Conference call

Interim report – first half 2020

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Investor Relations

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Chris Vogelzang – Danske Bank – CEO

Welcome to the presentation of Danske Bank's financial results for the first half of 2020. Thank you for all taking the time to listen in on this call today in the middle of the summer. My name is Chris Vogelzang, I am the CEO, and with me, I have our CFO, Stephan Engels and our Head of Investor Relations, Claus Ingar Jensen.

Slide 1, please. In today's call, we will present Danske Bank's financial results for the first half of 2020. We aim to keep this presentation to around 25 minutes. After the presentation, we will open up for Q&A as usual. Afterwards, feel free to contact our Investor Relations Department if you have any more questions.

Slide 2, please. In many ways, the first half-year of 2020 has been a turbulent period, in history as well as for Danske Bank. The outbreak of the Coronavirus pandemic in March led to a notable change to the world as we know it and has a huge potential for making us re-think the way we are organised around our customers and our stakeholders, including our own organisation.

Financially, we are today presenting a result that demonstrates a resilient business in a time of stress. The impact of the lockdown has been limited due to a combination of continuously good consumer lending activity, strong credit quality, sufficient public support and solid Nordic economies in general.

Net profit for the first half-year came in at DKK 1 billion, impacted by a weak result in the first quarter that was mitigated by a subsequent rebound in lending activity that led to a somewhat stronger result for the second quarter. As our income turned out to be more resilient in nature, two line items, expenses and loan impairments, explain the decline in net profit from the same period the year before. Total expenses increased, due primarily to costs related to the continuous strengthening and remediation of our compliance set up and the Estonia case. We also saw planned costs for the transformation to become a better bank.

Reducing cost remains a priority as we aim to lower our expenses by 8–10% in 2021 to around DKK 26 billion. Our initiatives will include additional structural staff reductions across the Group towards the end of 2020 as well as in 2021.

Loan impairments were clearly impacted by charges in Q1, primarily because of adjustment in model assumptions, but also, because of impairments against our oil-related exposure. Overall, credit quality remains strong.

On that basis, we maintain our financial outlook for 2020 for a net profit of at least DKK 3 billion.

Before we go into more detail about our performance in the first half of the year, I would like to comment on the progress we are making on our transformation agenda. In the second quarter, we maintained a strong focus on executing on our plans towards 2023 to become a better bank.

We are now seven months into the transformation process, and we continue to see good traction in all focus areas, which is vital for us to deliver an overall better customer experience. No doubt, we still have a lot of work ahead of us toward 2023, but let me start by providing you with some tangible proof points for the progress on our transformation before we move into the financial highlights for the period.

As we have previously stated, better ways of working is a key focus area as we need to fundamentally change the way we organise around our customers. Reducing hierarchy and complexity by working in empowered and multi-functional teams is a key requisite for placing customer needs at the centre of everything we do.

In June, we announced that 750 colleagues in Financing Development have started to work in a new, different and agile manner; and there is more to come as we expect that around 5,000 employees will be directly affected.

The next proof point from the transformation is the Better Nordic Retail Bank. With this initiative, we are streamlining and aligning our product offering at Banking Nordic and building one common platform instead of three in order to deliver a harmonised and scalable business model. Across the bank, we continue to strive for reduced complexity by simplifying our product offering, and, so far, we have removed 20% of our account products, with an ambition for even more before the end of 2020.

The new and more simplified processes mean that, over time, we will need fewer employees. In the first half-year, we had to let go of a number of people as part of the new ways of working initiative. This is an essential part of our Group-wide cost programme, together with increased discipline in relation to non-personnel costs.

As total expenses increased in the first half of the year, due primarily to costs related to the continued remediation of our compliance setup, as well as costs for the Estonia case, we will now expedite our efforts to bring costs down in 2020 and 2021. Needless to say, this is crucial for us for our competitiveness in a market with low rates, low margins and strong competition, but also, to deliver on our ROE ambition and cost target for 2023.

The compliance agenda continues to be a focus area. We are making good progress in terms of improving the foundation for building an effective and efficient compliance function. A large amount of resources is earmarked for developing and building our capabilities within financial crime prevention, and we are setting up a revised conduct framework and improving trade surveillance.

We have closed a large number of FSA orders and have been acknowledged by the authorities for the improved quality of our suspicious activity reports.

