Conference call

Interim report – first half 2019

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Investor Relations

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Chris Vogelzang – Danske Bank – CEO

Hello, and welcome to the presentation of Danske Bank's financial results for the first half of 2019. And thank you all for taking the time to listen in on this call today. My name is Chris Vogelzang, and with me today, I have our CFO, Christian Baltzer; and our Head of Investor Relations, Claus Ingar Jensen. I would like to open this call in my role as the incoming CEO of Danske Bank. This is my sixth week at Danske Bank, and I've spent the past few weeks meeting numerous customers, the team, the Danish public, authorities and other key stakeholders. The objective of those weeks has been to listen to all of them to get their perspectives and hear their concerns. You will, hopefully, appreciate that six weeks is a very short time.

However, I want to share a few very preliminary observations. I found Danske Bank to be a solid bank with long-standing customer relationships, a largely good portfolio of businesses, a strong balance sheet and funding profile and, compared with other banks, a bank with a well-advanced digital footprint. However, what has truly impressed me is the Danske team and its dedication to the bank and its customers in these particularly challenging times. I'm also seeing a substantial compliance issue, which we're working on, and which will be at the forefront of our minds for a long time.

In terms of challenges, I don't need to remind you of the rates and margin environment and the digital transformation challenges that the industry as a whole faces. So you will not be surprised to hear that my focus for the coming weeks and months will be to analyse our business, processes, products, infrastructure, teams and strategy in depth to come back to you at a later state with a strategic update and specific intentions with regard to how we, the management team, will take Danske Bank forward.

However, let me give you some of my basic thoughts about running a bank. The banks, in my view, that will be successful in the future are: Banks that tackle compliance issues head-on, embrace legislation and create a culture of making positive societal impact. Compliance is not only going to be a license to operate issue, but also a unique selling proposition.

The banks that will be successful in the future are banks that are able to operate in a low-margin environment and can still create an excellent customer experience.

The banks that will be successful in the future are banks that foster a culture of customer centricity, compliance and personal accountability and an urge to continuously improve.

Banks that are successful are banks that embrace and develop technology with agility to create customer value, operational safety and sustainable profitability.

And definitely, the banks that are successful, invest in the above in a targeted way and focus on the long-term creation of value for shareholders.

These will be our guiding principles when defining our strategy for the coming years. And as we've said, we will come back to you at a later stage this year.

I'm looking forward to our dialogue and debate, and I will now hand it over to our CFO, Christian, to present our numbers for the first half of the year.

Christian Baltzer – Danske Bank – CFO

Thank you, Chris, for those inspiring words. So to Slide 1, please. In today's call, we'll be presenting Danske Bank's financial result for the first half of 2019. We'll aim to keep the presentation to around 20 minutes. After the presentation, we'll open up for a Q&A session as usual. Afterwards, feel free to contact our Investor Relations department if you have any more questions.

Slide 2, please. As you're probably all aware, we published preliminary key figures for the result for the first half year in our company announcement on the 8th of July. Today, we are able to confirm the numbers and put them into context with the result from the first half of 2019, which I will comment on in more detail.

The first half of 2019 posted a weak financial result compared with the result for the same period the year before. Net profit for the period came in at 7 billion kroner, including the gain from the sale of Danica Pension Sweden against a DKK 9.2 billion in the first half of 2019. The main reason for the lower results were lower net interest income, higher expenses and fewer loan impairment reversals. Seen in isolation, the result for the second quarter was affected by the same type of headwinds that we had in the first quarter, and included the compensation we will pay to customers with the Flexinvest Fri product of an estimated 400 million before tax. On top of this, we saw a deterioration of the rates market conditions that had a negative impact on our trading activities. Given this clearly disappointing development, and on the basis of our expectations, which is that generally weak momentum in income will continue in the remainder of the year, we revised our net profit outlook on the 8th of July. We now expect net profit to be in the range of DKK 13 billion to DKK 15 billion against our previous outlook of between DKK 14 billion and DKK 16 billion. The revised outlook also included a revised outlook for expenses, now in the range of DKK 25.5-26 billion.

In respect to the overall business development, customer activity remained at a good level, with group lending up 3% from the year before. We continue to see a good inflow of business, in particular, in Banking Nordic. However, margins remain under pressure from higher funding costs and intensified competition. Lending in local currency grew 7% from the level in the same period the year before and 2% from the level of the preceding quarter. The development differs somewhat across the Nordic countries, however.

At Banking DK, there's no doubt that the daily business has been affected by our increased focus on retaining the existing customers and improving our compliance setup. Lending growth was only marginal, partly because we have adopted a more cautious approach, especially to retail lending, as sentiment in the housing market seems more mixed at this stage of the economic cycle. We saw good customer activity within remortgaging, and that had a positive impact on income. However, our decision to compensate customers with the Flexinvest Fri product had the opposite effect. Margins remained under pressure from higher funding costs and a mix effect between RD loans and conventional bank loans. The Estonia case continued to have a negative impact on our retail business at Banking DK in the first half of 2019.

In total, we have seen an outflow of close to 13,600 core customers. However, we saw some improvement in the second quarter, when the outflow amounted to approximately half of the outflow in the first quarter. The stable macroeconomic environment continues to support strong credit quality across our business. In the last couple of years, we have benefited from significant reversals of impairments. As expected, these reversals have started to decline, and we saw charges in the first half of this year.

