ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment Team on National Macroprudential Measures

Assessment of a measure taken in Denmark pursuant to Article 133 of the Capital Requirements Directive

Introduction

On 10 October 2023 the European Systemic Risk Board (ESRB) Secretariat received a formal notification from the Danish Ministry of Industry, Business and Financial Affairs of the decision to activate a new systemic risk buffer (SyRB), pursuant to Article 133 of the Capital Requirements Directive (CRD)[1]. The proposal is to introduce a sectoral systemic risk buffer (sSyRB) of 7% for all institutions authorised in Denmark. The proposed measure would cover a subset of sectoral exposures located in Denmark. The Ministry also requested reciprocation; however, this will be dealt with in a subsequent ESRB recommendation.

The ESRB must, within six weeks of receipt of the notification, prepare a draft opinion for the European Commission on the appropriateness of the proposed measure, with regard to the relevant requirements under the CRD and the Capital Requirements Regulation (CRR)[2], from a macroprudential and financial stability perspective. An ESRB opinion is required by Article 133(12) of the CRD as the sSyRB rate is higher than 5%.

As the sum of the sSyRB rate and the pre-existing other systemically important institution (O-SII) buffer rates exceeds 5%, the ESRB must include in its opinion an assessment of whether the combined buffer is appropriate, pursuant to Articles 131(15) and (5a) of the CRD. Following the issuance of the ESRB's opinion, the European Commission must adopt an act that authorises the setting of the sSyRB rate, provided it is established that the combined buffer does not entail disproportionate adverse effects on the financial system of other Member States, or the European Union as a whole, that form or create an obstacle to the proper functioning of the internal market.

The assessment, which informs the ESRB's opinion, draws extensively on quantitative and qualitative information provided by Danmarks Nationalbank, the Danish Financial Supervisory Authority and the Danish Ministry of Industry, Business and Financial Affairs. The information was discussed within the ESRB's Assessment Team on National Macroprudential Measures and the final opinion and assessment were approved by the ESRB's General Board.

[1] See "**Directive No 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC**", (OJ L 176, 27.6.2013, p. 338).

[2] See "**Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012**", (OJ L 176, 27.6.2013, p. 1).

Description of the proposed measure

The aim of the sSyRB, as a macroprudential tool, is to allow authorities to target specific systemic risks that are inherent in banks' exposures at a sectoral level. Compared with broader instruments, these tools might be more effective as they target only specific risks and relevant exposures, minimising unintended side effects and improving cost-effectiveness and banks' capital allocation. Article 133(5)(f) of the CRD therefore allows the relevant authorities to define, from the sectors listed in Article 133(5b) of the CRD, a subset that is specific to their needs. The European Banking Authority (EBA) has developed guidelines[3] to support the authorities in defining the specific subsets of sectoral exposures to which the sSyRB may be applied. Specifically, three dimensions were identified by the EBA: (i) type of debtor or counterparty sector, (ii) type of exposure, and (iii) type of collateral. In addition, if deemed appropriate, duly justified and proportionate when targeting systemic risks, the relevant authorities may supplement these dimensions with three subdimensions: (i) economic activity, (ii) risk profile, and (iii) geographical area.

The proposed measure consists of activating a new 7% sSyRB for all types of exposures located in Denmark to non-financial corporations operating in real estate and in the development of building projects . The sSyRB would apply to all institutions, at both consolidated and individual level, authorised in Denmark and would target a specific sectoral risk (Article 133(5)(f) of the CRD). In line with EBA's guidelines, the proposed measure would apply to non-financial corporations (i.e. debtors) operating in a specific sector (the counterparty sector). The relevant exposures to non-financial corporations have been identified by type of economic activity using Nomenclature of Economic Activities (NACE) codes[4] L (Real estate activities) and F 41.1 (Construction: Development of building projects). The proposed measure targets corporate exposures that are either secured by commercial and residential properties[5] or unsecured and located in Denmark. Lending to both cooperative housing societies and social housing associations are exempt from the proposed measure as these accounts are not subject to the same type of risks as real estate companies, their activities do not serve a commercial purpose and their loans are not supported by central government guarantees.

The proposed sSyRB would be activated on 30 June 2024. The decision will be reviewed at least every second year. However, the monitoring of risks related to the commercial real estate market and real estate companies is part of the regular surveillance and assessment of systemic risks performed by the Danish Systemic Risk Council. Should there be a significant shift in the risk assessment of the segment subject to the sSyRB, this would also feed into the assessment of the appropriate level of the proposed measure.

