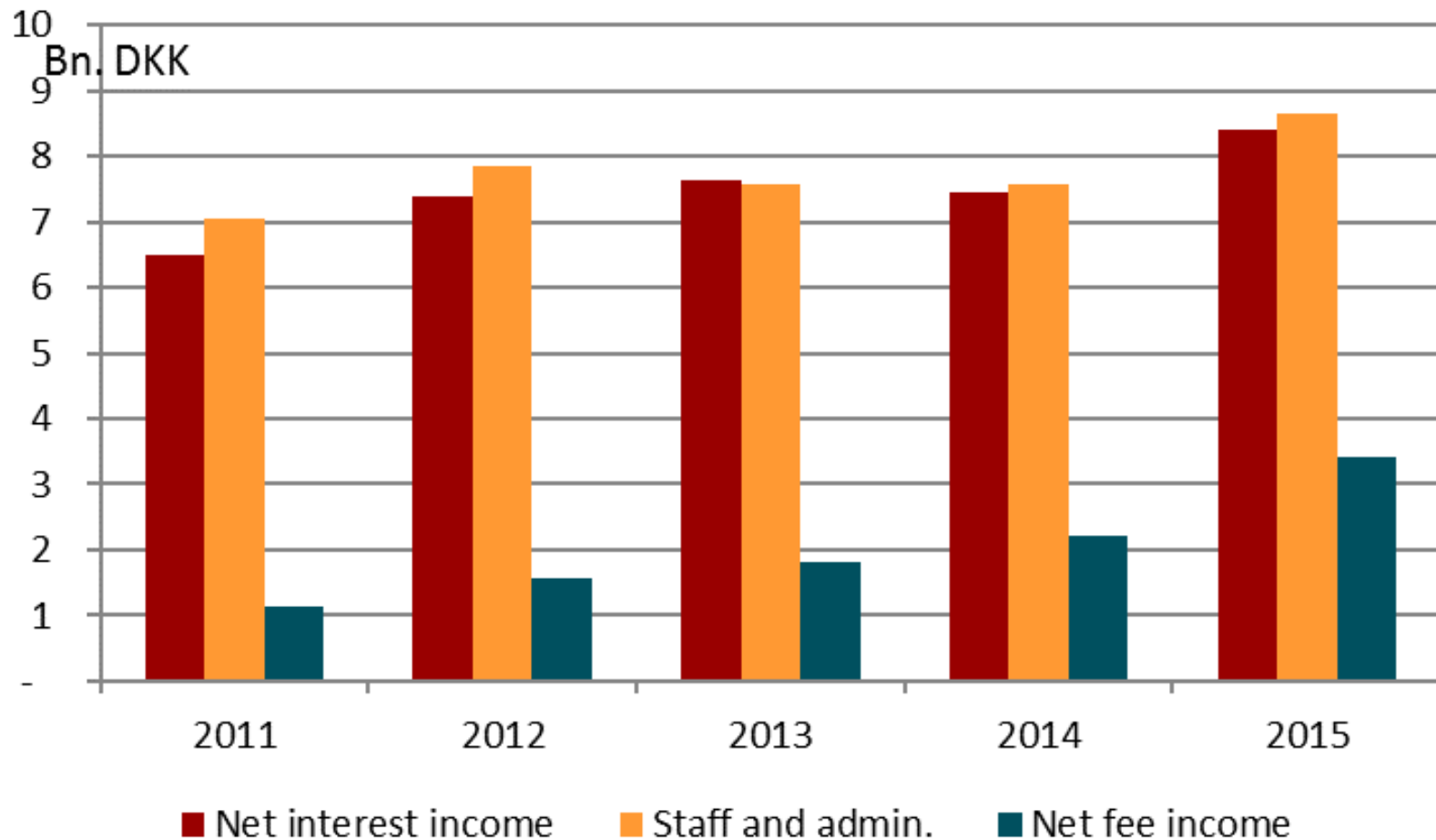
... but not at pre-crisis level

## Impairments are decreasing



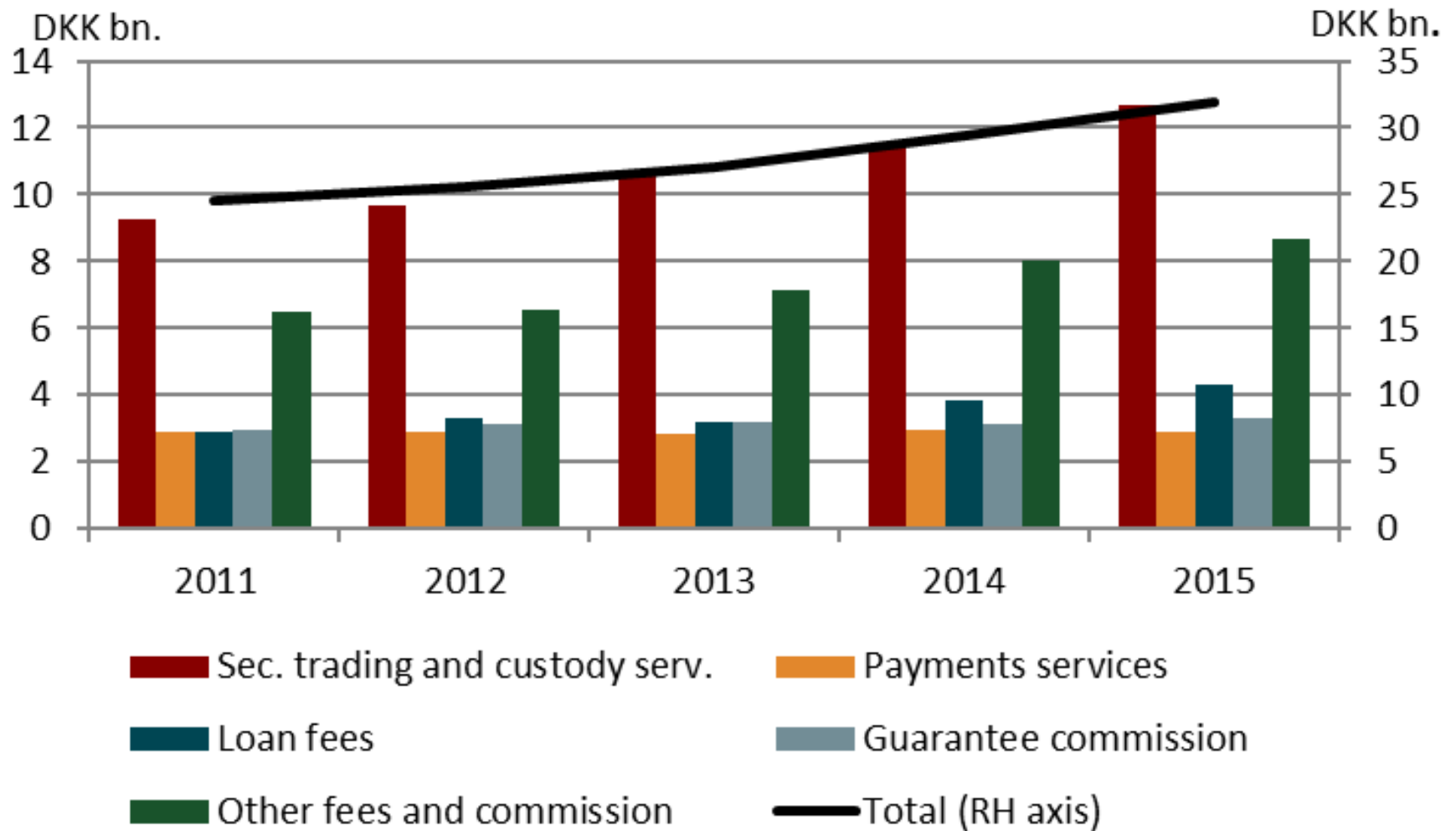
... due to business cycles or better credit quality?

## Net interest income match costs for admin and staff



...while the income from fees generate returns

## Fee income from 2011-2015

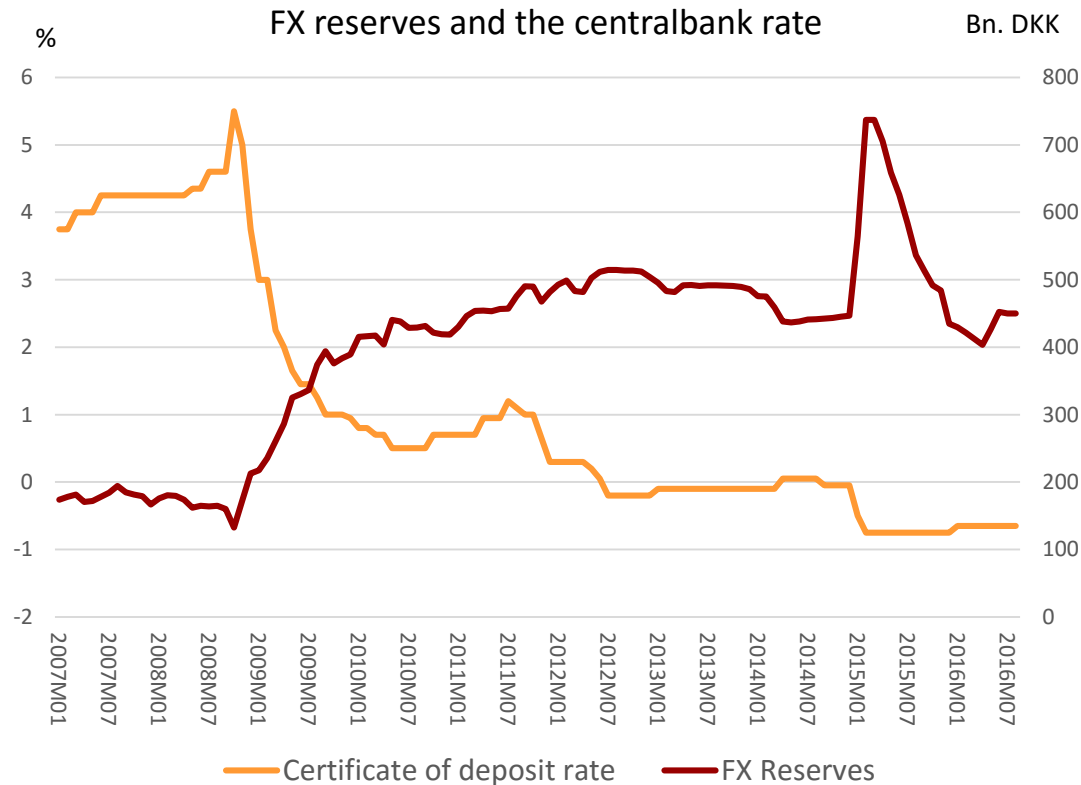


... how robust is this level of fee income?