I will leave the details of our financials to Stephan. Before I do so, let me proactively comment on developments in the Estonia case as previously stated. Our internal investigation into the non-resident portfolio at the now-closed Estonia branch is progressing as planned, and we still expect to finish our internal investigation in the fourth quarter of 2020, with many work streams completing in Q3 2020.

As we have said all along, Danske Bank is co-operating with the investigating authorities, sharing information from our ongoing investigation and it will be for the authorities to reach conclusions based on this work. Danske Bank itself does not intend to publish any further reports or findings from the internal investigations, and there are also restrictions on what we are able to disclose while under investigation. But we will, of course, comply with our legal obligations regarding disclosure if this becomes relevant.

We continue to be in close dialogue with the investigating authorities in Denmark, the US, Estonia and France; however, the timing and potential outcome of these discussions remain uncertain, and it is a matter for the authorities rather than for Danske Bank.

Because of the continued uncertainty, we remain unable to provision for any potential fines at this stage. However, based on the orders from the Danish FSA, Danske Bank's solvency need has been increased in 2018 by a Pillar II add-on of a total of DKK 10 billion to ensure capital coverage of the increased compliance and reputational risk in relation to the Estonia case.

Our goal will be to reach a co-ordinated resolution with key authorities following the above-mentioned completion of our internal investigation. But the timing and manner of any resolution will be for the authorities to determine.

Then over to Stephan for the financial results in more detail. Stephan.

Stephan Engels – Danske Bank – CFO

Thank you, Chris. First, a couple of general observations around H1 from my side on the different corona crisis-related effects we have seen so far. During H1, we saw lending trending up, specifically at C&I, mainly for short-term credit facilities. Since the gradual reopening of the societies began the main Danish macro-economic indicators, such as consumer spending and Nordic house prices, have recovered or look reasonably good.

Unemployment is still trending upwards, although not as high as we feared and well within our model assumptions. The true status of the economies is still not completely clear, as the various government aid programmes are still in place, and it remains to be seen how H2 will develop. Nevertheless, the way forward seems to be a good bit brighter than three months ago, but we still have reason to be diligent and cautious.

Slide 4, please. Let us look a bit more closely at the financial results for the period, which, overall reflects a resilient business model in a turbulent period, with the result for the second quarter coming in better than expected.

During the first half-year, we saw a very different dynamic that to a large extent explains the development between the quarters. The overall customer activity level fluctuated a lot during the first half due to the outbreak of the coronavirus pandemic. In general, customer activity was solid at the beginning of the year until mid-March. Then followed the lockdown period, with low activity that reversed in May when the societies started to scale down the various restrictions. Excluding one-off effects, total income was 1% lower than in the first half last year. Overall, total income came in at DKK 20.9 billion or 7% lower, due to a one-off gain from the sale of Danica Pension Sweden in 2019.

Net interest income increased as a result of good business activity and a slightly more positive development, mainly for deposit margins and volumes, which explains the better result of the second quarter. Deposits increased 17% in the period, primarily because of corporate deposits at market rates, whereas, the increase in retail deposits, primarily on ordinary transaction accounts, was due to significantly lower consumer spending during the quarter that also had a negative impact on transaction-based fee income.

Fee income, excluding one-off effects, was driven by higher customer activity among our Nordic customers and large corporates, whereas, reduced remortgaging activity in Denmark affected income in the second quarter as expected.

Trading income for the second quarter improved significantly due to much better market conditions and reversal of negative valuation effects from the first quarter. C&I being the main contributor to this line item, saw overall good customer activity and increased income. However, year-over-year trading income came in lower because of negative value adjustments.

Our expenses, which I will comment on in more detail later, were up from the same period last year, as well as the preceding quarter, due to transformation initiatives driven by our 2023 agenda and continually elevated costs for the Estonia case and remediation of compliance.

Loan impairment charges, which, to a high degree, explain the difference to the financial result for the same period last year, amounted to DKK 5.3 billion for H1, accounting for most of the charges we expect in 2020. Two items explain the development: firstly, the impact of model adjustments driven by changes in macroeconomic assumptions and secondly, an adverse development of our oil-related exposure, which I will come back to later.

The result for the second quarter in isolation was DKK 2.3 billion and was thus significantly up from the negative result in the first quarter, whereas the result for the first half-year amounted to DKK 1 billion, against DKK 7 billion last year.

