The Danish FSA

11 September 2014

More robust property financing

The supervisory diamond sets out a number of indicators that the Danish FSA initially considers to be mortgage-credit activities with a higher risk profile. The indicators have been set so that, on the one hand they counteract excessive risk assumption, and on the other hand they make it possible for resilient institutions to carry out profitable activities within the benchmarks and offer the credit required to undertakings and households, cf. Annex 1.

In order to provide mortgage-credit institutions with sufficient time to organise themselves, the indicators for interest-only loans and loans with short-term funding will be phased in so that they apply from 2020. The other indicators will apply from 2018.

The proposed supervisory diamond is now subject to public consultation until 8 October 2014.

Alongside the supervisory diamond, two additional initiatives will be launched to counter risk of price bubbles on the property market, cf. Annex 2 and 3. One of these initiatives is a requirement that home buyers will generally have to make a down payment of at least 5% when purchasing a home. The other initiative is a requirement that commercial properties must generally be able to generate a positive cash flow before they can be financed. Both initiatives will be implemented through amendments to existing executive orders.

Annex 1. Supervisory diamond for mortgage-credit institutions

1. Introduction

On 18 September 2013, the Committee on the causes of the financial crisis submitted its report "The financial crisis in Denmark - causes, consequences and lessons" to the Danish Minister for Business and Growth (the Rangvid report).

According to the Rangvid report, the committee is concerned about whether the mortgage-credit institutions' own initiatives for reducing the increased risk that has arisen as a result of the distribution of loans with refinancing risk and non-repayment are sufficient to ensure a robust mortgage-credit sector in future. The Committee therefore recommends that the Danish FSA establishes a supervisory diamond targeted specifically at mortgage-credit institutions.

A supervisory diamond for mortgage-credit institutions is a supervisory tool aimed at limiting mortgage credit institutions from assuming excess risk and contributes to the Danish FSA's obligations pursuant to section 344 of the Financial Business Act as part of its supervisory activity to emphasise the individual financial undertaking's business model.

The supervisory diamond sets out a number of indicators that the Danish FSA initially considers to be mortgage-credit activities with a higher risk profile. The indicators have been set so that, on the one hand they counteract excessive risk-taking, and on the other hand they make it possible for resilient institutions to carry out profitable activities within the indicators and offer the credit required to undertakings and households.

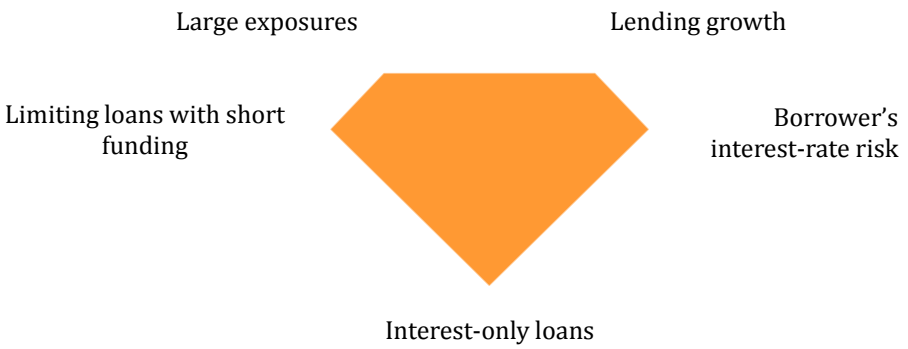
The supervisory diamond is a supplement to the existing solvency rules and addresses risks associated with an unsustainable business model. For instance risks which, due to their scope, cannot be overcome simply with more capital. The supervisory diamond does not alter the fact that the individual institution is still obligated to allocate the necessary and sufficient capital in relation to the risks which the institution assumes.

Institutions that exceed one or more indicators may receive a public risk information after an individual assessment. In more serious cases the institution may be ordered to prepare a statement or ultimately receive an order for the purpose of reducing the risk-taking. However, in all cases this will be based on an individual, concrete assessment according to the rules in applicable legislation. This means that there are no automatic sanctions associated with exceeding an indicator.