Our trading activity experienced a mixed picture during the first half of the year. The improvement in the financial market that we saw early in the year did not continue into the second quarter. A return to a more challenging conditions in the rates market due to a sudden change in the interest rate outlook towards even lower rates for even longer, had a negative effect on trading income at Corporates & Institutions. We expect a weak income momentum in this part of our business to continue for the remainder of the year.

Expenses were up 12% from the level in the same period last year as a result of increased costs for AML activities and regulatory compliance and continued investment in digital transformation. Expenses for the period also included part of the compensation to customers with Flexinvest Fri product.

Our capital position remains strong. The CET 1 capital ratio of 16.6% is well above the minimum regulatory requirement and above our target level of around 16%.

Slide 3, please. Now let me touch on the development of our cost base in order to give you some background for the expenses in the remaining part of 2019. As we have just recently announced a revision of the outlook for expenses, we find it prudent to provide you with insight on how we see the near-term development. The starting point is the 2018 cost base, excluding the donation of DKK 1.5 billion of income from the Estonia branch. You see here the building blocks for our original guidance of total expenses of around DKK 25 billion.

The new outlook for full-year expenses of between DKK 25.5 billion and DKK 26 billion is driven by AML activities in term of both upstaffing and higher expenses for ongoing legal cases related to the Estonia case. Upstaffing is driven mostly by our continuous effort to strengthen our expertise and capacity within financial crime compliance across the Group, and in the first and second lines of defence, in particular. The number of full-time employees working with AML activities is now above 1,900, against 1,400 at the end of 2018.

The resources spent on all compliance-related activities have increased significantly during the last couple of years. We expect Group cost to exceed DKK 2.5 billion in 2019. In addition to this, the cost related to the Flexinvest Fri case will also impact the revised full-year outlook.

Let's have a look at where we're spending the money allocated to AML investments and activities. Slide 4, please. As announced in the presentation of our 2018 annual report, we have identified a need for more resources to ensure a continuation of our efforts to improve and strengthen our work within AML. It is paramount for us to become best-in-class among peers, and at the same time, improve the efficiency of our AML procedures in order to deliver on our ambition to offer the best customer experience. As I mentioned before, in the short term, we need to upstaff our AML functions in order to ensure an immediate uplift in the quality and efficiency of our daily AML work. This is a key priority for us and explains a significant part of the higher cost level.

Longer term, we focus on efforts to avoid manual processes through digitalisation and automation of core AML processes with the aim to reduce labour-intensive tasks going forward. Our initiative for digitalisation projects and automation has been identified, and the projects are ongoing within the key areas: KYC, or know your customer processes, ongoing due diligence and transaction monitoring.

We see a big potential in digitalising and automating solutions for the low- to medium-risk segments, whereas in the high-risk customer segment, we probably will need a higher level of manual processing due to the generally greater complexity. The total plan for accelerated investment, as announced in the 2018 annual report, amounts to up to DKK 2 billion over the next three years. These are earmarked for AML digitalisation efforts. The impact on expenses in 2019 is still expected to be around DKK 0.3 billion, as shown on the previous slide.

Slide 5, please. Let me make some overall comments on our results for the first half before we take a more thorough look at the various items of the income statement on the following slides. As I mentioned in my introduction, net profit amounted to DKK 7 billion for the period, this is a decline of 24% from the same period the year before. Profit before impairment charges came in 13% lower at DKK 9.5 billion, driven by higher expenses. Total income was unchanged from the year before and up 7% from the preceding quarter. All income lines came in lower, except other income, which benefited from the gain of DKK 1.3 billion from the sale of Danica Pension Sweden.

Expenses, which I will comment on in more detail later, were up 12%, due mainly to costs for regulatory requirements and compliance and the inclusion of SEB Pension Danmark in our cost base. Loan impairment charges showed a net charge in the period of DKK 0.5 billion, up from the year before, but down DKK 0.2 billion from the preceding quarter. Overall, credit quality remained strong as the development, as expected, was driven by fewer reversals.

Finally, the result of our Non-core activity, which was a negative DKK 0.3 billion for the period - due to a one-off value adjustment, also had an adverse effect on the financial result for the first half of the year.

Slide 6, please. Now let's take a closer look at the underlying development in net interest income. NII was down 8% from the level in the year-earlier period and 3% from the level in the preceding quarter. The increase in volume had a positive effect, however, this was more than offset by an unfavourable margin development.

Three factors affected the business in the first half of the year. Firstly, competition continued to be very intense in most markets, which entails margin pressure. The margin pressure was also affected by higher short-term rates in Norway and Sweden in particular. Secondly, as I alluded to earlier, the increase we have seen in funding costs derives from the significant issuances of non-preferred senior bonds in order to meet the specific MREL requirements set by the Danish FSA. Thirdly, a low return on our hold-to-maturity portfolio and a higher capital cost also explains part of the decline, as well as our decision to move the Baltic and Russian exposures to Non-core.

With respect to the high-funding activities, we have now obtained the major part of our non-preferred senior funding for 2019. The vast majority of the NPS funding, which is clearly more expensive than preferred senior funding, was issued in the first quarter. The relief on NII from redemption of all funding in 2019, will, for the most part, come in in the second half of the year. As we have previously communicated clearly, the part of the higher funding cost that exceeds a comparable level for our peers is held internally and will therefore not be passed on to customers. These costs are included in the 'Other' item shown on the slide.