Slide 5, please. Now, let us take a closer look at the underlying development in net interest income. If we start with the developments from the same period last year, it is quite clear that the improvement in NII of 1% is affected by headwinds from the Nordic currencies and the Norwegian krone in particular. Adjusted for this, NII is up 3%.

Good customer activity in the form of lending and deposit growth, as well as higher deposit margins, had a positive effect, however, countered somewhat by continued pressure on lending margins. Compared to the previous quarter NII was up 1%, driven primarily by a positive deposit margin effect because of the Danish rate hike in March, whereas the pressure on lending margins resulting from the low interest rate environment continued.

Slide 6, please. Lending at Banking DK was down 2% year-over-year due to declining demand for credit among commercial and retail customers, as well negative value adjustments in the mortgage book. The pressure on lending margins was most evident at Banking DK, where we see the effect of our customers' shift towards longer-term fixed-rate mortgages with lower margins.

At Banking Nordic, we saw growth in business activity, with lending up 4% in local currency as a result of strong growth in retail Sweden and Norway, where the inflow from the partnership agreements continued in the first half of the year. We also continued to see higher lending in commercial Finland and Norway.

Adjusted for the effect of the depreciation of the Norwegian and Swedish krone, lending was up 1%. NII improved from the same period of last year, benefiting from volume growth as well as improvement in lending margins.

At corporates and institutions, lending volume increased 12% year-over-year and 5% quarter-over-quarter. The increase reflects the utilisation of part of the short-term facilities we granted in the first quarter due to the coronavirus pandemic. However, a significant part remains unutilised and serves as back-up facilities. NII benefited from higher lending and higher deposit volume at market rates.

The elevated level of deposits as well as some of the short-term lending facilities provided to corporate customers should be seen in the context of the current uncertainty and are therefore not necessarily of a permanent nature. Although pricing at C&I has improved, the average margin on lending is somewhat lower, reflecting shorter-term credit facilities originated with highly-rated corporate customers.

Slide 7, please. Let's have a look at fee income. Fee income was up 4% year-over-year. Adjusted for the Flexinvest Fri compensation in 2019, fee income was up 1%. Activity-based fee income declined from the same period last year and also from the preceding quarter due to the effects of the lockdown of societies during the spring.

Transaction-related fee income as well as fees from lending and guarantees were down 10% and 3%, respectively, whereas investment-based fee income was stable when adjusted for the Flexinvest Fri compensation.

Compared with income last year, fee income at Banking DK was unchanged, adjusted for the one-off in 2019. Transaction-related income came in lower due to a slowdown in the housing market-related activities and overall lower customer activity.

At Banking Nordic, fee income was up 2% since we saw good investment activity and higher commission fees in Sweden in particular. At C&I, higher customer activity in mainly equities and debt capital markets explains the increase of 7% in our capital markets-related fee income.

Fee income at Wealth Management was up 2% in the first half of the year from the year-earlier period, despite the effect of the sale of Danica Pension Sweden. In Q2, fee income from pension and insurance was up, mainly due to one-offs related to the reversal of losses on guarantees on certain Danica products booked in the first quarter.

Slide 8, please. Now let's turn to trading income. In the second quarter, we saw a strong rebound in trading activity as the markets came back. Trading income year-over-year, excluding the effects of value adjustments, was stable. Including value adjustments, trading income was down.

At Corporates & Institutions, which generates most of our trading income, the business benefitted from an overall good franchise value and a leading market position in a high number of specialised markets. Trading income was up 20% from the same period last year and amounted to DKK 1.8 billion in the second quarter, against a negative DKK 0.2 billion in the preceding quarter.

High customer activity and more positive developments for credit spreads in general, and for Danish mortgage bonds in particular, had a positive impact on trading income in FI&C. We also saw a positive contribution from the equity business. Negative xVA in H1 amounted to DKK 0.1 billion, as lower funding spreads reversed some of the negative impact from Q1.

In the banking units, trading income came in lower as a result of lower investment activity among retail customers, mainly in the second quarter. At Wealth Management, the investment results in the health and accident business benefited from a more positive development in financial markets in the second quarter.