2. Indicators in a supervisory diamond for mortgage-credit institutions

The most significant risks facing mortgage-credit institutions1 are related to credit risk for loans and access to the necessary funding. In light of this, a supervisory diamond is established which addresses five risk areas, cf. Figure 1.

Figure 1. The supervisory diamond for mortgage-credit institutions



The individual risk areas are reviewed in the following.

2.1. Growth in lending

High annual growth in lending infers a risk that growth occurs at the expense of credit quality and that a mortgage-credit institution has bad loans on its books.

Experience has shown that above average losses have been specifically detected in situations where a mortgage-credit institution has grown quickly within a specific customer segment. Because of this, the indicator for growth in lending is divided into segments.

Indicator 1: Growth in lending

Growth in lending by segments < 15% per annum

The loan is calculated excluding repos and after loan impairment charges. The indicator includes the following four segments:

1 In the following mortgage-credit institution group context mortgage-credit institution is understood as groups with more than one mortgage-credit institution.

- Private
- Corporate with housing purposes
- Agricultural property
- Other corporate.

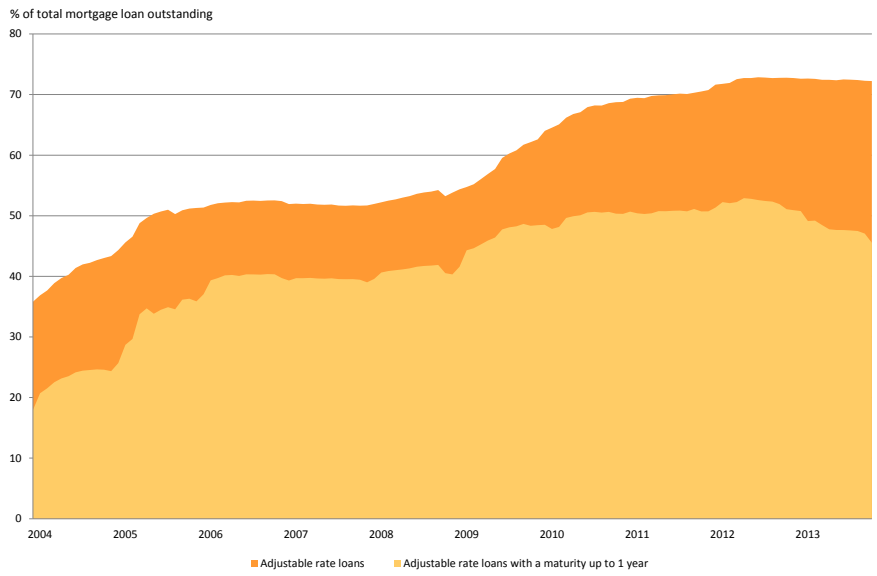
Segments in which the institution has very little lending (under 100% of the institution's total capital) must be disregarded.

This indicator is a particular early warning indicator which will also identify institutions in which there is no need to use the supervisory reactions mentioned in paragraph 4. For example, this may be because the institution's growth is rooted in a strong and sound competitive situation, including an excellent distribution power. Conversely, a higher limit value would mean that institutions that grow too quickly in relation to conditions such as distribution would not be identified.

2.2. Borrower's interest-rate risk:

The percentage of variable-interest loans has risen significantly in recent years. At the end of 2013, the percentage of variable-interest loans amounted to 72% of the total mortgage-credit loans, corresponding to double that of 2003, see figure 2.

Figure 2. Developments in variable-interest loans, 2004–2013



Source: Danmarks Nationalbank (Denmark's central bank) (MFI)

Customers with variable-interest loans with short fixed-interest periods are exposed to the risk that their monthly premium can increase significantly. At the same time, an interest-rate increase will affect many customers at

the same time, which constitutes a considerable concentration risk. The benchmark for interest-rate risk therefore places a limit on how great a proportion of the loan portfolio is subject to a variable interest rate with a short fixed-interest period.

The credit risk of a variable-interest loan is, however, significantly lower if the loan constitutes a low proportion of the value of the property (low LTV[2]). On this basis, the benchmark is formulated so that only loans exceeding 75% of the lending limit (80% for owner-occupied dwellings, 60% for recreational dwellings etc.) are included.

