

**FOR
INFORMATION**

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July 8, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Denmark—Financial System Stability Assessment—Statement by the Executive Director**

Board Action: Executive Directors' **information**

Additional Information: The attached statement from the Executive Director for Denmark, is being issued on Denmark—Financial System Stability Assessment (SM/20/99, 6/29/20) which is being considered on a lapse of time basis.

Statement by Mr. Poso and Mr. Damgaard on Denmark—Financial System Stability Assessment

INTRODUCTION

On behalf of our Danish authorities, we thank staff for their high quality Financial System Stability Assessment (FSSA) report on Denmark and for the constructive and candid technical discussions which preceded it. The authorities broadly concur with staff's analysis and assessment and will carefully consider the recommendations. They appreciate the overall assessment that the Danish authorities prior to the Covid-19 pandemic had taken important steps to ensure financial system resilience.

COVID-19

As has been the case all over the world, the Covid-19 crisis represents a shock to the Danish economy, with repercussions also for the financial system. While much of the preparatory FSAP work was conducted prior to the Covid-19 pandemic, the focus of FSAP assessments is mostly of a structural nature, and many of the findings remain pertinent in this new environment. The authorities also appreciate the inclusion in the report of illustrative examples of possible implications of Covid-19 on bank solvency, and they concur with the assessment that Danish systemically important institutions (SIFIs) still meet minimum capital requirements when taking the Covid-19 shock into account.

FINANCIAL STABILITY AND STRESS TESTING

The Danish authorities welcome the thorough solvency stress test of significant Danish institutions conducted by the FSAP team. Overall, the FSSA assessment shows that the significant banks and mortgage credit institutions (MCIs) are robust, even under very severe stress, as posed by the three scenarios employed in the FSAP solvency stress test.

The Danish authorities note that among the three scenarios explored in the FSAP solvency stress test analysis, the "Covid Central" scenario is the most probable. The remaining two scenarios are adverse scenarios which have a lower probability of materialising. The "Covid Prolonged" scenario is particularly severe and complements the most severe scenario in the recent stress test report published by Danmarks Nationalbank (DN). The Danish authorities consider the FSAP stress test results to be conservative, in the sense that substantial downside risks are reflected in the adverse scenarios. This in particular holds true at the institution level. Further downside risks are thus deemed limited.

Likewise, the Danish authorities appreciate the FSSA's recommendations to further incorporate feedback loops between the financial system and the real economy and contagion effects across financial institutions in the macroprudential stress test. While feedback loops between the financial system and the real economy are not explicitly modelled, scenarios employed by the authorities are calibrated using historical data, thereby implicitly incorporating realised second-round effects. The authorities appreciate the DN-IMF collaboration effort to develop the novel multi-layer contagion model of the Danish financial system and value the insights of the analysis conducted.

The Danish authorities encourage the IMF to explore options for incorporating granular data from authorities across Nordic and Baltic countries in future exercises. This would enable the FSAP stress test to better complement national authorities' stress test endeavours.

The authorities are supportive of the FSAP team's efforts in stress testing insurance and pension companies. With the bottom-up stress test, the FSAP was thorough and discursive with insurance and pension companies, which produced a greater understanding of stress test results and of companies' likely reactions to stressed scenarios. The top-down stress test was a simple, yet robust model and represents a step forward in the use of companies' Solvency II quantitative reporting for supervisory stress testing and monitoring. The trend towards market rate insurance and pension savings products underlines the importance of including the full insurance and pension system – companies and overall pension wealth – within future macroprudential stress testing.

SYSTEMIC LIQUIDITY

The authorities share the FSSA's conclusion that Danish banks have ample liquidity and are able to withstand further funding pressures if those were to emerge. In recent years, the Danish authorities have established a comprehensive analytical framework including both monitoring, stress-testing, and robustness tools to evaluate the liquidity situation in the banking sector. Going into the Covid-19 crisis, the banks' liquidity position was solid, and it was only modestly affected by the market turbulence in March 2020. This healthy position is mainly a reflection of the positive development of the deposit surplus in recent years. Also, the FX funding gap remains modest. These factors underpin that Danish banks are in a liquidity position where they can continue the flow of credit to the real economy.

The DN promptly provided liquidity support in response to the Covid-19 crisis by introducing extraordinary lending facilities and swap lines in euro and dollar. The DN has a comprehensive setup for liquidity support and stands operationally ready to expand the framework to include more nonstandard collateral if this is needed to support the financial stability in Denmark. Following the FSAP, the authorities will look into how interagency information sharing and collaboration can be further strengthened in this area.

