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Contacts

Elena Ioannou, CFA +44.20.7772.1716
Associate Analyst
elena.ioannou@moodys.com

Louise Lundberg +46.8.5179.1280
VP-Sr Credit Officer
louise.lundberg@moodys.com

Danske Bank A/S

Danske Bank's operational rationalisation will improve efficiency and support profitability

On 8 October, Danske Bank A/S (A2 negative/A3 stable, baa2[1]) announced a voluntary redundancy programme that would affect up to 1,600 jobs in Denmark. The cuts equal up to 7% of Danske's work force and are part of the bank's transformation plan, which includes reducing costs to improve efficiency and competitiveness. The cuts, which are in addition to an existing hiring freeze, will allow the bank to improve operational efficiency and profitability through lower expenses, and are a step toward achieving ambitions that include reaching by 2023 a cost-to-income ratio of low 50% range and a return on equity of 9%-10%.

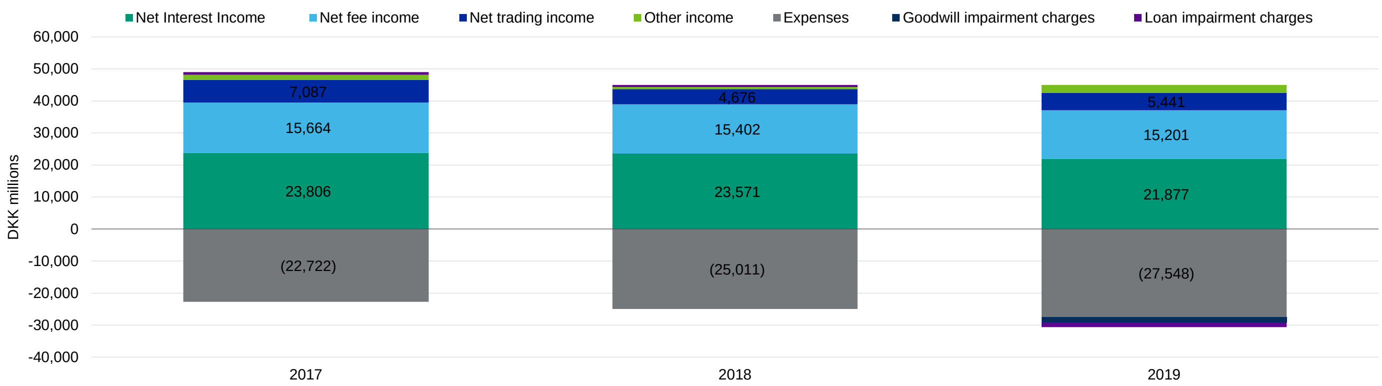
The combined effects of depressed revenue and increased operating expenses has negatively affected Danske's cost-to-income ratio, which deteriorated to 65.7% in the first half of 2020 from 47% in 2017. This widened the efficiency gap against the bank's Moody's-rated Nordic peers, whose average cost to income ratio [2] was 48% for the first half of 2020.

We expect Danske's profitability to be challenged over the next 12 to 18 months. Global interest rates are likely to stay low for longer than we previously expected as a result of the coronavirus crisis, and we expect Danish rates to remain negative over the next 12 to 18 months. This will continue to negatively affect the bank's net interest margins. Strong competition, particularly in the corporate loan market, will exacerbate the effect of low rates. At the same time the operating environment will remain challenging, even if we anticipate Denmark's economy gradually returning to growth.

In this environment of low rates, low margins and strong competition, Danske's ability to maintain tight cost control is essential. The bank targets a cost-to-income ratio in the low 50% range by 2023, which will be challenging. To achieve this, the bank has prioritised reducing costs, lowering expenses by 8%-10% in 2021 to around DKK26 billion. In addition to the workforce reduction, other initiatives undertaken by the bank include product simplification and focus on non-personnel expenses.

Even before the onset of the coronavirus pandemic, Danske's profitability was negatively pressured (see Exhibit 1) by increased compliance investments to strengthen its anti-money-laundering (AML) capabilities and higher funding costs associated with the front-loading of senior non-preferred debt issuances and in general higher funding costs relative to large Nordic peers.

Exhibit 1
Danske Bank's profitability has been hit by higher expenses and subdued revenue
The bank's core profits breakdown

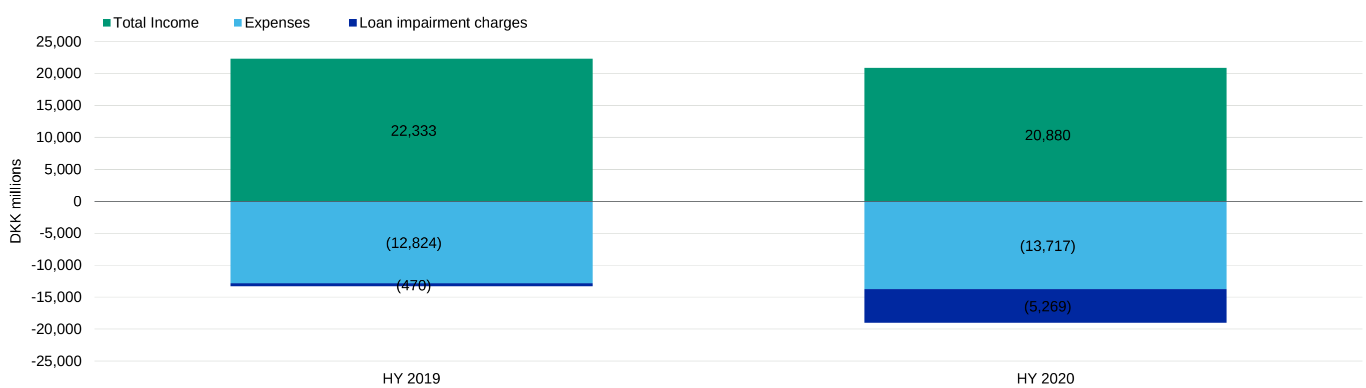


Source: Danske Bank

The bank's net interest margins (NIMs) have been hurt by the ultra-low interest rate environment, particularly in its home market of Denmark. Additionally, the bank is reporting significantly weaker trading income, which the bank expects will remain persistently lower going forward. Another challenge: the risk of a potential fine or settlement linked to the ongoing regulatory and legal proceedings related to allegations of money laundering at the bank's previous Estonian branch between 2007 and 2015 hurting the bank's profitability.

The fallout from the coronavirus-induced economic disruption has added to these challenges, with the bank's first-half 2020 net profit declining by 85% from a year earlier (see Exhibit 2), which translates to a ratio of net income to tangible assets of 0.1% for the first half of 2020. The drop was primarily driven by higher provisions related to the pandemic and drop in oil price. Provisioning costs were 11.2x higher than a year earlier. Provisions were driven by changes in macroeconomic assumptions and sector-specific post-model adjustments and credit quality deterioration, mainly for oil and gas related exposures.

Exhibit 2
The coronavirus pandemic has exerted additional negative pressure on Danske Bank
The bank's core profits breakdown



Source: Danske Bank

Endnotes

1 The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

2 Excluding administrative fines incurred by Swedbank and SEB.

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