Slide 7, please. The decline in net interest income was most significant in Banking Nordic, where we now also see a clearer pressure on lending margins in the Swedish retail market. On the back of higher central bank rates, a corrective pricing action has been initiated in both Norway and Sweden in line with our peers. However, we saw only a partial effect of this action in the second quarter. We expect additional effects from this in the third quarter.

We continue to see good lending growth in Banking Nordic, as lending was up 7% in local currency from the level in the first half of last year. The growth rate declined somewhat in the end of the period though. In Norway, we continue to see a strong inflow of customers from our partnership agreement with Tekna. At Banking DK, lending was up 1% from the level in the same period last year, driven by an increase in lending to commercial customers. Lending was flat from the preceding quarter, due partly to a slowdown in the housing market and a lower risk appetite. At C&I, a major part of the decline in NII was due to the transfer of the Baltic and Russian exposures to Non-core.

Slide 8, please. Let's have a look at fee income. Compared with the same period last year, fee income was almost unchanged. The acquisition of SEB Pension Danmark and remortgaging activities at Banking DK had a positive effect. However, the effect was negatively impacted by the compensation related to the Flexinvest Fri product, margin pressure and lower activity. The decline of 4% from the preceding quarter was due to the mentioned compensation and lower activity, but also the sale of Danica Pension Sweden.

Investment fees were down 15% from the same period last year due mainly to lower margin results from a change in the product mix in Asset

Management and the impact of the Flexinvest Fri compensation. Fee income from pension insurance activity came in 37% higher than in the same period the year before, but lower than in the preceding quarter due to the effect of the sale of Danica Pension Sweden. Fee income from lending and guarantees was up 12% from the preceding quarter, benefiting from higher remortgaging activity. However, lower activity in the housing market in general had an adverse effect. Capital market-related fee income came in lower than in the year earlier, but was 19% higher from the preceding quarter due to higher customer activity in Capital Markets at C&I.

Slide 9, please. Trading income was down 15% from the same period last year and 36% down from the level in the preceding quarter when trading income benefited from less challenging market conditions. At Corporates & Institutions, which account for the bulk of our trading income, market conditions were less challenging in the first quarter, which benefited from slightly higher volatility and tighter credit spreads. This had a positive effect on the trading of FI&C and DCM. In the second quarter, however, the rates business was negatively affected by a sudden change in interest rate expectations on the basis of new monetary policy signals from the central banks. Income from the refinancing of adjustable rate mortgages had a positive impact in Banking DK in the first quarter.

At Wealth Management, a negative one-off of DKK 140 million was booked in the first quarter due to a regulatory change in the discount curve for valuation of liabilities in our life insurance business. The second quarter result was negatively affected by a lower investment result and discount curve effects in the health and accident business.

Slide 10, please. Moving on to expenses. Total expenses for the first half of the year amounted to DKK 12.8 billion and were up 12% from the level in the same period last year. Compared with the expenses for the preceding quarter, there was a 9% increase. Expenses include the compensation payable in relation to the Flexinvest Fri product of approximately DKK 220 million. The increase in staff and consultancy cost includes higher expenses for compliance, the investigation related to the Estonia case and all costs related to SEB Pension Danmark, which is now part of the cost base.

Compared to the first half of last year, all business units, and Banking DK, in particular, were impacted by higher costs for regulatory requirements and compliance. Banking Nordic was also affected by higher VAT, whereas the headline number for C&I is lower due to the transfer of portfolios to Non-core and lower performance-based compensation. Expenses at Wealth Management increased because of the compensation payable to certain Flexinvest Fri customers and the inclusion of SEB Pension Danmark in the cost base. Finally, other costs were impacted by higher amortisation of intangibles relating to customer relations from SEB Pension Danmark and software.

Slide 11, please. Loan impairment charges in core activities amounted to DKK 0.1 billion for the second quarter, corresponding to a loan loss ratio of 2 basis points. Overall, credit quality remained strong on the back of a stable macroeconomic environment and strong collateral values. However, as expected, the level of reversals has fallen significantly from the levels in the last couple of years. Charges for the first half of this year amounted to DKK 0.5 billion, attributable to C&I due to single-name exposures in the retail and oil-related industries. At Banking DK, we saw significantly reduced impairment charges in the second quarter due to model adjustment and charges against agriculture in the preceding quarter. The impairment outlook for agriculture has improved, which led to reversals in the second quarter. In our Non-core activities, impairment charges amounted to DKK 0.4 billion as a result of fewer reversals and negative value adjustments.

Slide 12, please. Our capital position remains strong with a reported CET1 capital ratio of 16.6% at the end of the second quarter and above our target of about 16%. The total capital ratio was 21.2%, well above our total capital target of above 20%, but down 0.4 percentage points, following the redemption of Tier 2 capital. The development in the CET1 capital ratio was affected by a slightly higher REA due mainly to a higher market risk and a higher deduction due to volatility adjustment and adjustments to the merger of Danica and SEB Pension Danmark.