# Three key characteristics of Danish financial system

Danish GDP = 1.985 Bn DKK, pct. of GDP ult. 2015			
Banks			
	Assets	Liabilities	
Deposits	15%	84%	
Bonds	42%	19%	
Loans	83%	24%	
Shares and other equity	8%	19%	
Other	24%	34%	
Mortgage institutions			
	Assets	Liabilities	
Deposits	37%	0%	
Bonds	10%	139%	
Loans	134%	34%	
Shares and other equity	0%	10%	
Other	1%	2%	
Pensions and insurance			
	Assets	Liabilities	
Deposits	2%	0%	
Bonds	60%	0%	
Loans	3%	21%	
Shares and other equity	26%	10%	
Other	9%	151%	
Investment funds			
	Assets	Liabilities	
Deposits	1%	41%	
Bonds	21%	0%	
Loans	0%	0%	
Shares and other equity	17%	0%	
Other	4%	2%	



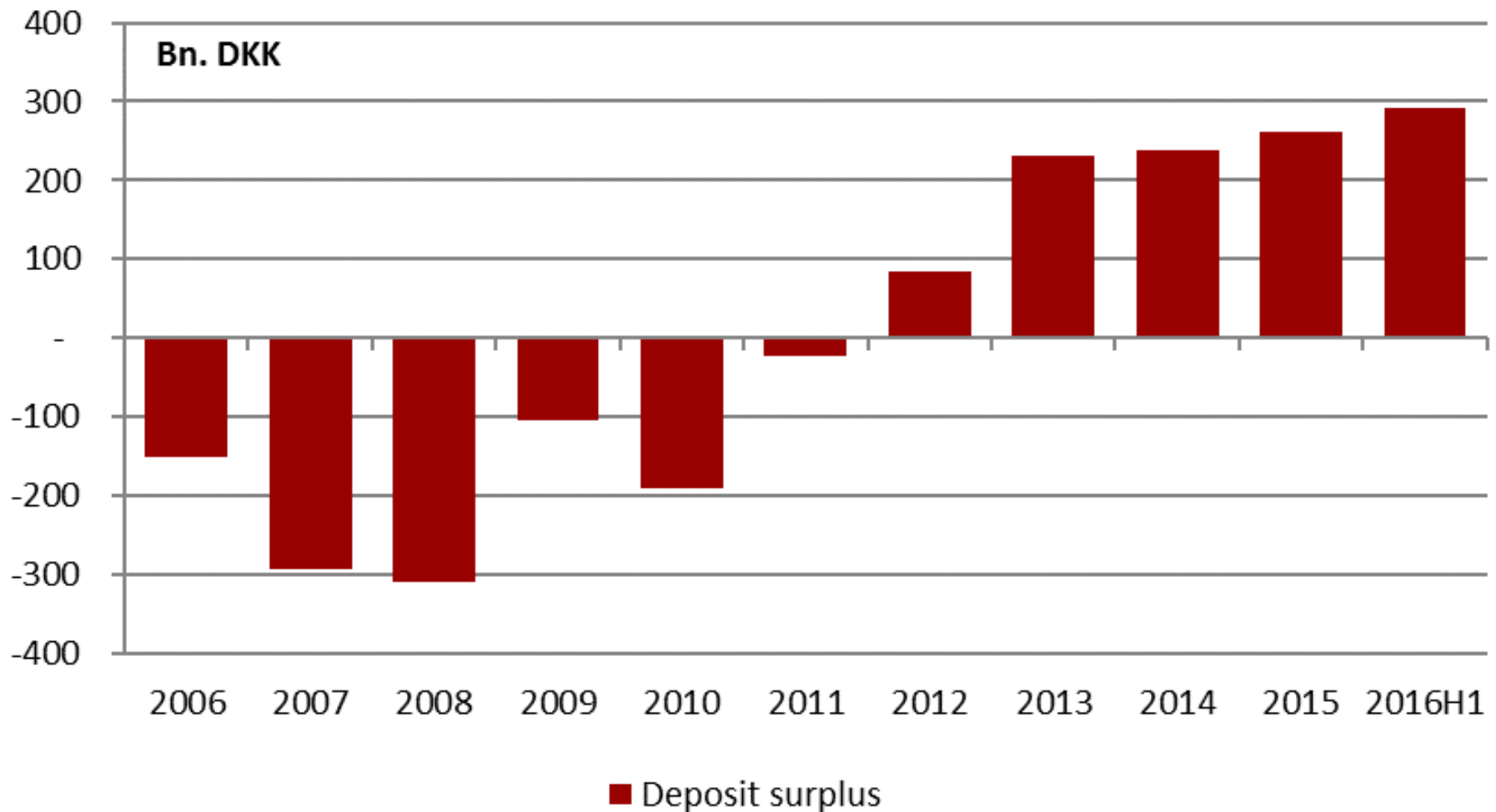
FX-peg drive CB interest rates below zero

Source: Reporting to the Danish FSA

Source: Danish Central Bank

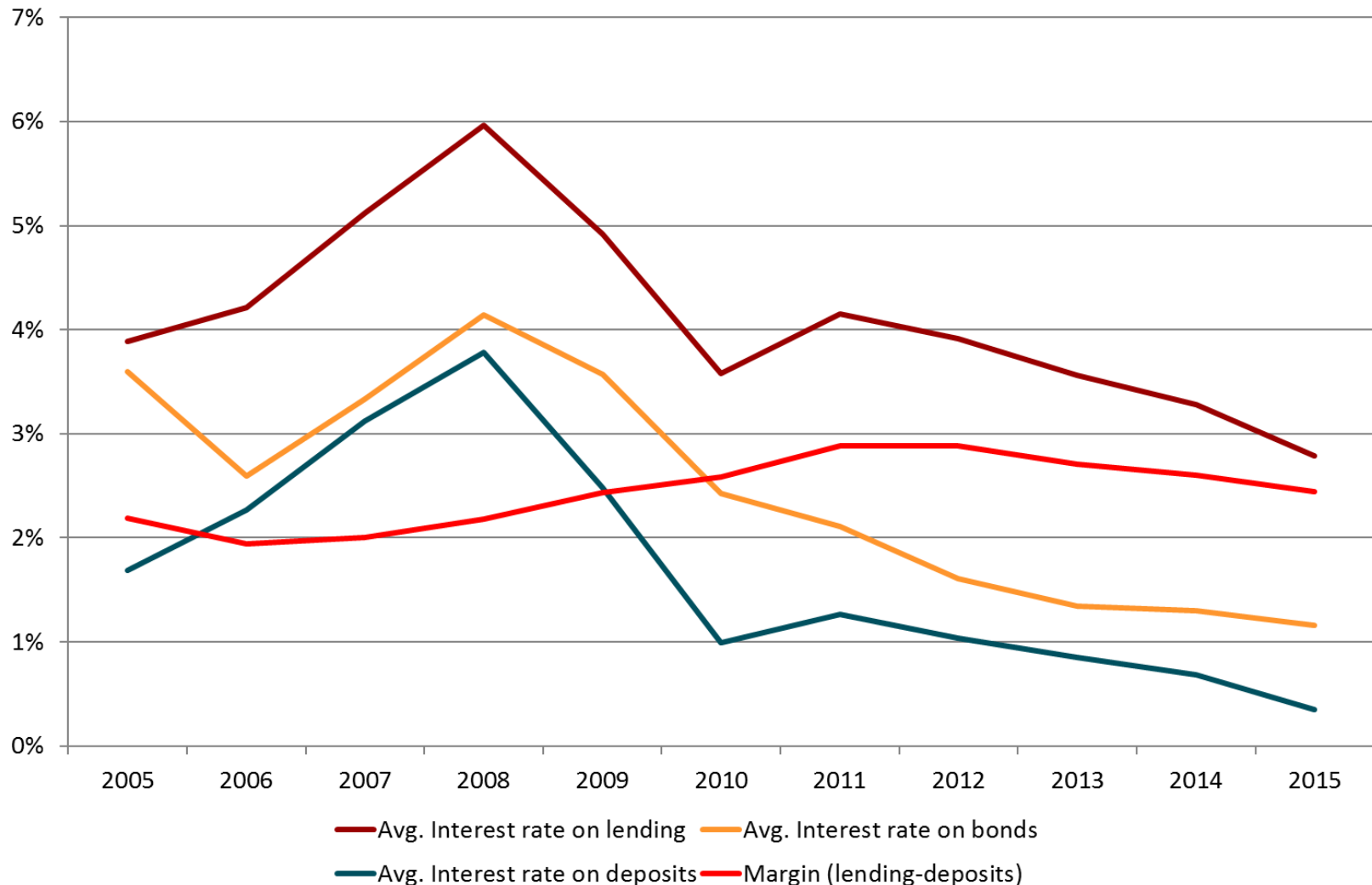
...mortgage credit institutions + pension funds + pegged exchange rate 9

## Deposit surplus is increasing



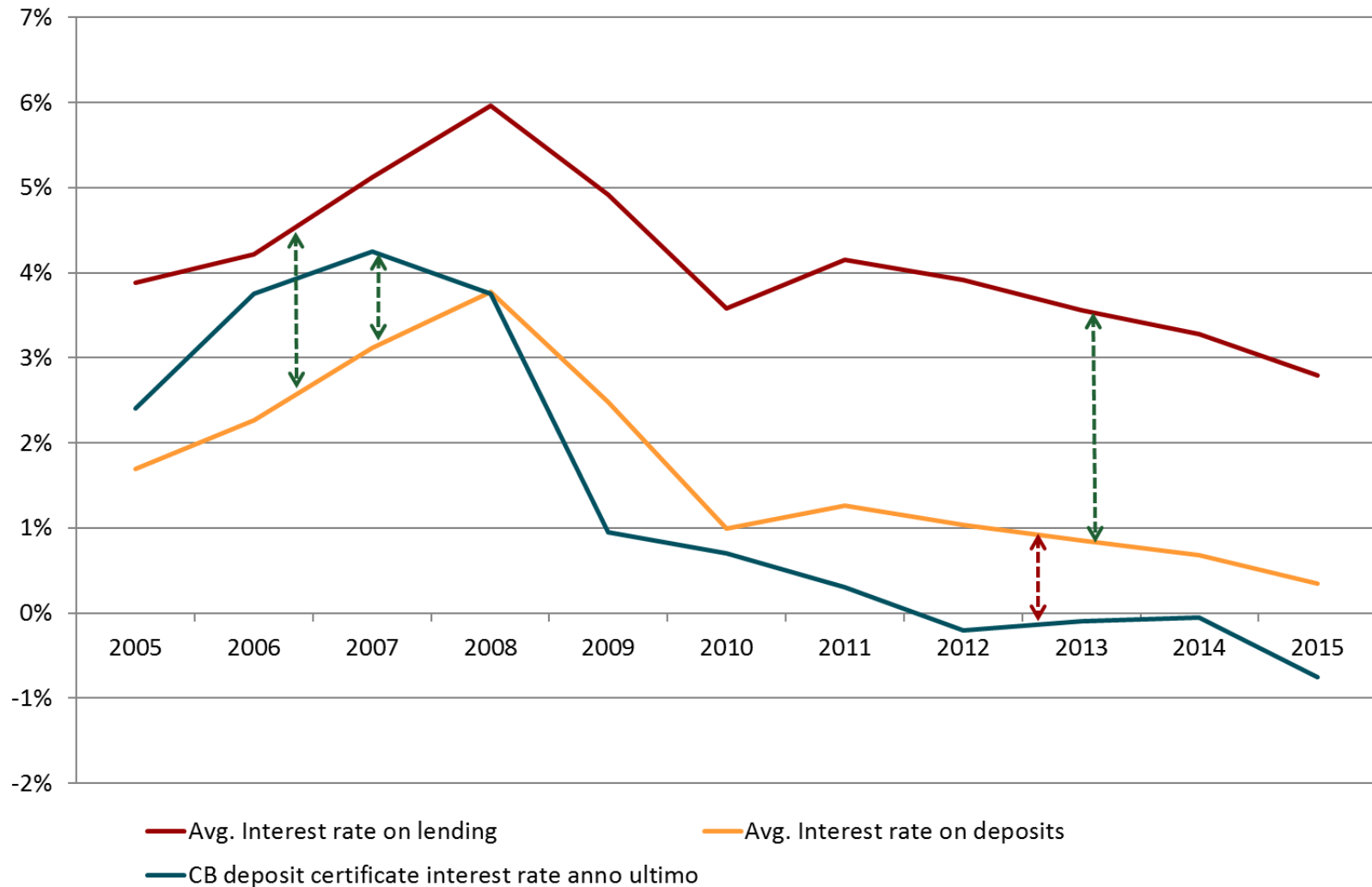
...partly due to the currency interventions protecting the peg 10

# Low interest rates squeeze banks core income



...lending margin only fallen slightly – increased risk premium? 11

## Deposit margins are negative



...while lending margins have increased

## New business areas create new risk types

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- New lending in economic growth areas
- Private banking
- Windmills and alternative investments



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... and require appropriate skills

## A strong board

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- Finanstilsynet have previously evaluated the boards in credit institutions.
- Going forward we will focus on boards having the right competencies and the ability to challenge management.