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[3] See "**Final guidelines on the appropriate subsets of sectoral exposures to which competent or designated authorities may apply a systemic risk buffer in accordance with Article 133(5)(f) of Directive 2013/36/EU**", EBA, September 2020.

[4] See "**Regulation (EC) No 1893/2006 of the European Parliament and of the Council of 20 December 2006 establishing the statistical classification of economic activities NACE Revision 2 and amending Council Regulation (EEC) No 3037/90 as well as certain EC Regulations on specific statistical domains**", (OJ L 393, 30.12.2006, p. 1).

[5] In this assessment, commercial or residential real properties are also referred to as commercial real estate.

Risks addressed through the proposed measure

The proposed measure aims to target risks to the banking sector stemming from exposures to real estate companies. As of the first quarter of 2023, these companies account for a significant share of lending by Danish credit institutions, with 14% of total lending and 37% of lending to non-financial corporations. Medium-sized credit institutions have seen the most significant growth in lending to real estate companies since the first quarter of 2022.

A number of vulnerabilities in the identified subset of exposures are present, including as a result of the role of the current interest rate environment. Denmark's currency, the krone, is pegged to the euro and so the interest rates used to control the krone exchange rate are closely tied to the monetary policy of the euro area. The real estate companies targeted by the proposed measure are highly sensitive to interest rate changes as their income and value of the assets posted as collateral are adversely affected by rate increases. As of the first quarter of 2023, 80% of real estate company lending was at variable rates, with the pass-through of previous interest rate rises not yet fully reflected in current real estate prices and company income. Furthermore, a substantial proportion of loans to real estate companies are mortgage loans financed through covered bonds. According to the Danish authorities, around 12% of these loans will see a significant interest rate increase between now and the end of 2025.

The challenges of the interest rate environment, together with the current macroeconomic conditions, pose additional sources of risk for these exposures. The Danish authorities anticipate a significant correction in commercial real estate markets given the current macroeconomic conditions. A weakening in economic activity could put pressure on the rental income of real estate companies through increased vacancy rates, which could have a direct impact on their ability to service their loans. This environment, coupled with the pass-through of rising interest rates, increases the probability of default of real estate companies and the size of the loss given default. Given the size of existing exposures, this can lead to large losses for credit institutions. More specifically, for the aforementioned medium-sized credit institutions and their significant exposures, it has been historically noted that they have experienced proportionally greater losses during past crises.

In September 2022 the ESRB issued a general warning that pointed towards potential vulnerabilities in European commercial real estate markets.[6] In January 2023, based on the analysis provided in the ESRB report on vulnerabilities in the commercial real estate sector,[7] the ESRB issued a recommendation focused on commercial real estate.[8] Some of the financial stability risks outlined in these warnings seem to have materialised since then. It has generally been observed, with respect to commercial real estate firms, that the largest firms have experienced strong declines in market value in the past 12 months, with several now being rated just above investment grade. At the same time, the probability of defaults and expected default frequencies is rising. Going forward, the ESRB anticipates that

6 See "**Warning of the European Systemic Risk Board of 22 September on vulnerabilities in the Union financial system (ESRB/2022/7)**", ESRB, September 2022.

7 See "**Vulnerabilities in the EEA commercial real estate sector**", ESRB, January 2023.

8 See "**Recommendation on vulnerabilities in the commercial real estate sector in the European Economic Area (ESRB/2022/9)**", ESRB, December 2022.

falling real estate prices and debt servicing capacity on top of rising financing costs and declining profitability will represent a major challenge for commercial real estate firms that could ultimately lead to bank sector losses. The ESRB's analysis complements and supports the information provided by the Danish authorities regarding exposures targeted by the proposed measure.

Appropriateness of combined buffers

The aim of the pre-existing O-SII buffer is to reduce risks posed by institutions whose failure would have a significant negative impact on the domestic financial system or the real economy. Capital buffers reduce the probability of failure of O-SIIs, which may be desirable given the high economic and social cost of their failure. In addition, capital buffers require O-SIIs to internalise externalities they impose on the financial system and the real economy, and the buffers may provide incentives for O-SIIs to reduce their systemic importance. The Danish authorities have identified nine O-SIIs that are of domestic systemic importance. The fully phased-in buffer rates range from 1% to 3% and are applied at the highest possible level of consolidation.

According to Article 133(8)(c) of the CRD, the SyRB should not be used to address risks that are covered by the O-SII buffer, as stipulated in Article 131 of the CRD. The objectives of the two buffers are clearly different in Denmark, with no apparent overlap between them. In particular, the SyRB only covers risks of exposures to Danish real estate companies, whereas the O-SII buffer addresses the systemic footprint of specific banks. The indicators used to identify the O-SIIs do not reflect lending activities to real estate companies in Denmark.