The regulatory CET1 requirement rose 0.3 percentage points, due mainly to an increase in countercyclical buffers. We have an ongoing dialogue with the Danish FSA regarding general product governance risk following the Flexinvest Fri case and an inspection of our IT governance structure. We anticipate an additional Pillar II add-on in the mid-single-digit billion range, and expect this to be treated as ordinary Pillar II, meaning that 56% should be met by CET1 capital. The leverage ratio was 4.4% according to transitional rules as well as fully phased-in rules.

Slide 13, please. Finally, the outlook for 2019. As stated in our company announcement of the 8th of July, we have changed our outlook for expenses and net profit from the outlook stated in the interim report for the first quarter of 2019. We now expect expenses to be between DKK 25.5 billion to DKK 26 billion, including the DKK 0.3 billion earmarked for AML digitalisation efforts. The outlook for full-year net profit was also changed, and we now expect a net profit for 2019 in the range of DKK 13 billion to DKK 15 billion.

Slide 14, please. Those were our initial comments and messages. We are now ready for your questions. Please limit yourself to two questions. (Operator Instructions) Operator, we are ready for the Q&A session.

Operator

(Operator Instructions) First question is over the line of Per Grønborg at SEB.

Per Grønborg – SEB

My first question, your Chairman of the Board, Karsten Dybvad, has been out in May-June talking about a bank that has been strongly underinvested over seemingly a quite long period of time. Can you put any flavour on what's the magnitude? And what the plan is to catch up on these underinvestments?

My second question is related to your C&I business area. If you look at the development this quarter, NII down 8% q-on-q despite lending is up 4%. Loan loss rate has been high for quite a long period of time. This time, I calculated 60 basis points; profitability 30% below what was the worst quarter ever, I guess, Q4 '18. What are your thoughts about C&I? That seems to be where your business is suffering the most at the moment.

Chris Vogelzang – Danske Bank – CEO

Okay. I'll start on the first question you asked. We are currently in a process of assessing what plans we have to implement to improve the performance of the bank. Part of that is looking at our current compliance status. And also looking at whether or not additional costs have to be made for that. So give me a little time, and I will revert on that later this year.

Christian Baltzer – Danske Bank – CFO

And if I could take your second question. I think we --

Per Grønborg – SEB

Can I just add?

Christian Baltzer – Danske Bank – CFO

Yes, go ahead.

Per Grønborg – SEB

On the first one, is this solely related to compliance? You don't see any issues on the IT and the general education of staff, et cetera? This is solely compliance rate, what we have seen Karsten Dybvad commenting on in the press, is that correctly understood?

Chris Vogelzang – Danske Bank – CEO

That is my interpretation, yes.

Per Grønborg – SEB

Okay. Perfect.

Christian Baltzer – Danske Bank – CFO

So Per, on your C&I question. I think if we just take a step back, you have to bear in mind that we, in C&I, have had a removal of the Baltics and Russian portfolios, which is basically explaining most of your -- some of your NII development. However, I do agree with you that we have seen a subdued performance from our C&I business. And we are in constant dialogue with Jakob Groot, the head of the business, to discuss which parts of these things are cyclical and are things that are fluctuating, and are there parts of this that are structural, and does that change our view. And that is part of the ongoing dialogue that we, in management, are having. And what we will revert with later this year is probably also some highlights, whether there's something within our C&I portfolio that we need to adjust for.

Operator

Okay. We now go to the line of Jakob Brink at Nordea Bank.

Jakob Brink – Nordea

My first question is regarding the mid-single-digit, let's call it DKK 5 billion Pillar II add-ons. How is this exactly related to Flexinvest Fri and/or product run-through and IT? It could be good to hear some more details.

And then secondly, on costs, could you give us some indication of where you are? I'm thinking, so some place, you write that you're now at, I think, 1,900 AML persons, I think I've heard in the past, that should go to 2,000, is that correct? What's the spill-over effect for next year? And then, I guess, also on that topic, on page 4, basically, every box you mentioned is something about automation, digitalisation of processes. So I guess, at some point, we should start to see some savings on the AML. Could you maybe give us some details on that as well, please?

Christian Baltzer – Danske Bank – CFO

Thank you, Jakob. So to give you a little bit more colour on the Pillar II. There's no -- so taking again a step back, overall, normally, you have operational risk in a Pillar I kind of setting. I think what we're generally seeing is that, where there's been inspections, where there is an operational risk that the FSA is concerned about, they have used Pillar II. We've seen this in model risk, we've seen this in all different types of risk to actually make sure to kind of push the bank into one thing, be more conservative, but also to give an incentive for the bank actually, to correct some of these things.

So as I think with the Flexinvest is an example of us paying out DKK 400 million because of a mistake that was made, so that is kind of the economic impact of that. And then in their inspection of both our IT, which is a regular inspection, and with the ongoing dialogue on Flexinvest, we are just saying, and again, normally, we would not come out commenting on ongoing dialogues with the FSA because we have that all the time, but kind of in the spirit of transparency and predictability, we want to give a little bit of insight that we do anticipate to see some Pillar II add-on from this. We also stated in the announcement when we announced Flexinvest that we anticipated some negative comments from the FSA at that point. So I think it's very much in line with what we have said before, at least. With respect to the --

Jakob Brink – Nordea

Christian, just one thing. It's just that DKK 400 million, that's a pre-tax number, and DKK 5 billion is a post-tax number. So I just think the magnitude is huge.