Indicator 2: Borrower's interest-rate risk

The percentage of loans in which LTV exceeds 75% of the lending limit, and the interest rate is fixed for less than two years < 30%.

The indicator only concerns an expanded housing segment consisting of Private and Corporate with housing purposes.[3] For these customers, the interest-rate risk features relatively highly in the risk profile and they have limited options for preventing this risk through other measures. For example in a property letting business there are typically fewer options for passing on interest-rate increases in the rent compared with a traditional business undertaking.

It is also important for a mortgage-credit institution to address the interest-rate risk for general business undertakings and agricultural customers. The diversity of these business have excluded them from the indicator. Instead there will be requirements in the Executive Order on Management and Control of Banks etc. on setting limits and for managing the interest-rate risk.

The indicator is based on the value of the property during the original loan authorisation at the time the loan was offered. This makes the indicator no less restrictive in good periods with rising property values and falling LTV, or more restrictive in bad periods with a decrease in property values and rising LTV. This will also facilitate management of the indicator as a result of the volatility in property prices and thereby also in LTV.

The fixed-interest period is calculated from the time the interest rate is fixed. Loans with a sufficiently low interest ceiling are not included. At the current interest rate level, a sufficiently low interest rate is assessed to

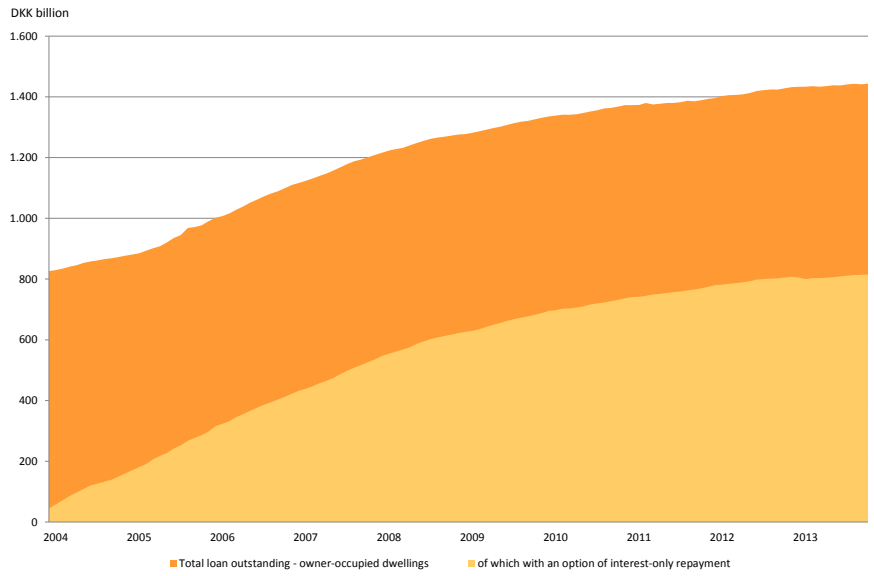
2 Loan-to-value
3 Subsidised building not included.

be 4%4. Loans financed for example with CITA bonds, where the interest rate is set every six months, are included in line with one-year and two-year floating-rate loans.

2.3. Limiting interest only loans for private customers

In the course of a ten-year period, interest only mortgage-credit loans have become the dominant product for private customers. The percentage of loans for owner-occupied dwellings and recreational dwellings where the interest only period was utilised amounted to 56% of lending at the end of 2013, see figure 3. Interest only loans increase the credit risk for mortgage-credit institutions if the households do not use the interest only period to consolidate their position in another way. This applies in particular to high LTV ratios, where the institutions carry the greatest risk of loss in the event of a decrease in property prices.

Figure 3. Development of mortgage-credit loans for owner-occupied dwellings and recreational dwellings with interest only, 2003–2013



Source: Danmarks Nationalbank (Denmark's central bank) (MFI)

The indicator for interest only loans is therefore targeted at a reduction in the institutions' proportion of interest only loans in the higher LTV band.