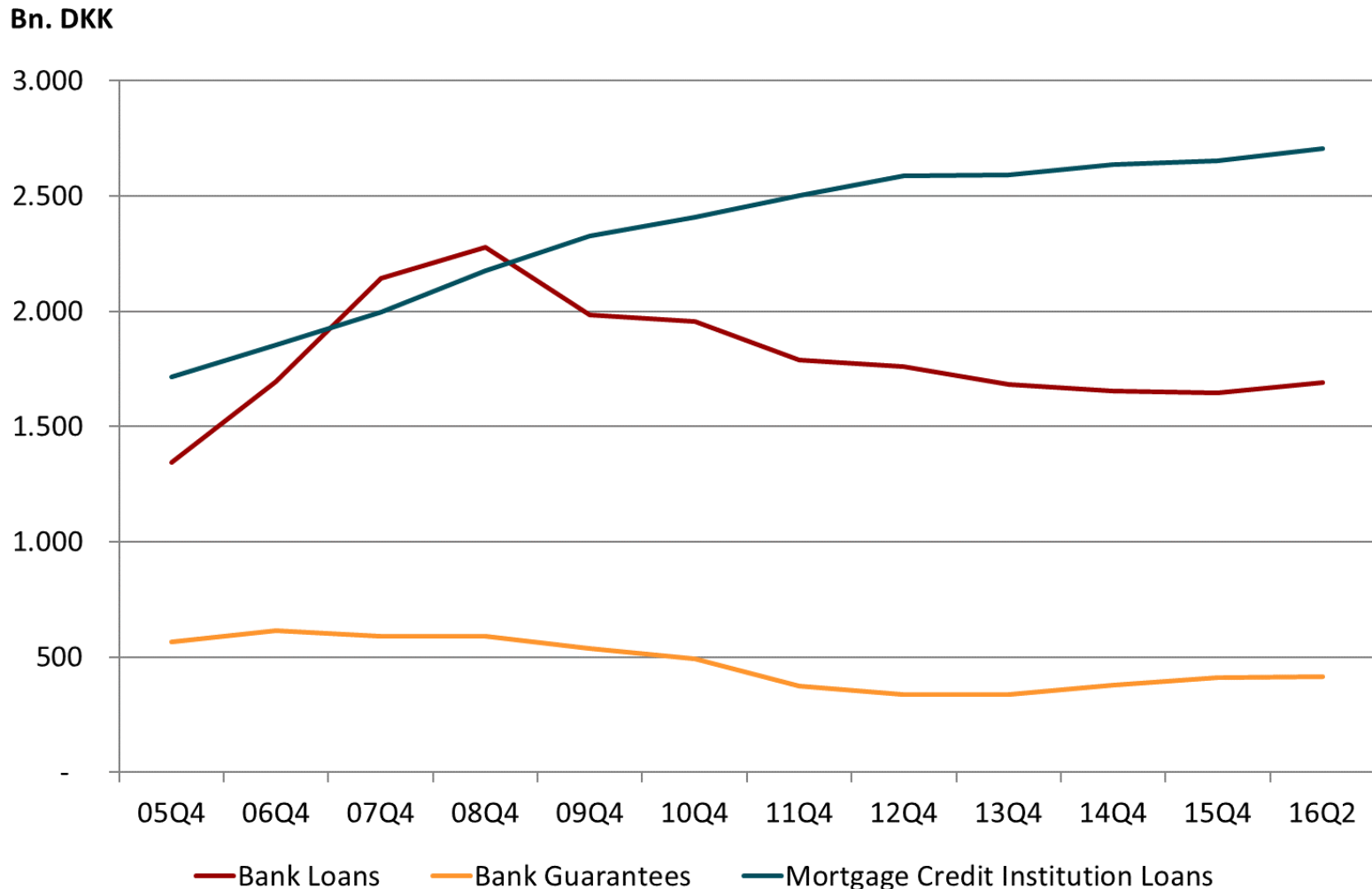


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... is an important counterweight to management

# Housing market developments and lending

## Bank lending has fallen since the financial crisis, but is now slightly rising

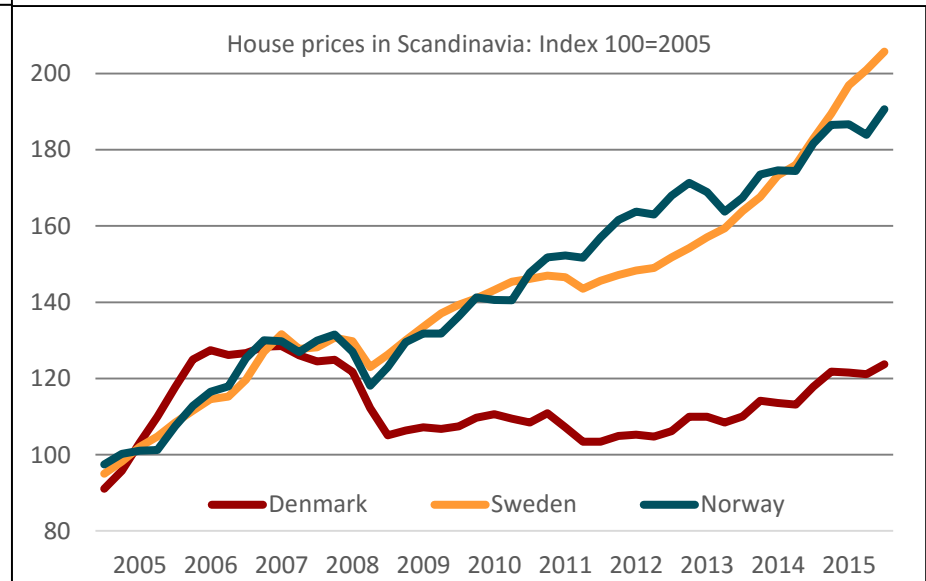
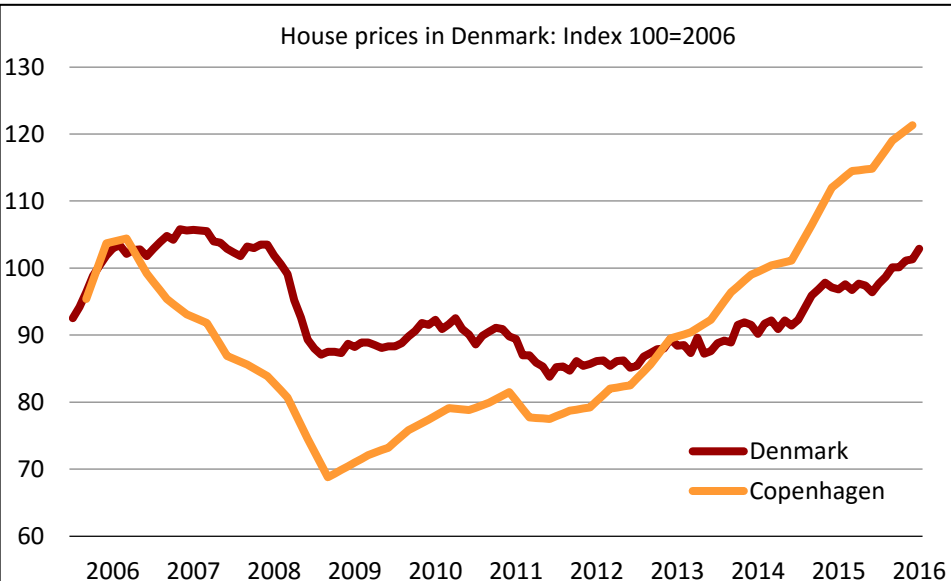
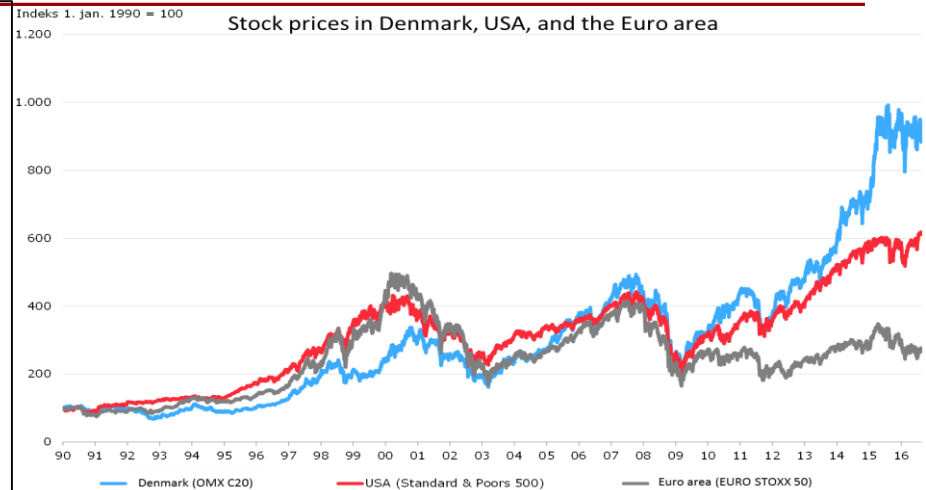
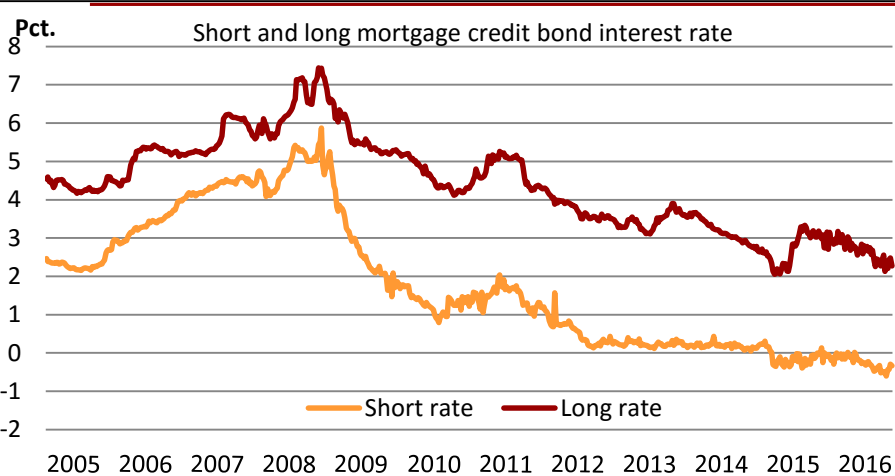


... while mortgage credit lending continues to increase



# Interest rates drive asset prices

Source: Danish Central Bank



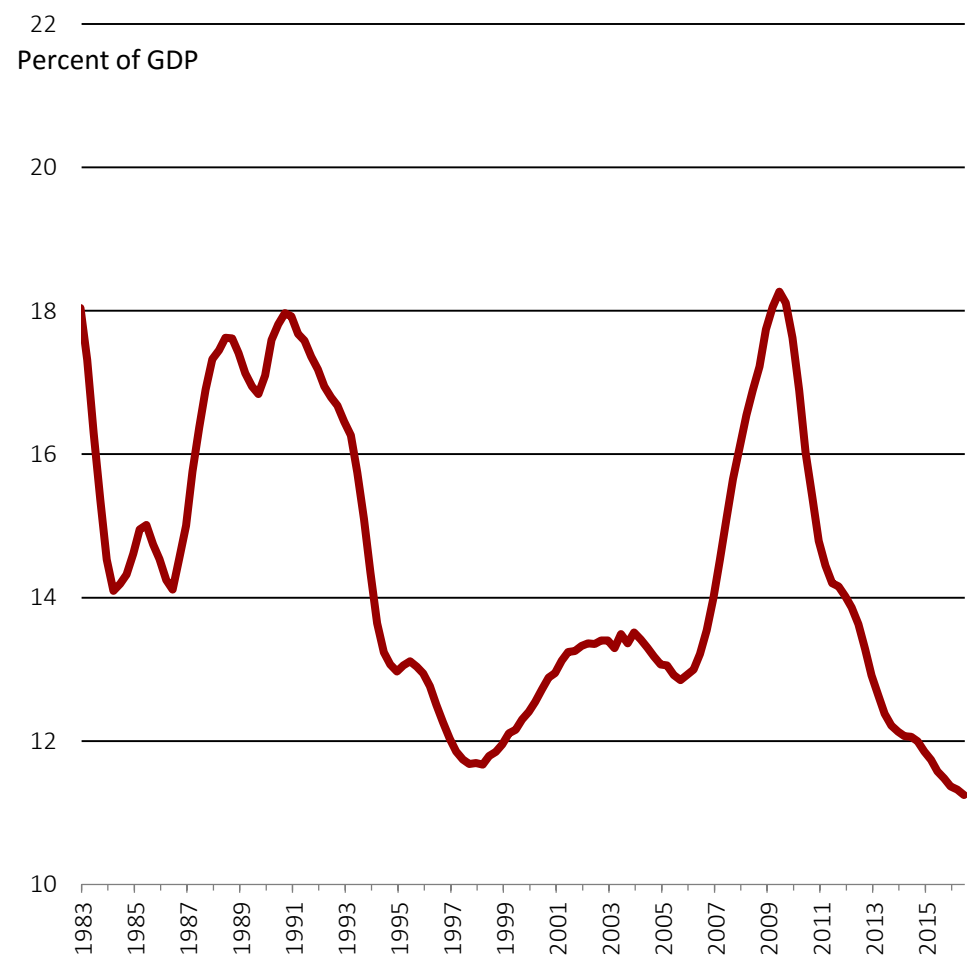
...property prices still more moderate in DK than in S and N 17