Christian Baltzer – Danske Bank – CFO

I think you need to see the Pillar II add-on as, again, a 99th percentile, I think, is what they're trying to gauge for in the capital. It is the ongoing dialogue we have with the FSA, about what the Pillar II requirement should be on this, and we're just giving you a little bit of insight that we do expect it to be in the mid-single-digit range. So I think we'll come back with more details on what this means later on, once we actually have the finalisation of the dialogue with the FSA, and that can take months. So...

Jakob Brink – Nordea

So but are you expecting anything further? Have they said something about that some of your other products need to be repaid or has been wrong as well?

Chris Vogelzang – Danske Bank – CEO

This is Chris. No, there is not an -- there is no other -- currently, there is no other customer issues of any magnitude going on.

Jakob Brink – Nordea

Okay.

Christian Baltzer – Danske Bank – CFO

So your second question with respect to the 1,900 or more than 1,900 FTEs that are now working with AML. You're absolutely right that, at some point, we will see a benefit coming from the investment that we're doing in digitalisation. I think this is not something we'll see tomorrow. I think we are actually, at the same time as investing heavily in upgrading this area, as I mentioned in my walk through, we are, at the same time, trying to see how can we also do this smarter, so that we, in the longer term, don't have to endure -- I mean, between a DKK 2.5 and/or, let's say, DKK 1.8 billion to DKK 2.1 billion of compliance-related activity costs is a high number that we are facing right now. And some of this, we can control ourselves; in new regulation, unfortunately, we cannot control ourselves, if we have another GDPR, MiFID II kind of activity, but we will work dedicated to kind of get the cost of AML down and also make it an integral part of our business. I mean, there's nothing wrong with knowing your customers. There's nothing wrong with making sure that we are fighting financial crime. We just need to make it a more integral part of our business, whereas right now, it's more of almost, unfortunately, a stand-alone activity. So I think that is the -- that is where digitalisation can build that bridge for us. I hope that makes sense without giving you a lot of numbers in terms of what to anticipate on benefits.

Chris Vogelzang – Danske Bank – CEO

Can I add one more thing? When I said, and Christian said, that there's no other ongoing things which we know of with clients at the moment, I want to make very clear that, as I said also in my introduction, we are embracing conduct and compliance. That means that we, in my opinion, should move from a reactive to a more proactive way of looking at the relationship, which we have with our clients. That is an ongoing process, but I cannot exclude, nor can any bank, that in that process, we will find other things. But I want, as a culture and as an attitude of this bank, that we, on a systematic basis, look at -- are we doing the right things for our clients. So there is -- I'm not saying that we will not encounter more things, but at the moment, I don't have anything on my desk.

Jakob Brink – Nordea

Is it fair to say that this -- when you come with your longer-term ROE initiatives later in the year, that could maybe include some sort of -- give us some details on what could be saved on AML longer term?

Chris Vogelzang – Danske Bank – CEO

I'm not sure. Let's -- I mean, given that I'm in my, literally, in my sixth week, I find it difficult to promise anything on this. But let's phrase it in another way, everything Christian said about making compliance an integral part of your business, but also doing it in an efficient and effective manner, I fully support.

Operator

We are now over to the line of Sofie Peterzéns at J.P. Morgan.

Sofie Peterzéns – J.P. Morgan

Here's Sofie from J.P. Morgan. So just a follow-up question on the Pillar II add-on. Your current core equity Tier 1 target is 16%, should we expect that to change with regards to add-on or will it remain unchanged? That would be my first question. And the second question would be around the ongoing AML investigations. Do we have any -- or do you have any time line on any potential settlement? Could you potentially -- or could you also give an update if you have found any sanction breaches of the clients that you have gone through so far?

Christian Baltzer – Danske Bank – CFO

Sofie, so with respect to the Pillar II, I think, in respect to the target, we are always reassessing our target level. And once we have any clarity on the Pillar II, we will also reassess if we need to do anything with our capital targets. So that will be part of the process and part of our communication, that is an ongoing thing that we do more or less on a quarterly basis through our ICAAP.

With respect to the AML activities, you could almost argue that no news is good news here with respect to sanctions because we have said that if we find material sanction breaches, we will come out and inform the market about that. So no news is good news.

With respect to the time line, it is still, unfortunately, very much in the hands of the Danish and U.S. authorities to have the time line. And what we are trying to do to make it as short as possible is to be fully collaborative, give them all the information that they need. And also, the investigation that we're doing ourselves to make sure that we are more or less handing information to the DOJ and to the Danish FIU in an efficient manner. So we're doing what we can from our end to make sure that all the stones are turned and that we can close this as quickly as possible. But unfortunately, we don't have visibility on the time line.

Sofie Peterzéns – J.P. Morgan

Okay. That's clear. But just a quick comment or a question around the capital targets. So if you reassess your capital on a quarterly basis, does that mean that once you get clarity on the full impact from the Pillar II, you could also give a new core equity Tier 1 target, so that could, hypothetically speaking, change in the next quarter?