4 The long-term interest rate plus one percentage point.

Indicator 3: Interest only lending

Percentage of interest only loans in the LTV band above 75% of the lending limit < 55%

The indicator only concerns loans for owner-occupied dwellings and recreational dwellings. Commercial loans are therefore not included. It is also aimed at the part of the lending volume which is in the LTV band above 75% of the lending limit, which corresponds to 60% of the property value for owner-occupied dwellings, and 45% of the property value of recreational dwellings.5

Interest only loans are defined as loans with a interest only option, where the option is currently used. Loans with a interest only option, where this option is not currently used, are therefore not considered interest only loans.

As with the indicator for interest-rate risk, this indicator for interest only lending is based on the value of the property of the original loan authorisation at the time the loan was offered.

2.4. Limiting loans with short-term funding

The aim of limiting loans with short-term funding is to limit the refinancing risk. While the Danish Refinancing Act establishes what happens in a situation where there are not enough investors to perform the necessary refinancing, the indicator in the supervisory diamond proposes to limit the risk of this situation arising.

Indicator 4: Short-term funding

The percentage of lending which is refinanced within a 6 month period must be less than 15% of the total lending portfolio.

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A mortgage-credit institution can meet the indicator both by reducing the volume of loans with short-term floating-rates and by spreading its refinancing auctions throughout the year.

5 As part of the consultation, the Danish FSA is requesting views of the concrete measurement of the loans included.

2.5. Large exposures

From experience, a high concentration risk in which a large part of the institution's exposures are concentrated on few major customers, constitutes a significant risk factor. The supervisory diamond's fifth indicator therefore addresses the customer-specific concentration risk.

Indicator 5: Large exposures

The sum of the 20 largest exposures lower than the Core Equity Tier 1

The calculation and limit of the 20 largest exposures are performed after deductions (e.g. for certain types of collateral with up to 50% of the value of the property). As a result of a fall in the deductions in the event of simultaneous fall in several parts of the property markets, the risk may arise that an institution breaks the indicator. The Danish FSA will demonstrate understanding that rapid adjustments cannot nor should not take place in such a situation.

Under current Danish legislation, deductions for collateral in offices or other commercial premises as well as forestry and agricultural properties have been allowed when calculating large exposures under certain conditions.6 It is expected that this will continue after the introduction of CRR7 for these property types for which deductions can be made – unless there are slightly less stringent conditions.

The supervisory diamond is calibrated based on this assumption. If it transpires that the Danish FSA's test of the property market according to Article 124 of the CRR changes the scope of property types or categories, for which a deduction can be given, the Danish FSA will reconsider the calibration.

The 20 largest exposures are calculated in all cases excluding exposures to financial undertakings under supervision and public authorities.

The application of Common Equity Tier 1 capital as a reference before own funds (total capital), which also includes subordinate loan capital of different types (Additional Tier 1 capital and Tier 2 capital) is because the Common Equity Tier 1 capital is fully loss-absorbing on a going concern basis.

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6 See previous Executive Order on Large Exposures.
7 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 (CRR).

3. Relationship to banks

Using a supervisory diamond for mortgage-credit institutions involves a principle risk that the risky loans will instead be transferred to the banks. This applies in particular to the interest only loans but is also – as far as this concerns a bank issuing covered bonds (SDO)8 – a relevant problem for variable-interest loans (borrower's interest-rate risk) and loans with short-term funding, see benchmarks 2 and 4.

In order to prevent this, independent bank reporting to the Danish FSA will be established in parallel with the introduction of the supervisory diamond for mortgage-credit institutions, under which the banks will be obligated to report the value of relevant indicators in their loans on a quarterly basis.