Slide 9, please. Total expenses for the first half of the year amounted to DKK 13.7 billion and were up 7% year-over-year. Quarter-over-quarter, expenses were up 3%. The increases were driven mainly by costs related to the Estonia case, compliance remediation and compliance build-up, as well as transformation costs.

If we look at the moving parts of our cost development, you will see that we have enhanced our disclosure, with details for transformation cost, which amounted to DKK 0.5 billion in the first half of the year. This is part of the DKK 1.5 to 2 billion budget in the 2023 plan, which we will spend on changing our organisation in order to remain competitive and customer-focused. Transformation costs increased significantly in the second quarter, and we expect total costs for this year of approximately DKK 1.5 billion.

Costs for the compliance-related activities and the Estonia case increased DKK 0.9 billion from the first half of last year, which is more than expected. The total spend in the first half-year amounted to approximately DKK 1.9 billion, compared with our previous estimate of total costs for these activities of DKK 3.3-3.5 billion in 2020. We now expect an increase of approximately DKK 0.7 billion to DKK 4-4.2 billion for the full year.

However, the effect of the Group-wide cost programme is now showing in our expenses. In the first quarter, 400 positions were discontinued, and we continue to make progress on further cost initiatives such as product simplification and focus on non-personnel expenses.

Now, let's look at what we would expect for the coming periods. Slide 10, please. As you could see from the preceding slide, expenses for the first half of 2020 reflect only a modest impact from our investment budget, partly because of a slight delay caused by the coronavirus pandemic. The transformation is now in full motion, and we expect to spend approximately DKK 1.5 billion this year and the remaining DKK 0.5 billion next year. Despite the change in timing, this is very much in line with our expectations.

Costs continue to be a priority to ensure that we can increase profitability in a highly competitive and low-margin market. With a cost/income ratio of more than 60% in the second quarter, underlying costs continue to be too high, and, given the increased macroeconomic uncertainty and the challenges this creates for our ability to drive top-line income, we have to focus even more on bringing costs down.

To ensure adequate progress, we will therefore expedite our efforts in this area, which will also include additional structural staff reductions in all parts of the organisation towards the end of 2020 as well as in 2021. This is a clear necessity for us in order to make sure that we can maintain competitiveness and deliver on our promises in the 2023 plan for a cost/income ratio in the low 50s.

The initiatives taken this year are vital for us to secure an adequate cost trajectory for next year. The cost base for 2021 will reflect lower expenses for compliance remediation, including a lower spend on the Estonia case, but also lower transformation costs and further FTE reductions as a result of our continued work in transforming the bank.

We therefore expect to see materially lower costs for 2021. As this is still very early days in respect of the financial outlook, our estimate, for now, is for costs to come down 8-10%, equivalent to around DKK 26 billion including transformation costs of around DKK 0.5 billion.

Slide 11, please. We are progressing on the Better Bank transformation, and now it is all about execution, which is where we decided to allocate around DKK 1.5 billion solely for transformation efforts in 2020, to help us reach our visions for 2023 for our stakeholders. Most of the transformation costs are allocated to the four prioritised focus areas for the remainder of the year, to enhance the speed of the transformation process and ensure the necessary attention resources. For better ways of working, we are, as mentioned, improving how we work, and we are therefore investing to change our organisation.

Investments include both non-IT and IT, which are also directed at improving end-to-end processes. We are also investing in purpose, brand culture and engagement, with the aim of redefining our purpose and culture to reach our ambitions for employee engagement and customer satisfaction.

On the Group-wide costs programme, we have taken action to become more disciplined in terms of costs across the Group. We are looking into further simplifying our organisation, just as we are looking at a broad range of non-personnel costs across units. Continuous diligence in terms of hiring, near-shoring, off-shoring and right-sizing the organisation is in focus going forward.

For compliance under control, we are investing to establish the foundation for Danske Bank to be a fully compliant bank. We are continuously improving the foundation and investing in tools to enhance our trade surveillance and sanctions and embargo setup.

Seven months into the programme, the transformation continues in breadth, and all streams will continue to be executing towards 2023.

Slide 12, please. Impairments in the second quarter amounted to DKK 1 billion, equivalent to a loan loss ratio of 22 basis points for the core activities. Loan impairments were significantly lower in the second quarter than in the first quarter, when charges were recognised primarily due to the changes to macroeconomic assumptions in the IFRS9 model and credit deterioration within our oil-related exposure.