Christian Baltzer – Danske Bank – CFO

So I think you definitely need to read into this, that as our capital requirements, they change, we would also naturally change and look at our capital targets. Do bear in mind that when you have countercyclical buffers, you have to add on. In a stress test and from what management buffer you need actually reduces the amount of management buffer you need in a stress test. So there are some of these additional capital requirements that actually pull, you could argue pull the other way from a target perspective. And then there are some of these other. And do bear in mind that the Pillar II, it's 56% and it needs to be met by CET1 capital, that actually pushes somewhat in the other direction. So there are a couple of moving parts here. And as we have finalised our discussion and kind of internally look to see what would be the right change, if any changes to our target, we will revert with that in due course.

Operator

We are now over to the line of Geoff Dawes at Société Générale.

Geoff Dawes – Société Générale

It's Geoff here from SocGen. A couple of questions from myself. First of all, I mean, to go back to some of the questions about technology and AML spend and everything else. Do you have any sense in terms of a benchmark, kind of where your current absolute spend level is relative to the peer group, so your Northern European banking peer group, has it now become significantly ahead? In the past, was it significantly below? I guess that should be numbers that you've looked into, is that something you can give us some colour on?

The second question is on the interest expense impact from the funding premium that you isolate within the corporate centre. Can you just give us an idea of how that might progress as funding costs change and also how funding costs are changing? I know it's, for example, the CDS spread has come in over the last six months. Is that playing out in terms of your interactions in the funding market and a lower risk premium? Or is it not? And will that change what we see on the other net interest income line? Those are the two questions.

Chris Vogelzang – Danske Bank – CEO

Thank you, this is Chris. In terms of the compliance benchmark, I mean, that is exactly what we are now trying to do and what we are now looking at. I mean there's two kinds, so of course, we have is -- of course, that we have a pretty heavy problem in Estonia, which we have to solve. But I also want to understand better where we stand on a BAU basis. And so that is currently work in progress. By the way, my benchmark – our benchmark wouldn't necessarily be the Nordic banks, but would be our European banks in general. So this is in process, and I will have to revert to that when I come back later in this year with my views.

Christian Baltzer – Danske Bank – CFO

And Geoff, to the funding, the way that we are seeing it right now is that as we have issued non-preferred senior and look at the spreads that we have compared to peers, it is the elevation that compared to peers that we have kind of kept centrally. Now, we are seeing that tightening. So as we issue new non-preferred senior, that amount that we keep centrally will become lower. We will, however, carry the issuing that we have done in the first quarter throughout the remainder period of that time that we have that funding. So it's something as margins tighten, or as our spread tightens compared to peers, we will see that effect be lower and lower, and we'll be able to, or we will pass more of that out into the business areas so they can pass it into the customer rates in general.

Geoff Dawes – Société Générale

Okay. That's clear. And just to clarify, how much have you seen that tighten? How far away from the peer group? Is it on more recent issuance or issuance that you may have pending?

Claus I. Jensen – Danske Bank – Head of IR

This is Claus here. We are still above a curve of peers, which we use for comparison. I think the uncertainty related to the AML case, which we have seen for a while, is still sitting in the spread. And therefore, it's impossible to give you any guidelines for when we expect that to narrow. That is completely up to the market. And what was your add-on question here?

Geoff Dawes – Société Générale

I think that was it. I assume that's everything answered.

Operator

We are now at the line of Mads Thinggaard at ABG.

Mads Thinggaard – ABG Sundal Collier

This is Mads from ABG. I have one first that relates to NII. Now we're seeing NII down at 3% quarter-on-quarter here in Q2. And I mean, I can hear you mention a lot of negative factors here. You also point to some positive ones, being redemption of old funding and also repricing in Norway, still to kick in. I was just wondering if you could give us kind of a view of the NII trajectory from here. What is kind of the outlook for Q3 and Q4? Could we get NII up in the second half of 2019? That would be my first question.

And then as the second question, I noticed today in Danish media, and you were kind of giving a pledge to the public, I saw that several times, about not charging negative rates on retail deposits. And I was just wondering, I mean, of course, as you see the kind of idea behind that and how challenging that would be to introduce. But is that a kind of a pledge that you'll give under -- I mean, forever, or at least a long time? And also, if the rate drops significantly from here.

Christian Baltzer – Danske Bank – CFO

Thank you, Mads, for your observations also in the Danish media. So with respect to NII, we are not guiding on the second half-year traction on this. However, in the moving parts, right? We are having some redemptions, which is going to give us a positive. We are seeing our repricing in Norway, that's going to take us some time. So we'll have a little bit of headwind of the repricing in Norway for Q3. We don't know what's going to happen to central bank rates in Denmark, but that can also give an impact that might give a negative -- even more negative sentiment to our NII. So we're not really guiding for the remainder of the year. But I think we're looking into more of a balance of positive and negatives affecting our second half year NII.

And then on that notion, as that we expect the negative rates in Denmark. I think if we were being quite delicate in saying that retail customers, standard retail customers with a checking account in Danske Bank should not expect a negative interest rate. So that is the notion, but we already have negative interest rate on our corporate clients above a certain threshold. They actually pay negative interest rates. That pledge, I think, is right. You could also say that we are actually able to have our money at the National Central Bank of Denmark at a 0% - the folio account that we have. So we actually do have a -- some of the money that we are having in the Central Bank that are at 0%, and not all is a negative 65 basis points.