The Danish FSA will therefore have a uniform opportunity to follow the development of this risk, both to banks and mortgage-credit institutions. Furthermore, the Danish FSA also has the same options for intervention pursuant to legislation. Therefore, it will be possible to create similar competition conditions for banks and mortgage-credit institutions for this type of loan.
In the case of interest only loans, all banks will be obligated to report the value of interest only indicators of their loans against collateral in Danish owner-occupied dwellings and recreational dwellings in the LTV band 75–100% of the lending limit for mortgage-credit loans on a quarterly basis. Monitoring will be directed towards the loans for which the banks are in direct competition with mortgage-credit institutions, in other words diverse forms of mortgage loans. Conversely, the supplementary financing from banks to borrowers wishing to borrow more than 80% of the value of the property for owner-occupied dwellings and 60% for recreational dwellings, which is the limit for mortgage credit lending, will not initially be covered. The latter are thus not in competition with mortgage-credit loans, and in the vast majority of cases it is not attractive for banks to offer these loans with interest only.

In relation to the indicators for borrowers' interest-rate risks (2) and loans with short funding (4) it will only be relevant to follow the corresponding loans in banks issuing covered bonds. Therefore, another independent reporting will be established, and will only cover banks issuing covered bonds.

To the extent that the bank issuing covered bonds is part of a group including a mortgage-credit institution, the group will be obligated to

8 A bank with licence to issue covered bonds (SDO). Currently, only Danske Bank has such a licence.

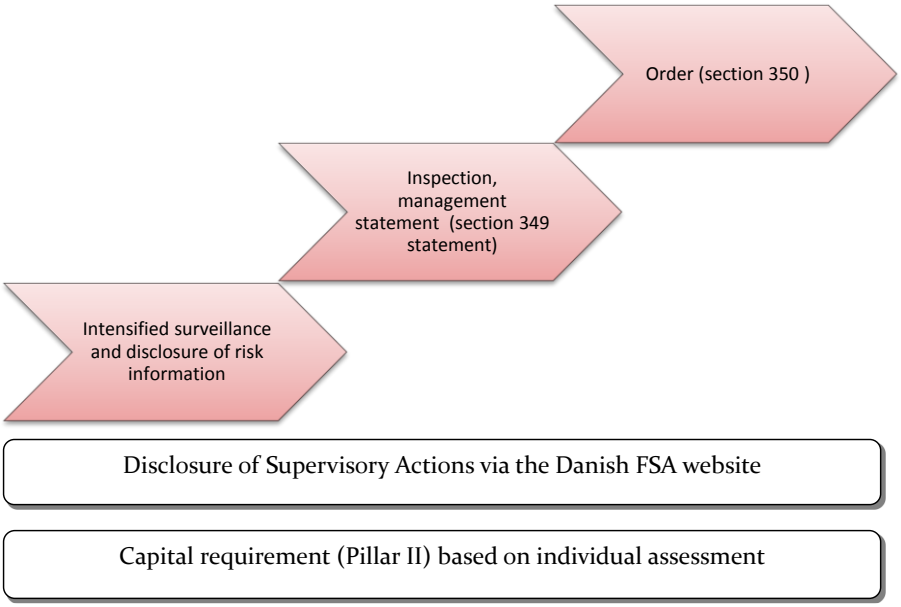
report the two indicators for the consolidated balance sheet financed by covered bonds (SDO), covered mortgage-credit bonds (SDRO) and mortgage credit bonds (RO) to the Danish FSA on a quarterly basis. To the extent that a bank which is not a group company with a mortgage-credit institution may begin to issue covered bonds, this will also be covered by the reporting requirement.

4. Consequences of exceeding the supervisory diamond

From 1 January 2018, institutions will be obligated, see paragraph 5, as a minimum to publish the financial ratios for the supervisory diamond's benchmarks in connection with the annual report and half-year interim report corresponding to what applies to banks, see section 132 b of the Executive Order on Financial Reports for Credit Institutions and Investment Firms, etc. Any breaches will also be available through the quarterly reports to the Danish FSA.

When the limit values for the supervisory diamond are exceeded, the Danish FSA will initiate a dialogue on this with the institution and carry out any supervisory reactions, see figure 4.

Figure 4. Supervisory ladder



All reactions are based on an individual and concrete assessment, in which the Danish FSA will use the least radical reaction based on a

proportionality assessment. The Danish FSA will therefore only use the higher level reactions in more serious situations, e.g. with repeated breaches and a lack of reaction on the part of the institution.