In the second quarter, we updated our macroeconomic model scenarios to reflect a more Covid-19 bespoke impact. The changes led to a more adverse GDP scenario, but also a slightly lower weighting of the downside scenario, and assumes a softer effect from the development and property prices in 2020 and in 2021, resulting in a reversal of DKK 0.5 billion.

Most of this reversal was offset by post-model adjustments of DKK 0.2 billion, representing not yet materialised, but expected, credit deterioration for retail as well as commercial property exposure that might not be fully captured by the models.

Impairments against our oil-related exposure, which I will come back to in more detail on the next slide, continue to have a negative impact and amounted to DKK 1 billion in the second quarter. The charges against this sector in the first half of the year explain the high charge at C&I.

Specific charges against single-name exposures, for which a deterioration of creditworthiness has been identified, amounted to DKK 0.4 billion, due mainly to industries highly affected by the coronavirus pandemic.

Total impairment charges for the first half of this year, which amounted to DKK 5.3 billion, are in line with our guidance and represent most of what we expect for the full year. Under the current assumptions, the impairment charges booked year-to-date should represent 70-80% of what we expect for the full year.

We will now provide additional comments on our oil-related exposure.

Slide 13, please. As you can see from the pie chart on the left side, the oil-related exposure accounts for only 0.8% of our total credit exposure. A little more than half of our oil exposure is against oil majors and oil services, whose credit quality in general is considered to be strong and stable. The remaining part, which accounts for 0.4%, is against various off-shore segments in Norway, where the majority of exposures were entered into up to 2015 in a more benign market environment.

However, the significantly and almost permanently lower oil prices that we have seen since the middle of the last decade made new exploration activities less profitable and left the off-shore sector with over-capacity in terms of production facilities and associated support capacity.

Despite representing less than half of our oil exposure, the charges recognised represent 84% of total expected credit losses of DKK 4.4 billion. Around two-thirds of the exposure is now in stage three. Despite a rebound in oil prices during the second quarter, oil prices continue to be at a low level. The prolonged weakness of the oil market leads to continued uncertainty in especially the off-shore services and drilling segment and makes restructuring increasingly difficult.

We consider the additional impairments we have recognised in the second quarter to be adequate, based on the deteriorating outlook for the sector we have seen lately.

Slide 14, please. Our capital position remains strong, with a reported CET1 capital ratio of 17.6% at the end of the second quarter. The CET1 capital ratio was flat, as an increased REA and higher deductions for Danica offset the effect of net earnings after dividend accruals. The fully-loaded CET1 capital ratio was 17.3%. The REA came in slightly higher than at the end of last quarter due to an expected increase in market risk REA of DKK 15 billion.

Credit risk was down DKK 3 billion, as the effect of increased lending was mitigated by the implementation of CRR quick-fixes as expected. We expect to see an increase in the credit risk REA in the second half of the year because of the implementation of a revised set of EBA guidelines. We expect the implementation to increase the REA by around 3%, with further increases in 2021. The leverage ratio was at 4.4% according to both transitional and fully-phased in rules.

And then a couple of small adjustments to our financial outlook for 2020. We expect net interest income to be at around the same level as in 2019, as margin pressure and higher funding costs will offset continued volume growth.

For loan impairment charges in 2020, we still expect significantly higher charges, however, we now expect that most have been recognised in the first half of the year. The financial target for 2023, where we have an ambition for a return on equity of 9 to 10%, is unchanged.

Slide 16, please and over to Chris.

Chris Vogelzang – Danske Bank – CEO

Yes, thank you, Stephan. Lastly, let me give you a quick update on our targets for societal impact and sustainability. We have set ambitious targets in this area because we know that, as one of the largest Nordic banks, we have a special responsibility to contribute to the societies we are part of. And only six months after we launched these targets, I am happy to say we are well on our way to reaching them.

For example, we have made great progress on our sustainable investments as we increased our green investments by DKK 10 billion in the first half of 2020 alone. We are now at DKK 20 billion and are well on our way to meeting the target of DKK 30 billion in 2023.