# Metrics for property prices and debt service ratio not dramatic

Houseprice to income



Debt service ratio: Households and non-financials



Source: Danish Central Bank

...however, prices have increased in major metropolitan areas

## Steps taken to limit froth in real estate market

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- 95 percent LTV limit for lending for residential real estate
- Mortgage banks shall increase share of loans with amortisation payments and reduce borrowers interest rate risk (supervisory diamond)
- **7 best practices mostly aimed at metropolitan areas, incl.:**
- Banks shall assess the robustness of the costumer's disposable income at higher interest rates than those prevailing,
- demand some form of amortisation if there is negative net assets or interest only loans,
- be especially cautious when lending to coops.
- The Danish Systemic Risk Council is assessing the need for further measures based on a public consultation that will end very soon

# IFRS 9

## New accounting standard – IFRS9

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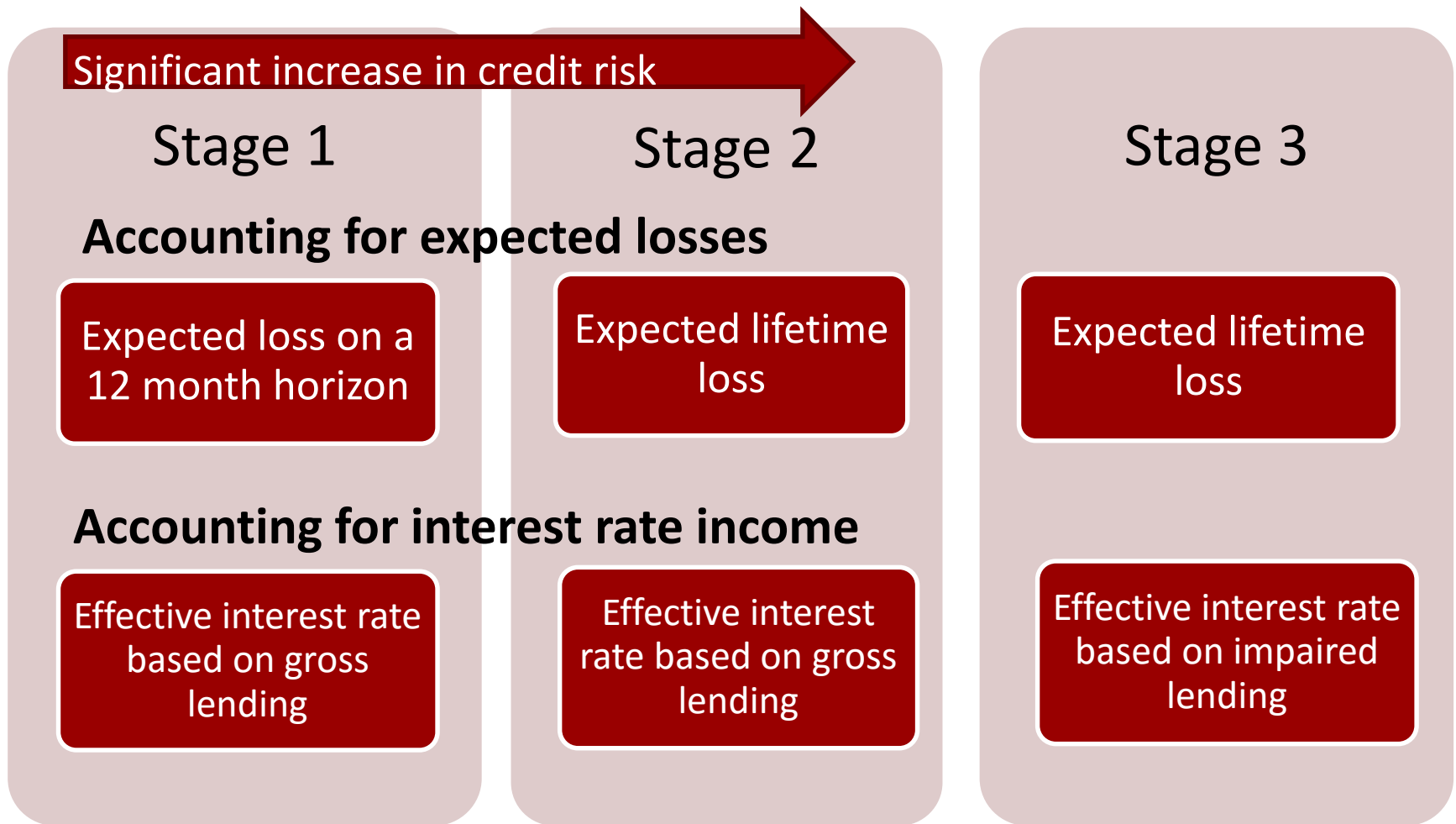
- The existing impairments model featured impairments at “incurred losses”, which turned out to be too little and too late during the financial crisis.
- The impairments model therefore moves from incurred to expected losses.



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... earlier recognition of potential losses

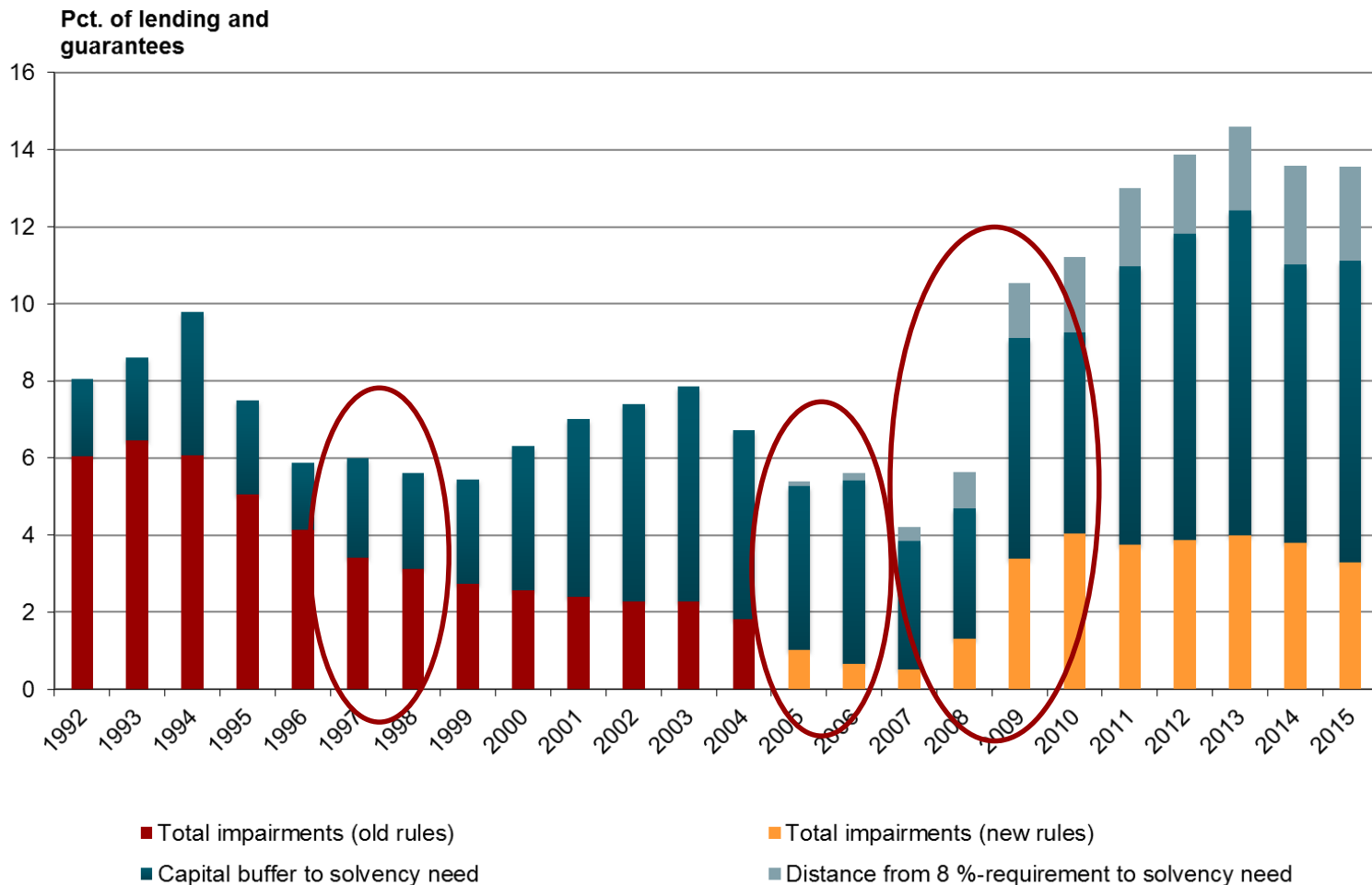
## 3 stages in the IFRS9 impairments calculation



...will increase impairments

# Still a need for cautious accounting standards

## Impairments and solvencybuffer as share of lending and guarantees

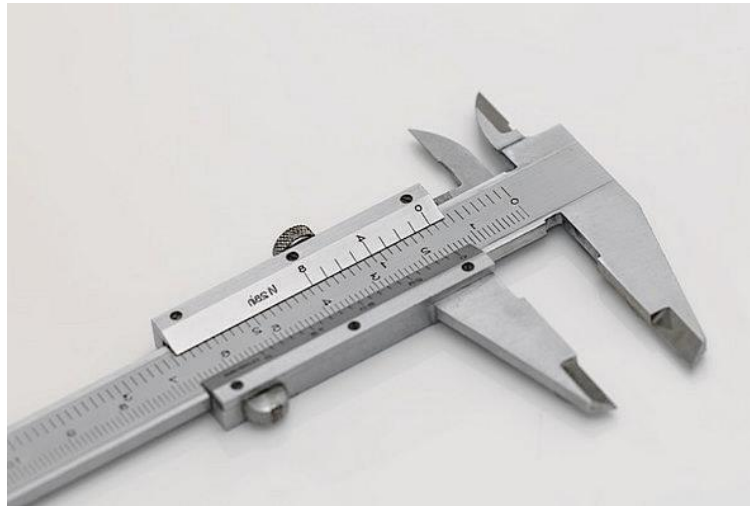


... before and after IFRS9

## Updating of impairment rules

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- Important, that:
  - there will be no easing of the impairment rules when adapting to IFRS9
  - there will continue to be sufficient precision in the rules