The mildest sanction is more stringent monitoring. More stringent monitoring typically involves the Danish FSA extending regular reporting of the benchmarks when the limit values are exceeded. An institution subject to stricter monitoring can also expect regular dialogue with the Danish FSA on how the institution intends to deal with the breach of the limits. The Danish FSA will carry out an individual and specific assessment of the extent to which risk information must be given in the situations in which the bank exceeds the limit values in the supervisory diamond. The Danish FSA will carry out its assessment under consideration of, for example, mergers, acquisitions, group situations and other conditions that may be of significance to the risk profile.

According to section 2 in the Executive Order on Publication[9], the institution will be obligated to publish any risk statements that the Danish FSA deems to be of significance to the company's customers, other creditors, etc., which will be the case here.

For the next step on the supervisory ladder, the Danish FSA can request the institution to prepare an account of future activities to prevent continued breaches of the limit values in the supervisory diamond.

Under section 349 of the Danish Financial Business Act, the Danish FSA can also order the management of an institution to prepare an account of the financial position and future prospects of the undertaking. The object of the account is to explain and analyse the financial situation of the undertaking and its future prospects for use by the management of the undertaking and for use in the supervisory activities carried out by the Danish FSA.

The Danish FSA may order the institution to prepare a section 349 account when there is reason to believe that the institution may run into problems in the future, but when the institution has not breached any legislation. According to the supervisory diamond, the order can be given when the institution repeatedly has not reacted adequately to the risk information from the Danish FSA in relation to the supervisory diamond, and after a specific assessment of the financial situation of the institution.

The Danish FSA may also initiate a functional supervision of the specific risk area, if it is assessed that there are areas related to the supervisory

9 Executive Order on the Duty of Financial Undertakings etc. to Publish the Danish FSA's Assessment of the Undertaking etc.

diamond which have not been adequately described. The assessment will be based on the account from the institution and on the basis of the reports received by the Danish FSA from the institution. Following the functional supervision, the Danish FSA will prepare a report which the institution must publish, see section 2(1) of the Executive Order on Publication.

The report will contain the Danish FSA's assessment of the institution, including important orders, reprimands and risk information that the institution has received from the Danish FSA.

Finally, the Danish FSA may, based on a defined and individual assessment, give the institution an order under section 350 of the Financial Business Act to e.g. reduce growth in lending. The order may be used in situations where (1) the financial position of the undertaking has deteriorated to such a degree that the interests of the investors are at risk, or threatened, or (2) there is a significant risk that the financial position of the undertaking will develop such that this institution loses its licence.

An order pursuant to section 350 of the Danish Financial Business Act must be specific enough to enable the management of the institution realistically to comply with it.

As a general rule, the institution must publish orders pursuant to section 350 of the Danish Financial Business Act, if it is deemed that the order is significant for the institution's customers, investors or the financial markets on which the shares in the institution are traded, see section 2(2) of the Executive Order on Publication. Orders pursuant to section 350 of the Danish Financial Business Act are presumed to be significant for the groups mentioned, and therefore as a general rule the institution must publish the order issued pursuant to section 350 of the Danish Financial Business Act.

5. Phasing in the supervisory diamond

In order to provide mortgage-credit institutions with the opportunity to adapt to the indicators in the supervisory diamond with associated limit values, the Danish FSA will initially implement a systematic monitoring and follow up with effect from 1 January 2018, including the use of supervisory reactions as laid out in paragraph 4. The indicators for interest only and short-term funding are incorporated with a longer phase-in and will take effect from 1 January 2020.

The Danish FSA expects an ongoing permanent data reporting to the Danish FSA from the beginning of 2017.

Annex 2. Down payments of a minimum of 5% when buying a home

In a report on counteracting the price bubble in the property market via financial regulation, an expert group under the Danish FSA has drawn attention to possible initiatives that could contribute to curbing the fluctuations in property prices. One of the initiatives is a loan limit for financing of owner-occupied dwellings and recreational dwellings, corresponding to the borrower needing to contribute a fixed minimum down payment. The institutions can allow higher mortgage borrowing only in extraordinary circumstances, and only if they ensure it is in the customer's interests and is justifiable in relation to the customer's finances.