So I think it is the right thing that the ordinary Dane with a checking account should not pay a negative interest on their deposits. Do bear in mind that we have fee structures and other things where people pay for their -- banking with us on a more ongoing basis, and it's more on the fee line that we've been, in generally, over the last 3-5 years, compensating for the negative sentiment on the interest rates.

Mads Thinggaard – ABG Sundal Collier

Okay. So looking into your new plan for the future version of Danske Bank, then it's more the fee line, we should look to in how to improve the income?

Christian Baltzer – Danske Bank – CFO

I think you are taking the words out of my mouth to what we've done in the past. I think, in general, back to what Chris was saying in his intro, we need to find good ways to operate in a low-margin environment. And a lot of that is through also leveraging technology, in leveraging efficiency gain measures, in general. So I think we would more be looking in that area than to try to pass on additional costs to our customers necessarily, or unnecessarily, so to speak.

Mads Thinggaard – ABG Sundal Collier

Okay. So by kind of the marginal economic argument for charging for retail deposits, we're not really going to see that over the next years?

Christian Baltzer – Danske Bank – CFO

That is correct.

Operator

We now go to the line of Marco Di Matteo at Goldman Sachs.

Marco Di Matteo – Goldman Sachs

I wanted to ask firstly about the NII. So you mentioned that deposit margins have been an area of weakness in the quarter, and could you elaborate on what drove that? In particular, is there any pricing action to offset customer outflow? And secondly, with regards to capital, I wanted to ask your view of how do you think about calibrating a management buffer that works for all your stakeholders? And I'm thinking, in particular, about the credit market, considering that your funding spreads are more elevated than peers'.

Christian Baltzer – Danske Bank – CFO

Thank you for your question. So with respect to the NII, I think we have to make sure that we are -- I'm saying we're operating in different environments. So in Norway, where we're actually doing repricing, we are pushing more prices through on the lending than we are giving back on the deposits. So there, actually, we are improving our long-term NII for the Norwegian business. In Sweden, where the rates have been somewhat flat, we've not been able to push as much pricing through since Q1. In Denmark, I mean, we have seen an inflow in some of our deposits, which also has an impact. So that's how you should view the deposit margin quote here, and I don't know, Claus, if you have further comment on that, no?

In respect to the target, I'm not going to start speculating here about what we might do to our target, but I think, in general, we will reconsider when we have this consideration after the FSA discussions, how do we have a target that is more in line with something that will satisfy stakeholders in general. And when I mean stakeholders, we're talking about shareholders, we're talking about the public, we're talking about, like, FSA, the regulators. So that's kind of the sentiment and the view that we will be taking and looking at our capital target position during the coming months as we also have dialogues with the FSA.

Operator

We are now over to the line of Joakim Svingen at Arctic Securities.

Joakim Svingen – Arctic Securities

I have two questions as well, if I may. The first one is could you elaborate a bit on which types of customers and who you are losing to in your home market Denmark? And the second question is relating to efficiency measures. Have you made any efficiency measures since the AML case surfaced at all?

Christian Baltzer – Danske Bank – CFO

Thank you. So with respect to whom we are losing, what kind of customers, I think it's very broad spectrum. It is not a specific type of customers that we can see is -- has left us, it is more from all the way to high value, high net worth, customers to low net worth customers in general. So we're not seeing any specific patterns. I think, in general, we're seeing a lot of the smaller banks picking up market share and picking up some of our customers. Again, we don't see a single bank that has been taking all of our customers per se. So it is a more of a broad picture than it's a single kind of this-is what-is the exact measures or the exact customer area that we're losing.

With respect to efficiency measures, I think that when you look at the bridge from our '18 to '19 right now, and you're looking at this other income and activity, which is 0.3 to 0.5 that which is the other bucket. Do bear in mind, we have about a 2% to 3% salary increases in general on our staff. We have had other kind of increases in cost, so when you scrape all of those out, you will actually find that we have had significant cost measures in general over the last year. So if you walk the hallways of Danske Bank, you won't feel that there has not been any kind of cost focus over the last quarters at all. There's no doubt, within the AML area, we are investing heavily in this. We are controlling the costs that we are spending to make sure we get the best out of it, but with the acceleration of these investments, there's no doubt that is something we are continuously focused on controlling that we get the right value out of the investments that we do.

Operator

We're now over to Jacob Kruse at Autonomous.

Jacob Kruse – Autonomous

So I guess my first question, I guess, will be this FSA order with respect to your IT governance. Do you see that coming with meaningful investment into your IT systems or platforms? Or is this just a question of how you manage those IT systems? So should we expect another round of cost creep for the next couple of years? And my other question was just on NII. Would it be fair to say that your NII is now broadly linked to volumes in the absence of meaningful rate moves in terms of the balance between repricing efforts and ongoing price pressure?

Chris Vogelzang – Danske Bank – CEO

I'll react on the first question. Let's first frame it. I think there is, in general, much more attention where regulators all over Europe, at least, on IT and IT governance. Two, this is literally very, very new that we had this very preliminary discussion with them. And again, we thought in the interest of transparency, we'd share it with you, but it is very preliminary. As far as we are understanding it now, it has nothing to do -- as far as we understand now, - it has nothing to do with investments in IT, but more in like how have we organised the first, second and third lines of defence kind of set-up around IT, i.e., are there change-risk assessments in IT investments carried out by others, is there a good division of responsibility and accountabilities, et cetera.