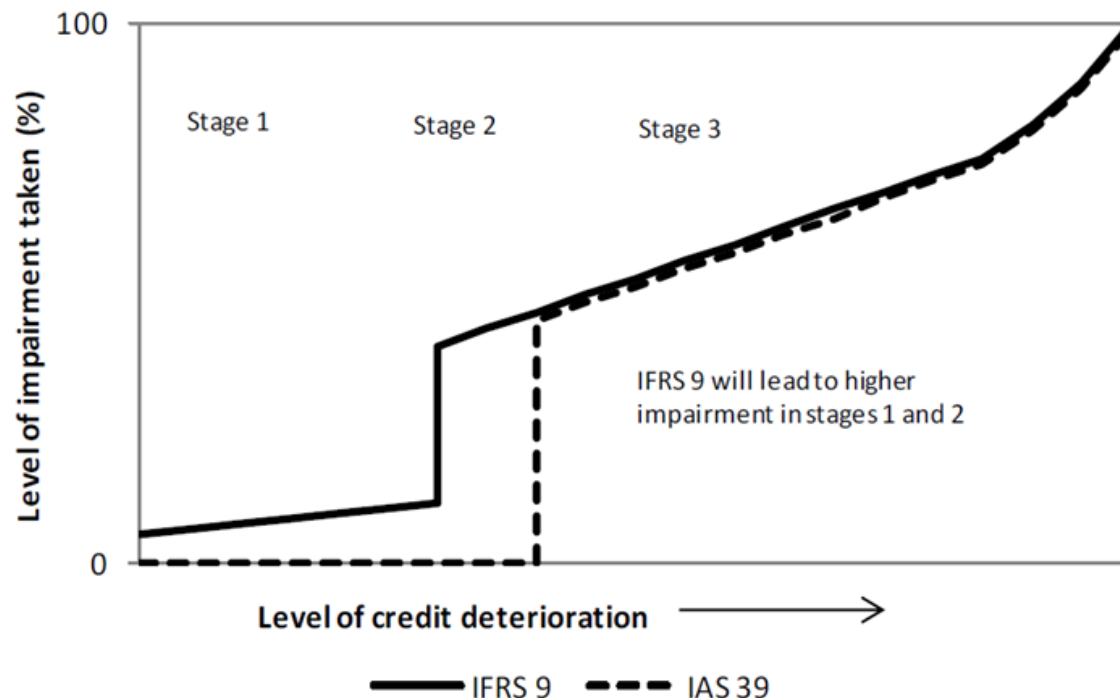


- It is easier to find solutions for solvency challenged institutions, if there is clarity about the value of the lending book



## IFRS9 impact assesment: Provisions and CET<sub>1</sub>

- EBA impact assesment of 58 EU institutions (Nov. 10 2016):
  - The estimated increase of provisions is, on average, up to 18% and up to 30% for 86% (75th percentile) of respondents.
  - CET1 ratio is estimated to decrease by up to 75 bps for 85% (75th percentile) of respondents.

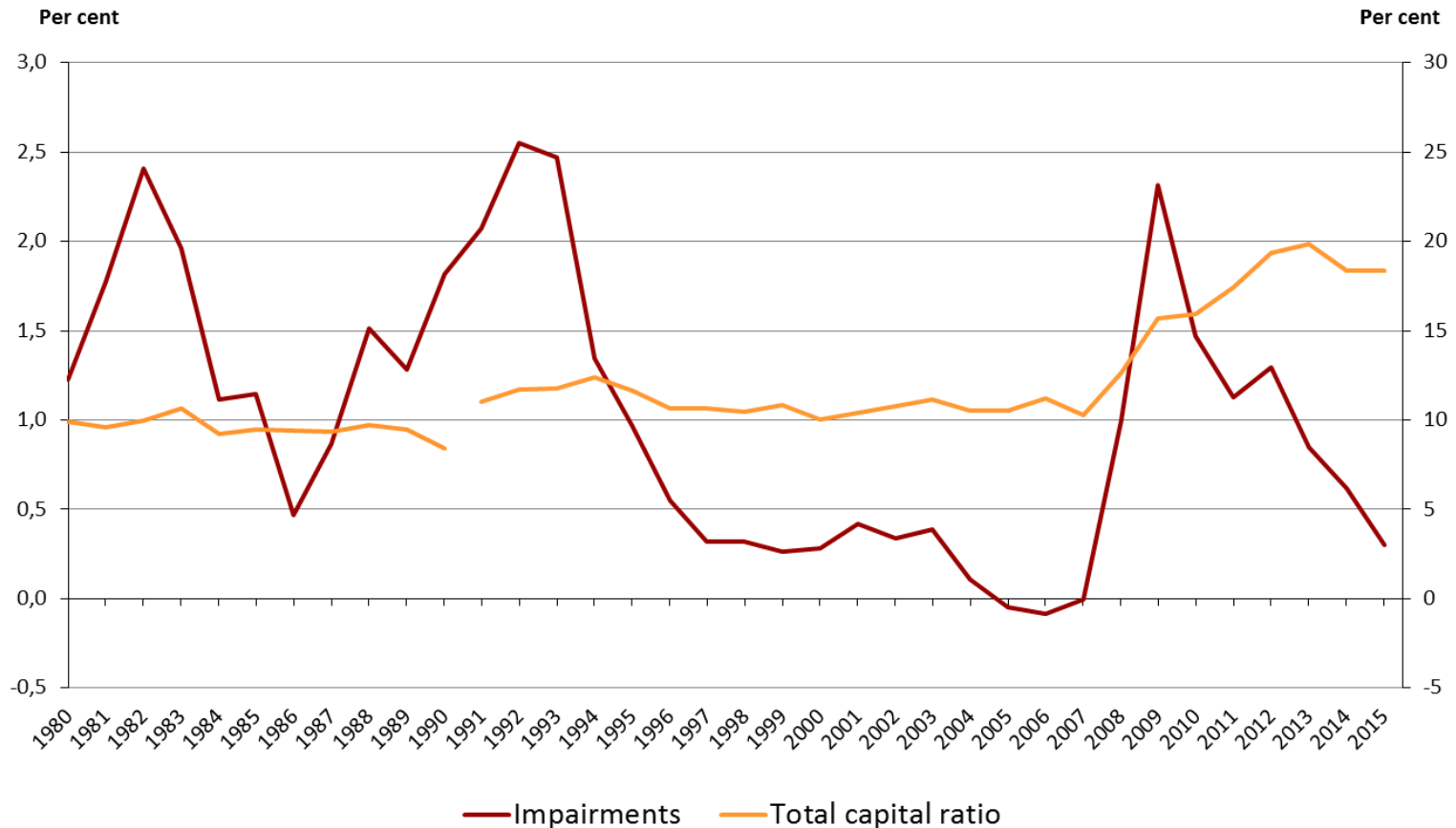


...new stage 1 and 2 provisions, yet consequences seem manageable 25

Capital target and dividend payouts –  
competition is good, but not on payouts

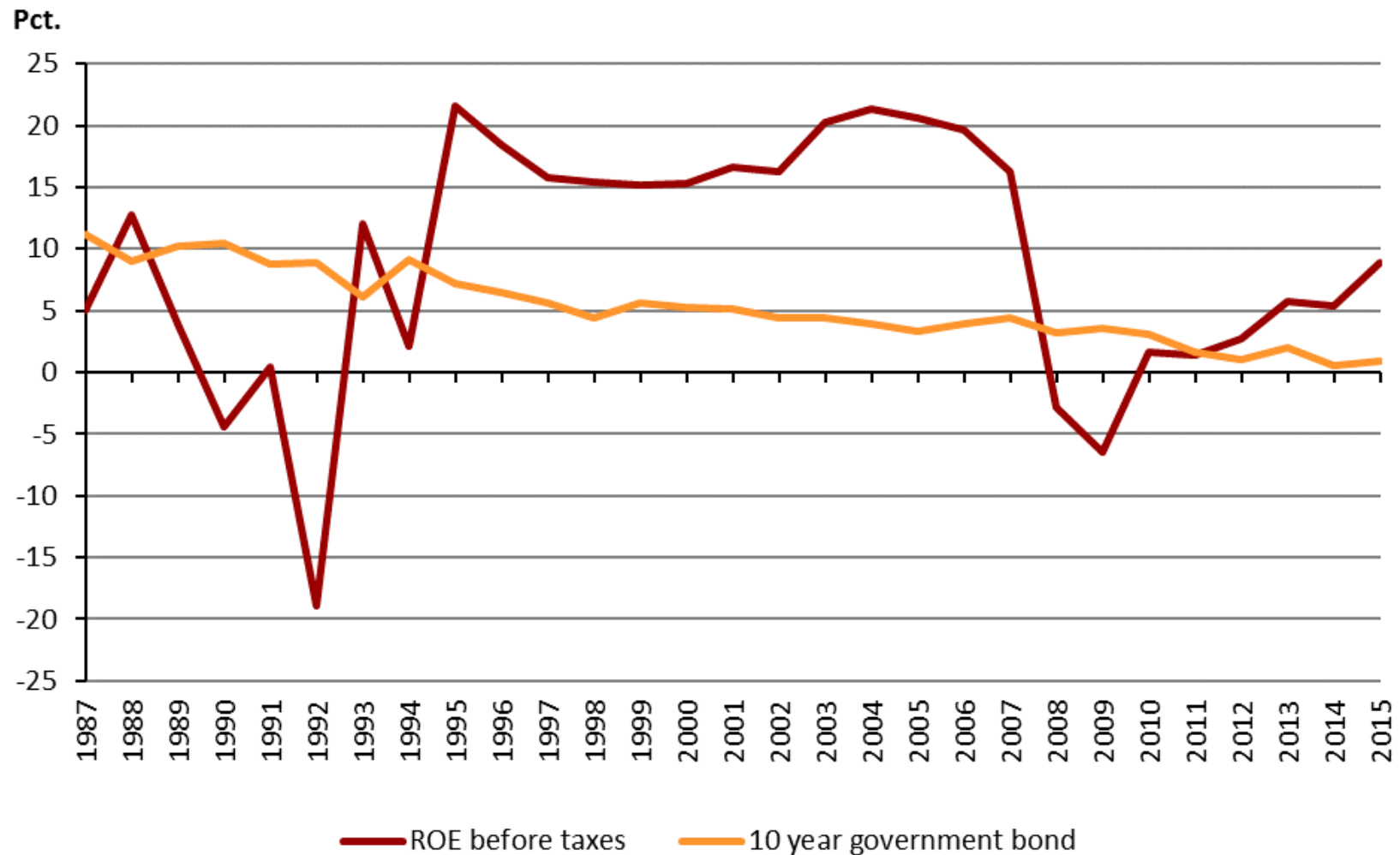
## Credit institutions' capitalisation have improved since the financial crisis

Banks' impairments and total capital ratio 1980-2015



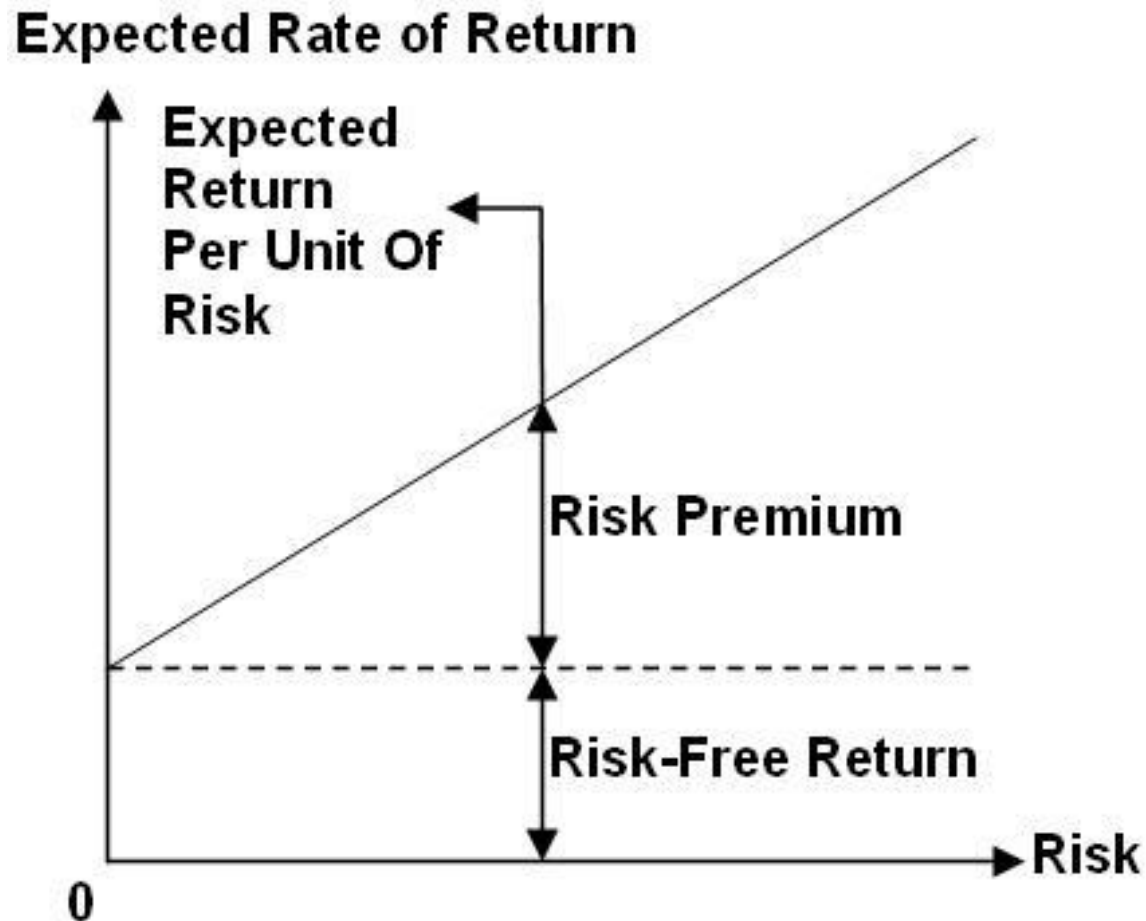
*Note: Solvency rules after 1990 is based on Basel-standards*