The ESRB notes that the proposed sSyRB is intended to complement non-capital-based microprudential measures addressing risks to real estate companies. Going forward, the Danish authorities should also ensure that any future potential overlaps between microprudential capital measures, such as the additional own funds guidance (Pillar 2 guidance), and this macroprudential measure are avoided.

Overall, based on the information provided by the Danish authorities, the ESRB considers that the proposed sSyRB does not address the same risks that are covered by the existing O-SII buffer requirements.

Effectiveness and proportionality

The sSyRB targets specific exposures where the systemic risk is stemming from and applies to the risk exposure amount, thus resulting in a more effective application of the proposed measure.[9] By applying the proposed measure to a subset of the exposures subject to the systemic risk, relevant institutions with relatively large exposures to this source of systemic risk would be subject to a higher requirement (in nominal terms), compared with those with relatively smaller exposures. Furthermore, as the buffer applies to the risk exposure amount, exposures with higher risk weights (reflecting higher credit risk) would have a higher requirement (in nominal terms). Thus, the underlying risk weighting of the exposures is preserved. Taking this into consideration, a broader application of the SyRB would not be optimal.

9 While the proposed measure identifies the subset of exposures using the EBA's guidelines on the appropriate subsets of sectoral exposures (see Footnote 3), it does go beyond NACE Level 1. This increases monitoring and compliance costs given the greater granularity needed in a further NACE breakdown. However the ESRB still supports the proposal as it leads to a more proportionate and effective buffer level.

Given the current high levels of bank profits in Denmark, the Danish authorities do not expect the increased capital requirement to lead to a tightening of credit conditions. The proposed measure was calibrated to ensure sufficient capital to cover losses that might materialise in a scenario of higher interest rates, a fall in income for the real estate companies and price falls in commercial and residential real estate. The results of this analysis, balanced against the capacity of credit institutions to accumulate capital without a contraction in credit supply, led to the proposed buffer rate. Furthermore, the assessment for the calibration was based on the experience of building up the countercyclical capital buffer (CCyB) in Denmark and on a number of studies on the subject to ensure it is proportionate. According to the Danish authorities, credit institutions have sufficient capacity to meet the requirements without a contraction in their credit supply.

The ESRB is of the view that the new sSyRB is effective and proportionate. The proposed measure acts on the objective of increasing the resilience of institutions – those with specific exposures in Denmark to real estate companies – to potential severe corrections in commercial real estate markets by increasing their Common Equity Tier 1 capital in relation to exposures to these markets. A 7% sSyRB is considered commensurate with the intensity of, and potential losses stemming from, the above-mentioned risks in the Danish financial system. The Danish institutions that would be affected by the direct application of the proposed measure apparently have sufficient earnings in 2023 to increase their capital buffer levels, while still maintaining management buffers large enough to absorb losses in an adverse stress scenario. This, along with the immediacy of the potential realisation of the systemic risk, supports the introduction of the proposed measure quickly and without a phase-in.

Other measures in the pecking order of the Capital Requirements Directive and Capital Requirements Regulation

The proposed measure does not cover risks set out in Article 130 of the CRD. A CCyB of 2.5% is currently active in Denmark. The proposed sSyRB specifically targets risks stemming from the commercial real estate market, and the calibration explicitly deducts the 2.5% CCyB from the possible losses. In this sense, the sSyRB covers specific losses that may arise on the exposures targeted beyond what is already covered by the existing CCyB.

The O-SII buffer and sSyRB rates are cumulative and clearly target different risks. As previously mentioned, the sSyRB covers risks of exposures only to Danish real estate firms, whereas the O-SII buffer addresses the systemic footprint of specific banks. Given the O-SII buffer applies to all of a bank’s exposures, there is no apparent concern that the O-SII buffer would be a better alternative to the measure proposed for a systemic risk confined to a specific sector of exposures.

Conclusions

The ESRB deems the proposed sSyRB appropriate. Its effectiveness and proportionality mitigate the identified risk. The proposed measure sufficiently mitigates risk over time, with limited unintended impact on the general economy. It is a consistent use of the sSyRB, meeting its relevant objective while complementing the other existing macroprudential tools in Denmark, without apparent undue overlap.

Furthermore, the ESRB is of the view that the proposed combined sSyRB and O-SII buffer for the institutions concerned is appropriate for addressing the identified risks. The proposed sSyRB does not entail any overlap of the risks covered by the existing O-SII buffer.