SYSTEMIC RISK OVERSIGHT AND MACROPRUDENTIAL POLICY

The Danish authorities take note of staff's recommendation to give the chair of the Systemic Risk Council (SRC) the ability to make proposals for a recommendation after due consultation with other SRC members without the need to strive for consensus. The Danish authorities do not share the view that the need to strive for consensus makes the system vulnerable to inaction bias. The DN agrees on the other hand that the limited powers of the SRC may lead to inaction bias where the feasible policy option risks being a second-best policy option.

The Danish authorities welcome the acknowledgement that several measures have been undertaken to address household vulnerabilities since the 2014 FSAP. The authorities monitor the development in the housing market closely and stand ready to act should vulnerabilities arise. The Danish authorities will revisit the assessment of the housing market later this year when answering the European Systemic Risk Board (ESRB) recommendation on medium-term vulnerabilities in the residential real estate sector in Denmark.

BANKING AND INSURANCE SUPERVISION

The Danish authorities welcome the assessment of the regulation and supervision of the Danish banking and insurance sectors, and generally share the views and assessment expressed in the report. Observations and recommendations will be used to further improve the work with regulation and supervision in Denmark.

The authorities agree with the FSSA's view that governance of financial institutions and their risk culture have become increasingly important, which has also been reflected in the Danish Financial Supervisory Authority (DFSA) greatly increasing attention and resource allocation towards governance and compliance issues. As an example, the DFSA has conducted a top-down review of the compliance and risk management functions in Danish banks and published a "best practice paper" on its website with 10 specific guidelines. The DFSA will continue to dedicate substantial resources to this area. It does, however, not believe that it would be prudent in the present circumstances to divert even more resources from financial risks towards top-down reviews of governance.

In a world where the importance of models and data inexorably increases in supervision, the authorities acknowledge the need to enhance approaches to explicitly confirm the veracity of supervisory data and information received. The DFSA would, however, like to stress that already today, all data submitted to the DFSA is subject to a general validation process where outliers and other suspicious-looking data are identified. The DFSA would also like to flag that the verification of information submitted to the DFSA is a main function of its on-site inspections. A political agreement struck in March 2019 also made explicit the requirement for financial institutions to inform the DFSA of any pertinent developments as well as correcting erroneous or misleading reporting. The agreement furthermore introduced the possibility of fines in case of non-compliance with reporting requirements.

The FSSA recommends increasing on-site inspection frequency for insurance companies. Following the implementation of the EU Solvency II directive, the DFSA's experience is that full on-site inspections require an increasing amount of resources. The DFSA will continue to perform full on-site inspections, but will also prioritize other relevant supervisory activities. These activities include theme-based inspections such as valuation of alternative investments and ad-hoc information collections such as the one focused at market return products. These activities give valuable insights into risk and compliance across the sector and often include risk areas that also fall under full on-site inspections.

ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

The Danish authorities welcome the assessment of the AML/CFT supervision of the financial sector. Reforms and a strengthened legal framework in the field of AML/CFT have paved the way for a stronger supervision of obliged entities. The Danish authorities are grateful for the FSSA's acknowledgement of the authorities' work in this field.

The Danish authorities share the FSSA's view concerning a new risk assessment model, and the authorities are confident that the model will become a valuable tool for the DFSA. The model is comprehensive and will be finished in 2020 with the first reporting in the 2nd quarter of 2021. The

DFSA also welcomes the recommendation concerning intensified on-site inspections in higher-risk entities which can prove to be a valuable method of inspection to combine with the growing list of methods that the DFSA AML/CFT division is taking on. However, combining the need to deep-dive into certain institutions with the need to have a sufficiently large number of inspections is a balance which is at the core of the risk-based approach.

As financial crimes often involve cross-border financial flows, further international consolidation of AML/CFT supervision is of the essence. The Danish authorities will continue to pursue increased cross-country cooperation and thus welcomes the recommendation concerning working towards increased EU consolidation of AML/CFT supervision.

FINANCIAL CRISIS MANAGEMENT AND SAFETY NETS

The Danish authorities welcome the assessment and the observations made by the IMF regarding the financial crisis management framework. The authorities take note of the FSSA's findings that the Danish financial crisis management, including bank resolution, has improved significantly over the last years, and that there is a sound legal foundation. This includes the resolution strategy for small- and medium-sized banks which has been successfully tested in practice in a couple of cases. Regarding the resolution of SIFIs, conceptual work on the potential use of a bridge MCI as a resolution tool has been conducted. Notwithstanding this, going forward, it will continue to be a priority to ensure that the resolution of SIFIs is both feasible and credible.

Concerning liquidity in resolution, the Danish authorities acknowledge the importance of having procedures in place, and follow the EU discussions on the topic. In Denmark, various options are being explored: liquidity provided through emergency liquidity assistance, from the Resolution Fund with government back-up, or from the government directly. Lastly, the Coordination Committee for Financial Stability, which is an important pillar of the Danish financial safety net, will be expanded to include participation from the Financial Stability Company (FSC).