## ROE expectations



... increasing ROE, but probably not mean reversion

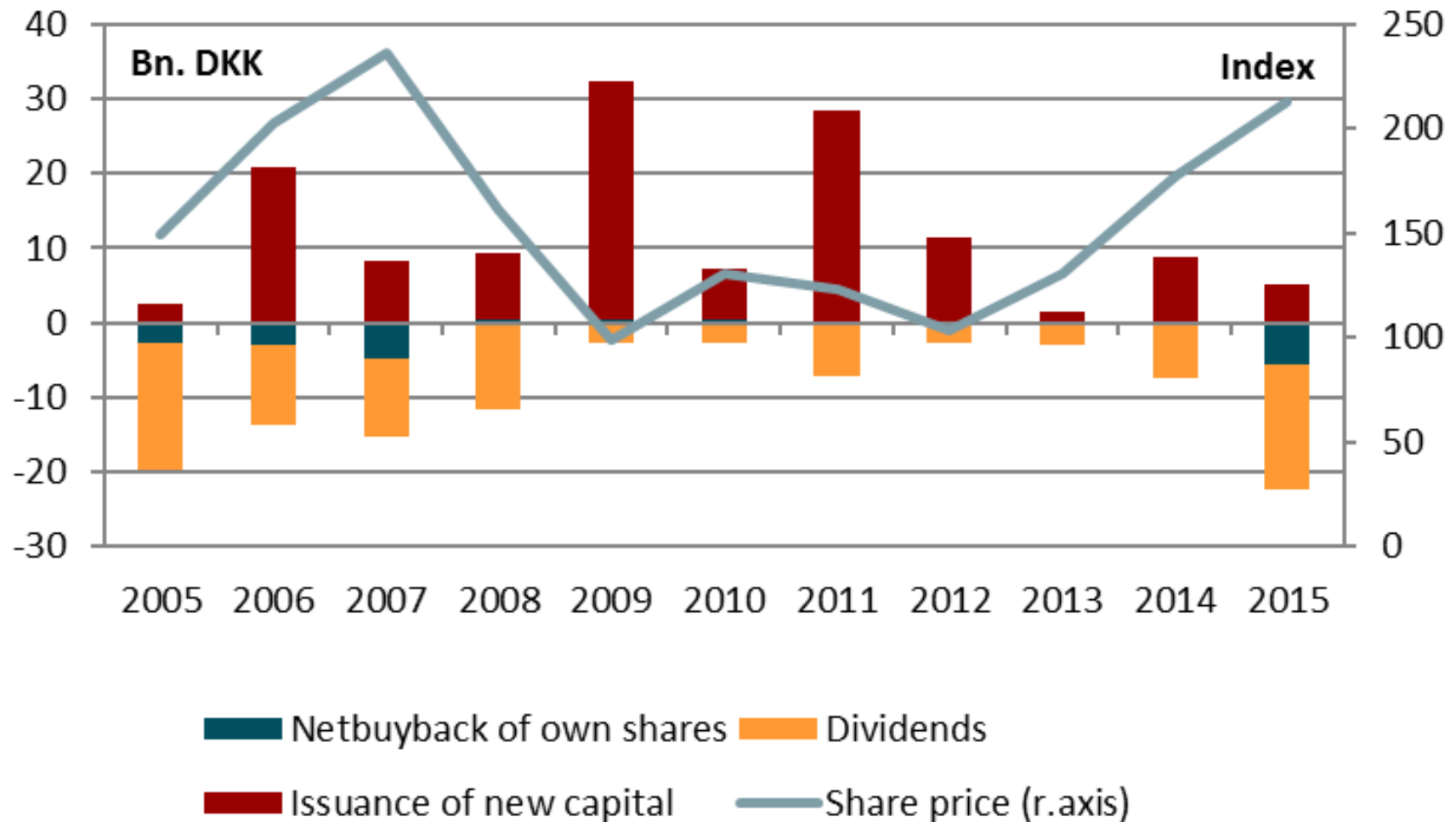
## High expected rates of return in spite of negative risk-free return



$$\text{Expected Return} = \text{Risk-Free Rate} + \text{Risk Premium}$$

... might result in excess risk taking

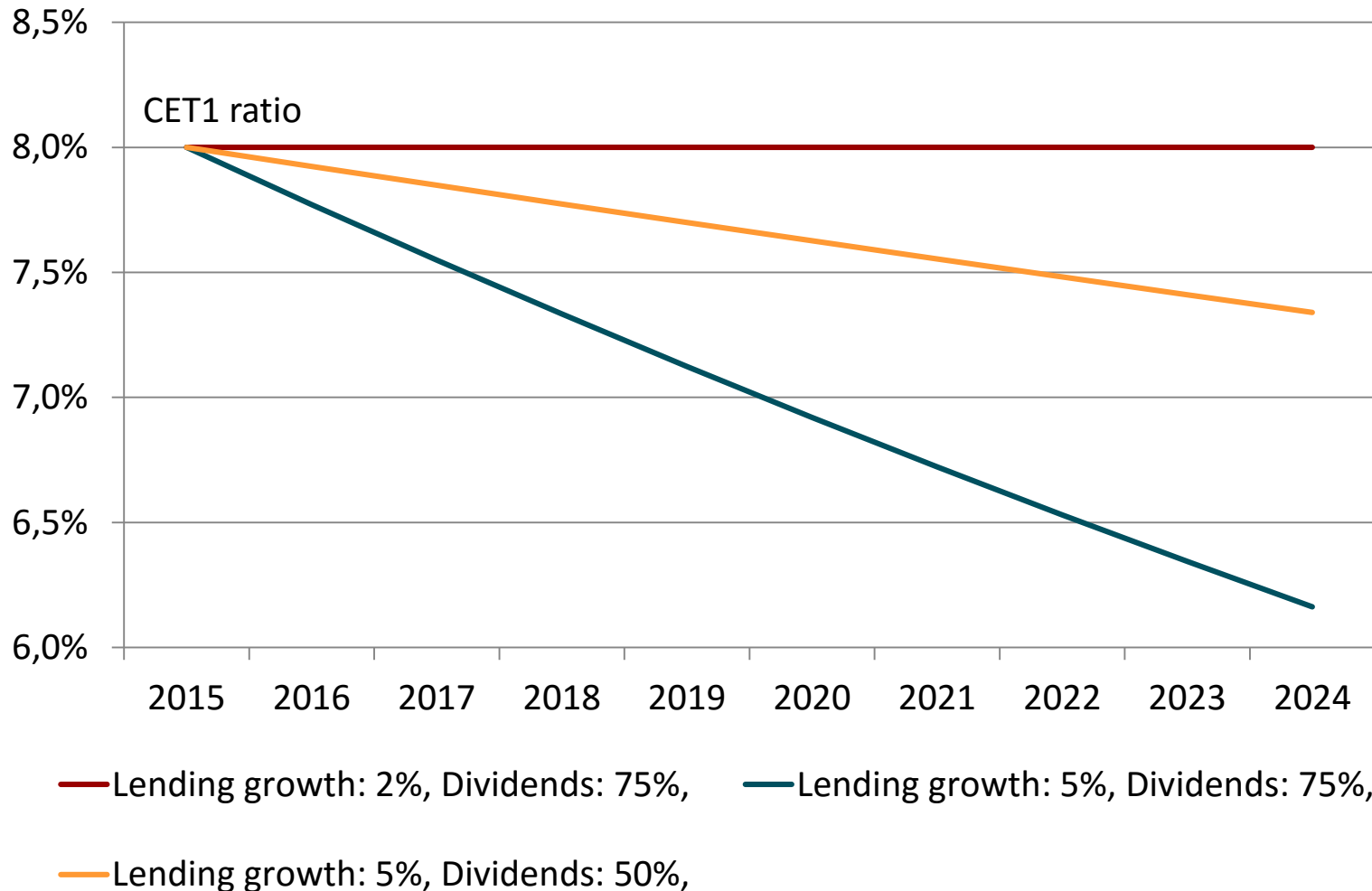
## Sector dividends and share buybacks since 2005



... timing is not optimal for shareholders

# High payouts decrease capitalisation

Development in the CET1 ratio at a return on equity of 8 pct.



... continued room for growth in lending?

# New international regulation and requirements



## Still new regulation in the horizon

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...still a large degree of uncertainty

## Denmark is an outlier on pensions & insurance and mortgage credit

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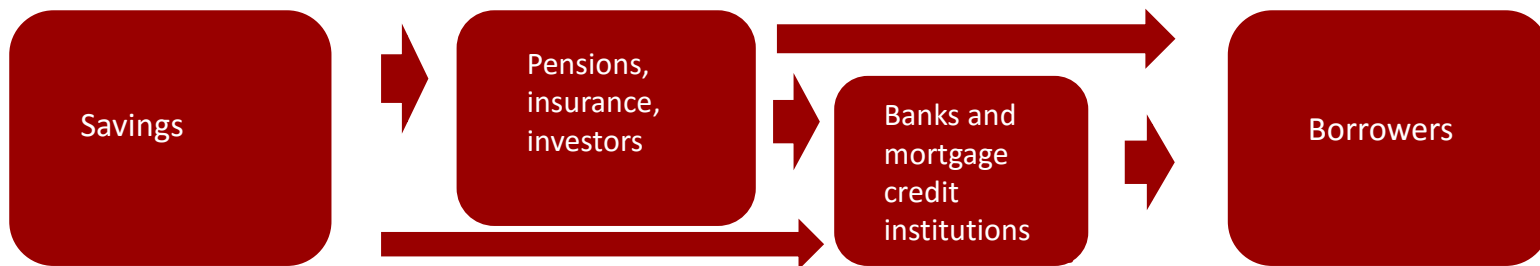
### The US model



