

**FOR  
INFORMATION**

FO/DIS/20/153

July 10, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Denmark—Deletion/Modification—Financial System Stability Assessment**

Board Action: The attached deletion from and modification to SM/20/99 (6/29/20) has been proposed by the authorities of Denmark and agreed with staff in accordance with the policy on publication of papers:

**Highly Market-Sensitive Material**

**Pages 17 and 18 (included due to text overflow)**

Questions: Mr. Elekdag, MCM (ext. 34835)



Importantly, the analysis suggests that a further deterioration of economic prospects and tighter financial conditions, relative to those assumed under the scenarios, could bring about a situation where SIFIs breach their minimum capital requirements.

## Liquidity Stress Tests

**22. The analysis suggests that the banking system could withstand significant withdrawals of short-term funding.**<sup>6</sup> The cash-flow based tests assessed the resilience of individual banks to severe shocks to their cash inflows and outflows combined with asset liquidations subject to valuation haircuts. The assumed shocks in the liquidity stress tests were significantly larger than those that have materialized in 2020 Q1. Banks can counterbalance negative funding gaps by using their cash and by liquidating securities both in the markets and at the central bank (via standard monetary operations). The tests reveal that all five banks would be able to survive extreme liquidity pressures without external support for longer than three months.<sup>7</sup> Tighter financial conditions relative to those assumed in the tests could affect bank's access to liquidity and funding costs unevenly and may result in acute liquidity strains for some banks.

## Insurance Stress Tests

**23. The resilience of insurance companies was assessed through a top-down (TD) and bottom-up (BU) solvency stress tests implemented before the onset of the COVID-19 pandemic.** These tests build on the narrative and severity of the market shocks adverse scenario and are also subject to uncertainty and downside risks. Note that these tests encompassed several market shocks which resulted in a combined stress scenario that was considerably more severe than what was observed in 2020 Q1 (Appendix II). Importantly, in contrast to banks where credit risk is critical, market shocks are the main risk factor relevant for the insurance sector, especially for the life insurance segment.

**24. Under the adverse scenario, although regulatory solvency requirements are met in aggregate, the life insurance sector is significantly impacted.** The BU tests indicated that although the industry is able to withstand severe asset price shocks, most of the solvency impact would be attributed to the increase in domestic sovereign and covered bond yields. After stress, the median solvency capital requirement (SCR) ratio in the life sector dropped from 188 to 127 percent, while in the non-life sector the ratio declined from 233 to 207 percent (Figure 20). One life company drops below a solvency ratio of 100 percent, ~~and the capital needed to restore a full coverage of solvency capital requirements amounts to around DKK 4 billion, equal to less than 3 percent of the sample's aggregate capital, and the capital needed to restore a full coverage of solvency~~

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risks have not been assessed, underscoring the uncertainty surrounding the solvency stress test results, including their implications for individual SIFIs.

<sup>6</sup> The liquidity stress tests were conducted before the onset of the COVID-19 pandemic.

<sup>7</sup> According to the May 2020 DN Financial Stability Report (FSR), systemic banks, in aggregate, could cover their liquidity needs under a severe liquidity stress scenario. The FSR notes that the overall liquidity situation for systemic banks has not been materially affected by the COVID-19 pandemic as of mid-March. Moreover, the median LCR across systemic banks increased to 198 percent in April 2020 from 174 percent at end-2019.

requirements would only be a moderate fraction of the sample's aggregate capital. The TD tests broadly confirmed these results. Resurgent financial market turbulence associated with even more severe shocks relative to those assumed under the adverse scenario could impair insurers' solvency positions and profitability to a greater extent.

**25. Over the medium-term, insurers will face declining investment returns as their higher-coupon bond holdings expire.** In aggregate, the Danish life insurance sector still records positive spreads of investment returns over guaranteed interest rates, and is also expected to regain profitability after the materialization of the adverse scenario, but significant differences exist across companies. While insurers which are more active in non-life and unit-linked life business are less affected by the current low-yield environment, companies with a high legacy stock of guarantees on their policies are likely to experience a drain on their profitability.

**26. The insurance sector appeared capable to withstand the losses simulated under the adverse scenario without materially amplifying market risks.** In response to the stress conditions, life insurers would consider gradually divesting riskier holdings (equities, non-investment grade bonds) and increase their investments in sovereign and covered bonds. Likewise, non-life companies would also rebalance their portfolios and may even expand their investments in equities and real estate. In sum, the surveys from the BU test suggested that insurers reactions under the adverse scenario may mitigate the impact of the shocks on financial markets as they try to shore up their capital buffers.

**27. Sensitivity tests point to longevity risks and the resilience of non-life companies to climate-related catastrophic events.<sup>8</sup>**

- A strong increase in life expectancy would reduce the median SCR of life insurers and occupational pension funds to 210 percent. Higher mortality rates however, including temporarily stemming from a severe epidemic, would decrease annuity payments, while coverage for sickness pay and hospitalization are only moderate.
- In terms of climate-related risks, non-life insurers are mainly exposed to windstorms and cloudbursts, of which the latter occur more frequently, but remain local events with moderate losses per event. A repetition of windstorm Anatol, which hit Denmark in 1999 would result in a reduction of non-life insurers' own funds of only one percent as risks are largely ceded to reinsurers (see also Box 4).

**28. ATP displays a considerable degree of resilience in the stress test.<sup>9</sup>** Its individual reserve requirement remains covered by a significant margin. The stress reduces ATP's profits, which would turn negative in the first year of the projection horizon, and remain flat in the following two years assuming that asset prices would not recover. At the same time, wider spreads and a sharper decline

<sup>8</sup> These sensitivity tests were also conducted prior to the COVID-19 pandemic.

<sup>9</sup> The stress test of ATP was implemented before the COVID-19 outbreak.