That is the information we got so far, but we are literally very much in the beginning. And again, to put the whole thing in perspective, we gave you the numbers, including the concern around Flexinvest. So I don't, at this moment, foresee any sizable investments related to IT governance.

Christian Baltzer – Danske Bank – CFO

And with respect to NII, I think that, in general, volume is a way to grow the NII. I think we will be looking into the next several years with where we are converting senior preferred bonds into senior non-preferred bonds, that will give us a continuous headwinds over the coming years on our NII line. And in general, we need to work with both our pricing side but also the volume side. So I think that there's several moving parts in volume, I would say, it's not the only one we can affect, but there are also other measures to take in order for us to, in general, try to improve the NII line.

Jacob Kruse – Autonomous

But sorry, just on this NII question, it sounds like you have some funding cost headwinds. It sounds like you have some liquidity portfolio rollover headwinds. And then repricing, from what I can tell, seems to be mostly coming from the Norwegian business, whereas elsewhere, your geographies, there is very little repricing upwards going on. Or is that -- am I missing a kind of positive element here?

Christian Baltzer – Danske Bank – CFO

No. That would be the negative sentiment, when you look at, I think, it's page 28 in our investor deck, where you can see the funding and liquidity cost. We are seeing that the NPS we are issuing has been at 195 basis points. And the stuff that we are redeeming is more around 25 to 50 basis points. So when you're doing that shift in the funding, that's going to give a headwind. The repricing is Norway, you're absolutely right. That's also where the central bank rates have been moving upwards. So that is also why we're doing that repricing.

So I think that those are kind of the sentiment around the NII. And there are headwinds on that line. And I think we need to, during the next couple of months, quarters, years also find out how to make sure that we'll also get some positive momentum in our NII.

Operator

The next question is from the line of Riccardo Rovere of Mediobanca.

Riccardo Rovere – Mediobanca

Most of my questions have been already asked. Just one final one. With regard to the trading line, which is giving you quite a lot of headaches over the past few quarters, would you say that the level that we have been seeing over the past, let's say, 2, 3 quarters, is now a structural level? So that the trading profits that we were used to see a couple of years ago ahead of the AML issue and -- have now, should just be forgotten, and you're going to have a structurally lower contribution from the line in the P&L?

Christian Baltzer – Danske Bank – CFO

Thank you, Riccardo. I think it's an excellent question because predicting what is structural and what is cyclical... what we do know is that what we saw in '16 and '17, we saw a significant inflow of Danish kroner. There was also some significant tailwind, so to speak, in our trading line, so we have probably had elevated income on our trading line in '16 and '17. Now what we are seeing with the low rates in Denmark, what we're seeing in general with Denmark, with the spreads being so low as they are: I think whether you want to call it structural or you want to call it just from a longer cyclicality perspective that we are in this very low-interest, low-margin and hard to carry a spread on this may be the case.

And I think, as I was mentioning to Per earlier – Per Grønborg earlier in the call, these are some of the things that we are taking into consideration as we are looking at our analysis of the bank and where to improve our performance, or if there's things we need to do. So we're not calling it out to be one or the other yet, but we are definitely aware that we right now have had four quarters out of five with a not-so-good trading income, and that is something we need to react to.

I think we'll take one last question. And then in the interest of time, we will end the call.

Operator

Okay. In that case, the final question for today is over to the line of Richard Smith at KBW.

Richard Smith – KBW

I guess, just sort of circling back on costs. I mean, as I look at slide 3 in the build-up that you've got there of some of the blocks. I mean, it looks like consensus is effectively holding costs flat out beyond 2019 at that level. And looking at some of those blocks, it feels like some of those should start to abate going forward. And I just really want to get a sense of, as we look at maybe some of the compliance costs, how quickly you think those might come off? But also perhaps some of the pieces like the Flexinvest case, whether you saw that persisting out beyond '19? And if there were any other blocks there that you feel might start to ease going into next year?

Christian Baltzer – Danske Bank – CFO

And without trying to guide into 2020 cost level or beyond, I think the Flexinvest in all of this is the one that we know will not come for next year, that's Flexinvest. Then there's the Estonia case, which we still anticipate that we will be spending a good amount on U.S. lawyers, legal fees in 2020. At what level, we are not sure we have the transparency on yet, but those will be the two blocks in my mind that very quickly should be able to disappear.

Now the overall, and back to some of the questions earlier, say, what do we -- how much AML we actually see going forward. And I think we need to brace ourselves by actually saying, we need to invest further in AML also and the digitalisation, and the benefits we are getting from that will be something we'll more see on a more mid-term than a short-term basis in our cost base. I hope that, Richard, without guiding into 2020 cost level that, that gives you -- gives you a little clarity there.

Chris Vogelzang – Danske Bank – CEO

Thank you. It is Chris again. Thank you all for your interest in Danske Bank and for your questions. As always, contact IR, Claus and his team, if you have more questions. As indicated, a transcript of this conference call will be added to our website and the IR app within a few days.

Again we are, as a team, working on looking at how we can improve the performance of the bank, including that for the shareholders, and we'll be coming back on that later this year, and I hope to continue with the discussion with you before that, but definitely then. Okay. Thank you very much.