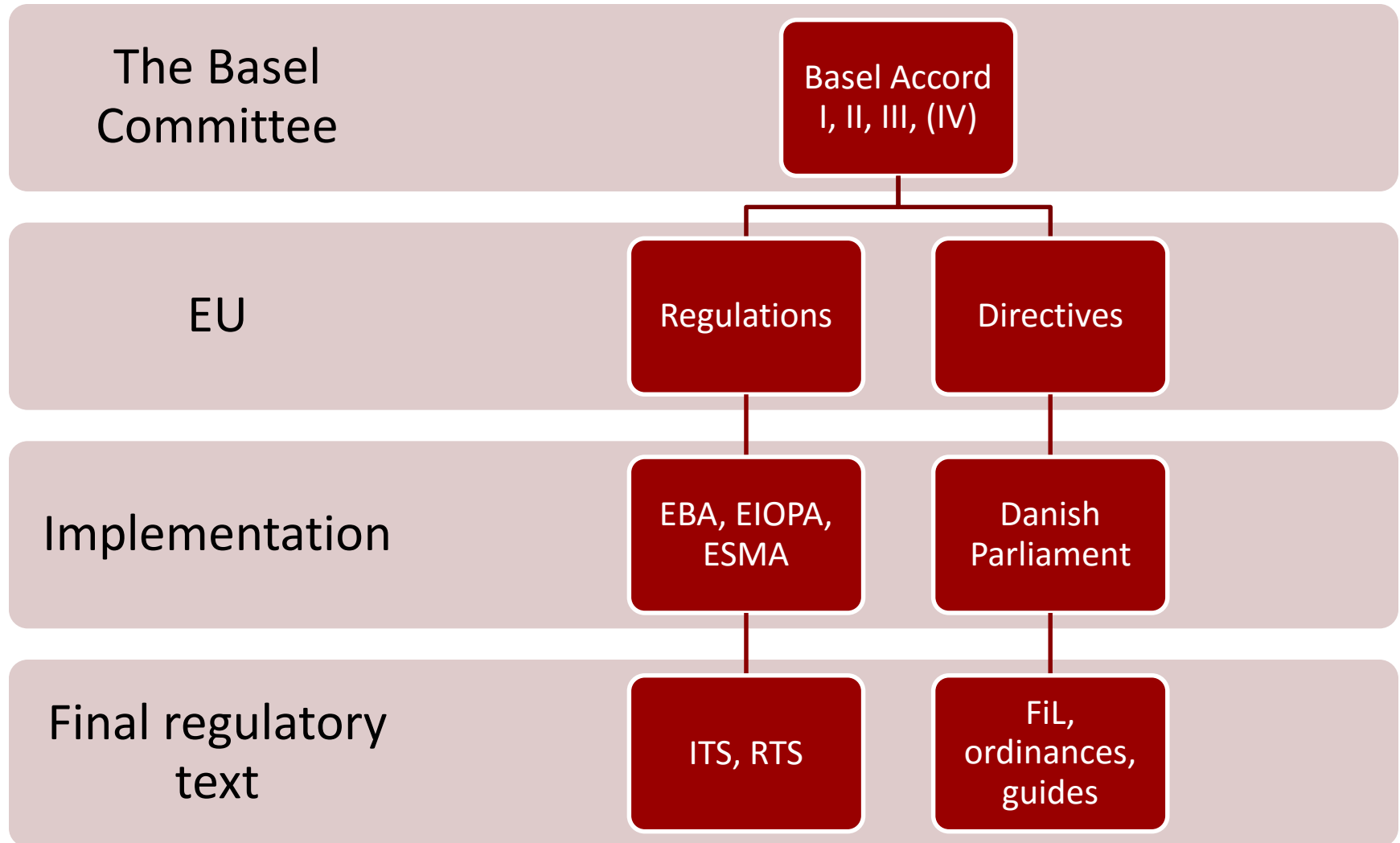
### The European model



### The Danish model



# Financial regulation: From the global to the national



... we aim for a principle of proportionality

## New standard method for credit risk and IRB REA-floor (Basel 4)

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- The Basel Committee published a revised proposal for a new standard method for credit risk in december 2015.
- The proposal contains requirements that are both harder and softer depending on the credit categories and bank type.
- Still uncertain what will happen in the EU.
  - The EU Commissioner and government ministers from important EU countries have expressed critique and doubt concerning the Basel 4 proposals.

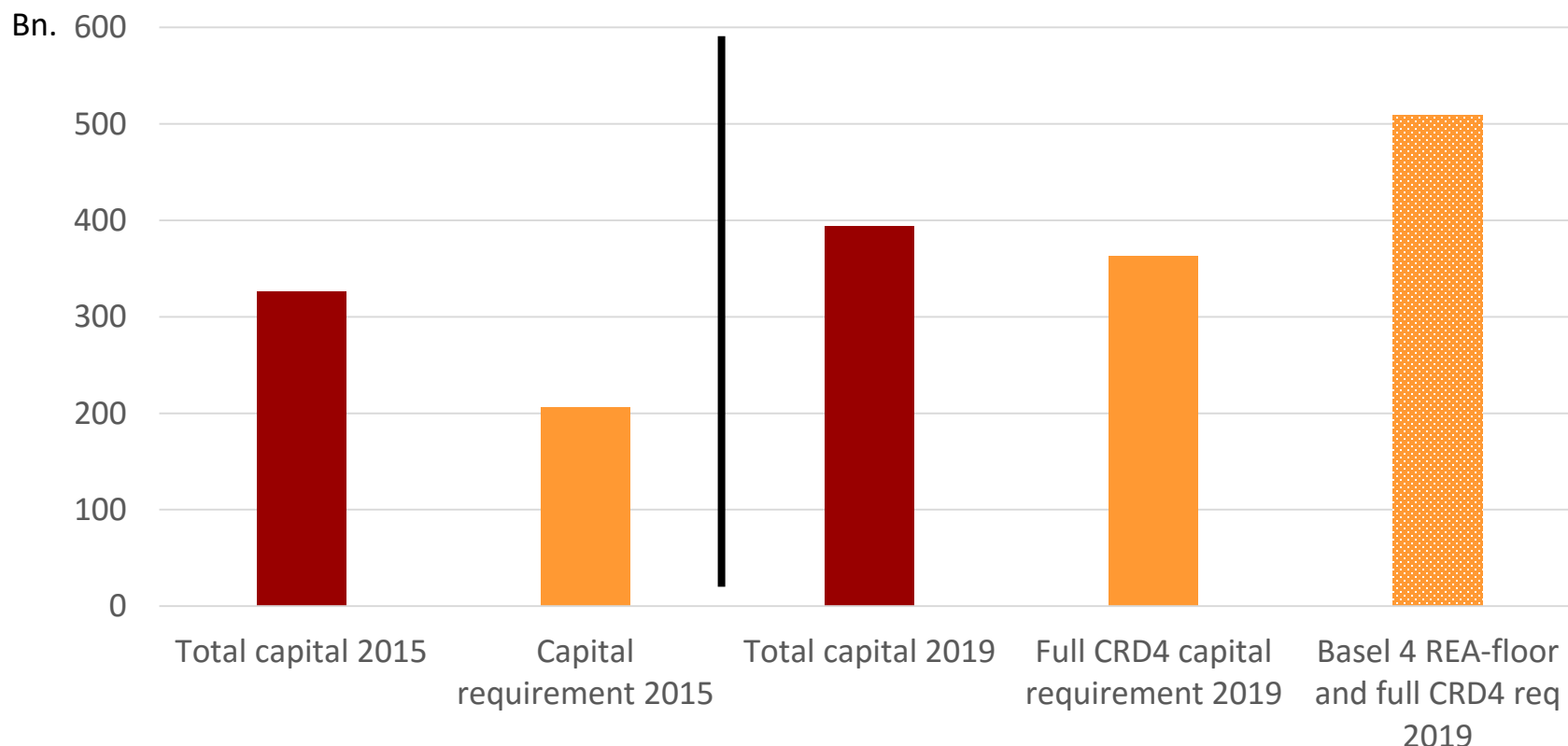


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...likely that changes give a higher capital requirement for Danish banks 36

## Possible effects of new IRB REA-floor for DB, NK, NB, and JB consolidated

The Basel minimum capital requirement, based on the new revised standard method, might become a floor under REA-weights rather than capital amount.



...potential total capital shortfall of 116 bn. DKK in 2019

# Resolution and MREL

## Resolution mechanisms and bail-in

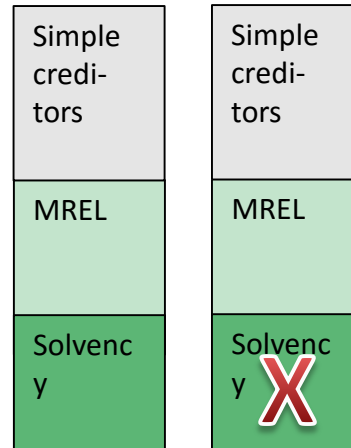
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- Going forward: Losses are taken by the banks (stockholders, creditors, etc.) – not the state
- Approach to resolution: Minimize the risk of losses for simple creditors
- That requires padding – therefore MREL-requirements
- EU development: MREL is subordinated to simple creditors



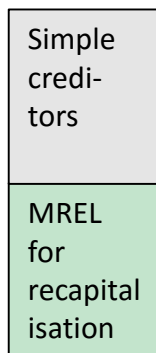
# When the plug is pulled

## 1. Before 2. After (Loss)



## Institution in resolution

### 3. Resolution



Simple creditors  
**do not take losses**  
(But only if MREL  
is subordinated)

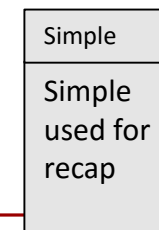


## Institution NOT in resolution

### 3. More losses



### 4. Resolution

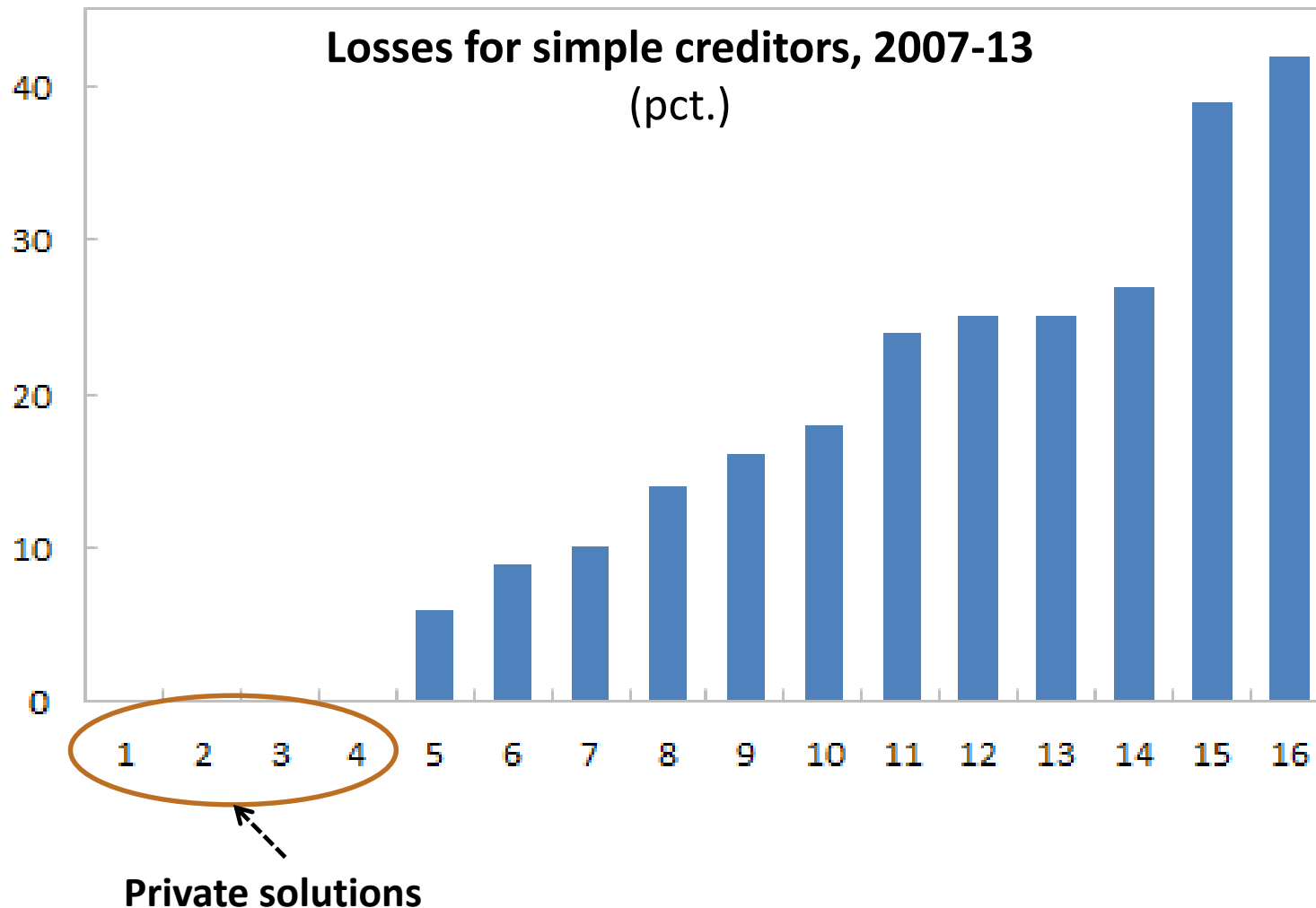


Simple  
creditors  
**take losses**

... is currently at Finanstilsynets discretion



## How high should the MREL requirement be?



... when history shows potentially serious losses

## What actions will Finanstilsynet take when MREL comes to term

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- Countdown from 365 days
- Difficult to issue in times of crisis
- Contagion to other credit institutions



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... and there is a risk of creditor displacement?