On the basis of existing practice among the institutions, among other things, the assessment is that a minimum down payment of 5% will be appropriate.

The purpose of the proposal is to increase the customers' robustness by testing their ability to save before the purchase. Thus, reducing the risk that they take on a mortgage that is too expensive. The customers will also achieve a greater robustness in relation to the fluctuations in property prices, if they need to sell their property as a result of a job migration, divorce, or other circumstances. The higher mortgage level before the financial crisis and the resulting steep decrease in house prices has thus meant that a number of families have technically become insolvent.

The initiative is carried out via an amendment to the Executive Order on Good Business Practice for Financial Undertakings. The executive order has been supplemented with a provision that a credit institution must ensure that appropriate own financing has been carried out with a purchase of owner-occupied dwellings or recreational dwellings by private customers. The executive order already contains a rule that floating-rate and interest-only loans may only be given to customers who pass a credit assessment for taking out a fixed-interest-rate loan with repayment. The rules will apply to all banks and mortgage-credit institutions providing home loans in Denmark.

The banks have announced that a requirement for 5% down payment is in line with their current practice. However, there may be individual institutions that have introduced an absolute requirement. Other institutions allow first-time buyers with particularly strong finances to increase their mortgage level in certain circumstances. The new rules will contain this type of opportunity to deviate from the main rules if the institution carries out a particularly justifiable assessment, and provides

advisory services to the customer in accordance with this. This is also found in other Nordic countries which have introduced loan limits when purchasing a home.

The option for deviating from the main rule may be relevant for first-time buyers with a high capacity to pay. In such situations, the institutions should ensure that a lower down payment is offset in combination with a more stringent repayment profile. Furthermore, customers must be informed of their situation in the event of a decrease in house prices. Deviations may also be relevant for technically insolvent homeowners who need to move as a result of a new job, for example. Such authorisations for deviation should be taken at a higher decision level in the institution than other authorisations.

There is a general assessment that this requirement is part with the current access to home loans on the market, so that it does not stress the housing market. Inversely, the requirement is assessed to protect against a relaxation of the standards in the future when the economy is back on its feet again. The increasing prices in the Copenhagen housing market indicate that this is the right time to carry out this initiative. It is also an assessment that the demand for down payment will be of greater significance specifically in the larger cities where housing is most expensive, and where the 5% therefore constitutes the largest amount.

Annex 3. Positive cash flow when financing commercial property

In a report on counteracting the price bubble in the property market via financial regulation, an expert group under the Danish FSA has drawn attention to possible initiatives that could contribute to curbing the fluctuations in property prices. One of the initiatives is to introduce a principle based on allowing the financing of a commercial property if it can generate positive cash flow.

The aim of the initiative is to reduce the banks' and mortgage-credit institutions' vulnerability in relation to the more speculative property sector, as experience has shown that parts of the property sector have been associated with significant losses in situations of a decrease in property prices, see. e.g. the report from the committee on the causes of the financial crisis. Loans should not be provided for property purchases where the loan can only be paid back if the property continues to increase in price. In addition, caution must be exercised with financing development projects where the borrower cannot support the project themselves, or where the outlook for lettings or sales is unsure.

The initiative is carried out through an amendment to the Executive Order on Management and Control of Banks etc. Annex 1 of the executive order already contains requirements for the credit policy and procedures in individual credit institutions to ensure that credit decisions are based on robustness of the customer's future earnings and cash flow. The initiative will clarify these requirements further, as well as expanding the requirements to also include mortgage-credit institutions.

The amendment will mean that banks and mortgage-credit institutions will not be able to provide financing for commercial properties that do not generate positive cash flow, unless the institution can prove that this is justifiable in credit terms. With financing for commercial properties without positive cash flow, the institution's procedures must therefore include compensatory requirements or arrangements to ensure that the financing is justifiable in credit terms.

The types of compensatory requirements or arrangements that may be relevant to e.g. development properties, unbuilt-on plots, etc. will be discussed in depth in associated guidelines. These could be, for example. requirements on commitment for sales or lettings. It will thus still be possible to carry out financing of development projects on a justifiable basis.