# New strategy: Justified confidence

## Justified confidence



Citizens and corporations should make financial decisions with justified confidence in the Danish FSA's safeguarding of their interests

# Justified confidence

## BENCHMARKING DENMARK



The indicators show how Denmark's deviates from the peer group, which consists of Finland, Germany, the Netherlands, Norway, Sweden and the UK. A score above 1 indicates that Denmark is doing better than the peer group. With regard to financial stress, the peer group is the Eurozone.

- *“Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time.” – Arrow*



# 7 strategic focus areas

1.

Supervision in  
good times

2.

Supervision  
with a systemic  
perspective

3.

Well-functioning  
capital markets

4.

Technology,  
cyber risk and new  
business models

5.

Consumer  
protection

6.

Safeguarding  
Danish interests in  
international fora

7.

Prevention of  
money laundering  
and financing of  
terrorism



# Supervision in good times

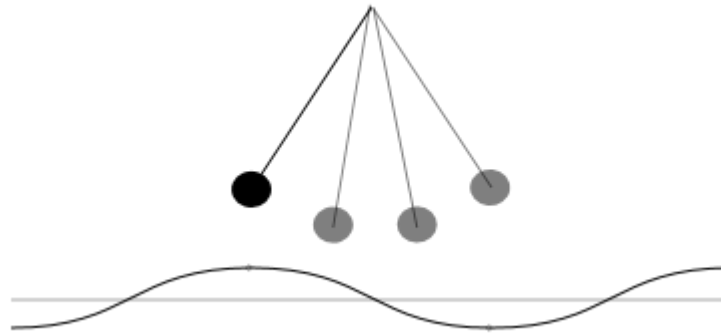


We must be Denmark's financial memory.

## Continued caution in spite of smaller profits

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- The pendulum will swing back and impairments will increase once more, regardless of prudent lending.

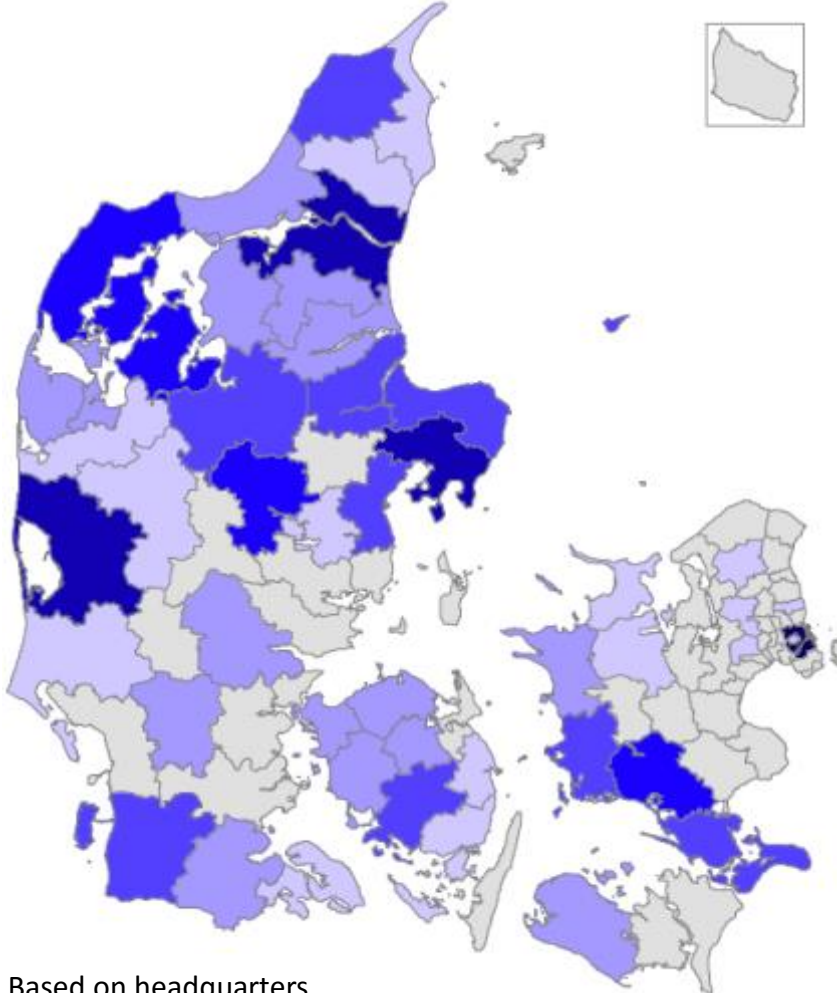


- We have yet to see the last crisis.
- But next time it should not be a bank crisis.

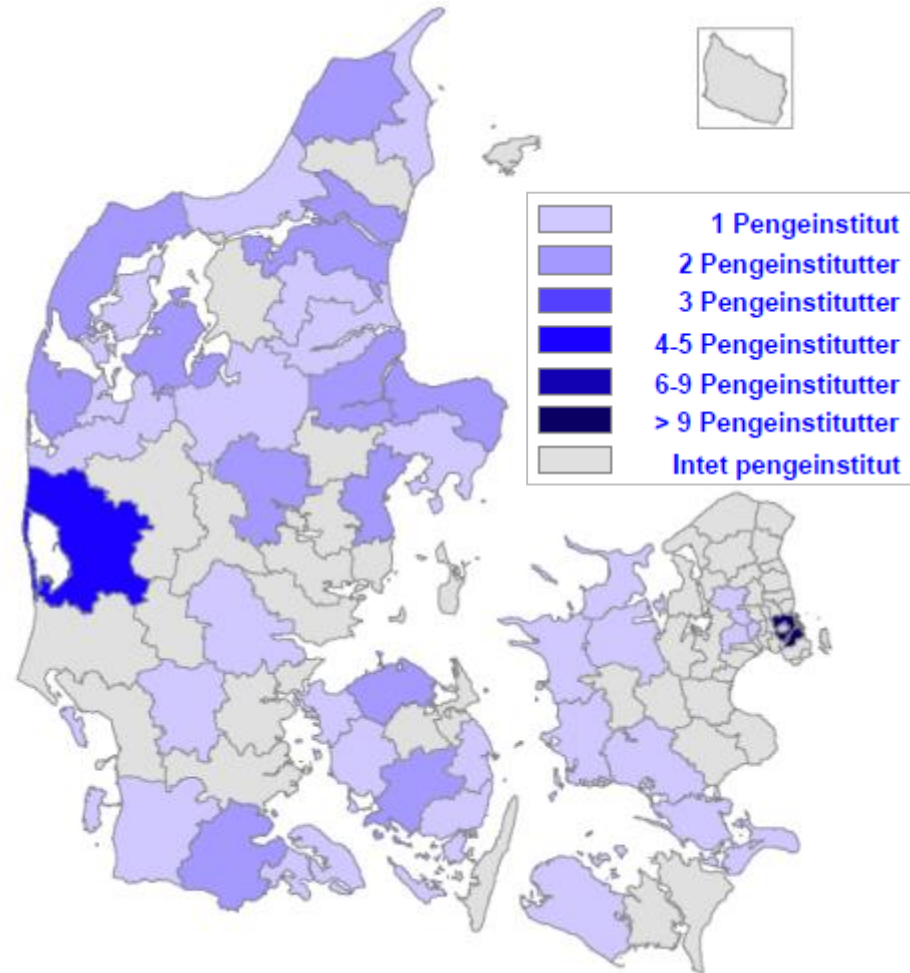


# Commercial banks in Danmark – before and after the crisis

Ultimo 2007: 145 Commercial banks



Ultimo 2015: 75 Commercial banks



Based on headquarters

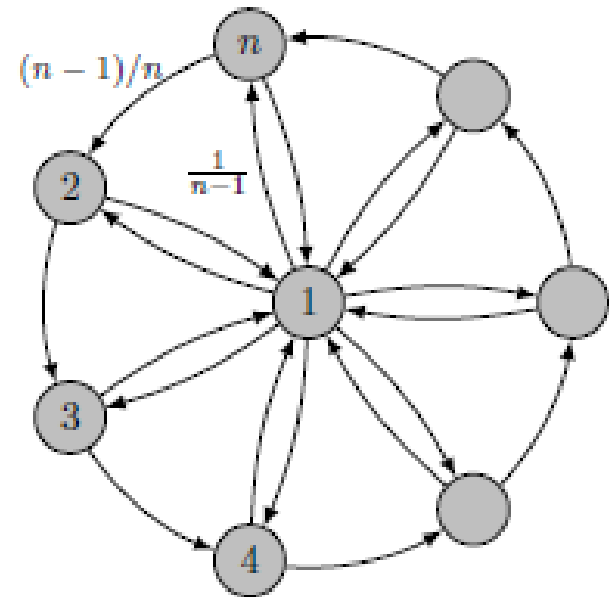
Fewer commercial banks – but still locally and regionally based institutions left

## Supervision with a systemic perspective



Data and analysis ensure that  
risks are seen together.

# Vulnerable, connected and complex system





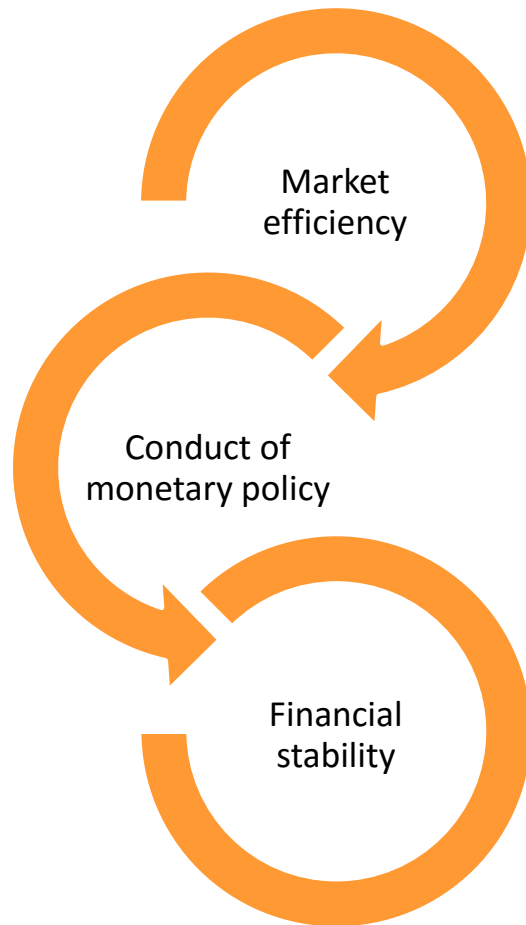
# Well-functioning capital markets

Possible sources of finance  
should increase without  
damaging financial stability.



# The role of liquidity

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A liquid market requires many ingredients.....

- ✓ Competitive market structures
- ✓ Minimization of transactions costs
- ✓ Low fragmentation
- ✓ Sound infrastructure
- ✓ Heterogeneity of market participants



# Technology, cyber risk and new business models



Increased focus on supervision of new tech-based business models and cyber risk in the financial system.

# Digitalisation and new business models is already happening



... to be or not to be disrupted?

# Consumer protection

1. Consumer knowledge
2. Information and counselling
3. Products and conditions







## Safeguarding Danish interests in international fora

We shall safeguard Danish interests by stepping in in the early phases of negotiations, when topics and frameworks are decided.

# Prevention of money laundering and financing of terrorism

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

- <https://www.finanstilsynet.dk/Om-os/Strategi2020>