The same goes for sustainable financing. With DKK 71 billion at the end of the second quarter, we are well-placed to meet our target of well above DKK 100 billion in 2023. We have also already supported more than a million people with financial literacy tools and expertise, an increase of 43% since the end of 2019. This is driven by our new platform, Pengeskyen, which, of course, you know, means money cloud, and illustrates how digitalisation and new IT solutions help us to drive our work forwards and reach our new target audiences. We continue this important work going forward and will keep you updated on the progress.

The last slide, please. Those were the initial comments and messages. We are now ready for your questions. Please limit yourself to two questions. If you are listening to the conference call from our website, you are welcome to ask questions by e-mail. Operator, we are ready for the Q&A session.

Operator

(Operator Instructions) Our first question comes from the line of Jakob Brink from Nordea.

Jakob Brink – Nordea

Thank you very much and good afternoon everybody. The first question regarding costs; that DKK 500 million underlying cost improvement you are guiding for in 2021 on slide 10 I believe it is, is that a consequence of the whole agile processes you are doing? And also, in that connection, is the DKK 1.5 billion you are spending this year and DKK 500 million next year, how much of that is related to that agile process? That is the first part.

The second part, also on costs, on AML costs: I guess it is fair to say that this is not the first time that Danske has been guiding up on AML costs, so, why are you still so confident that you can reach the 2023 target on cost? I mean, it is a pretty big decline you need at some point, so what makes you confident that this time is different than the other times?

And then, if I may, just a very short question on funding, what should we look for? Is it DKK 15 or 35 billion of additional funding needed in H2? Could you just give us some guidance there please, thank you?

Stephan Engels – Danske Bank – CFO

Yes, if I can take that one. If you look at the change of underlying costs, you need to keep in mind that there is between '20 and '21 probably also a good bit of inflation on the cost base. So, the DKK 0.5 effectively is a bigger gross number and will be addressed by the Better Bank initiatives as well as the structural changes to our employee base that we have mentioned earlier.

Out of the DKK 0.5 to 1.5 billion, I think the question was, how much is allocated to Better Bank? That is a mix of two things – one is investments in new abilities and the second part is investments also in new systems. But I would think that about, let's call it, a good third is allocated to this initiative.

On your question on AML cost, there I would like to differentiate that a little bit in the sense of that what has been driving, for the most part, the higher costs in the first half of this year is around the Estonia case, where we are now really crossing the T's and dotting the I's and, as Chris has said, we still expect to be finished with our internal investigation by Q4, some of that probably already in Q3. It is around these expenses, which are, unfortunately, hard to predict.

The other part of it is mainly around AML remediation, where we kind of work off on our backlogs and KYC and ODD and other stuff, where not in all the cases we have seen the effectiveness and efficiency of the setup that we have been looking for. So, that is that part.

The way going forward, again, we are confident that we (a) will see much lower Estonia costs next year as, again, the remediation and the forensic part, as well as some of the litigation money spent, should reasonably come down, and the same is true for remediation. We will still have an elevated level of compliance costs in total that, over the year, and if we have really achieved full compliance, then will only come down if we can apply more efficiency there going forward.

On funding, you have seen that our funding spreads came nicely back during Q2. We have also seen quite some funding activity in Q2 and, so far, I think there is nothing really specific to be mentioned on H2 this year.

Claus I. Jensen – Danske Bank – Head of Investor Relations

If I may add just one thing to Stephan's comment on funding, Jakob. As you know, we have a funding need for the year. But, as you have seen in previous years, if the funding conditions in the market turn out to be favourable, we can, of course, in the second half also decide to start front-loading some of our funding need for the next year.

Jakob Brink – Nordea

But I have seen, I guess, it is not that great. You mentioned some place in the report that you could also tap into central bank facilities. Is that part of the additional funding need?

Stephan Engels – Danske Bank – CFO

No.
Okay. Next question.

Operator

Thank you. And our next question comes from the line of Mads Thinggaard of ABG. Please go ahead; your line is open. Mads, if you have your phone on mute, you will need to unmute that.

Mads Thinggaard – ABG Sundal Collier

Yes, I am very sorry. Thank you for taking my questions. Yes, I was muted indeed. Looking, going back to the compliance hump that we discussed, or Jakob asked about before, could you tell us a bit about how exactly you are going to bring a reduction next year, I mean besides the AML drop over the Estonia costs. I don't know if you could be a bit more specific there in telling us a bit about what plans you have to reduce it for practical matters? And, also, under that, if you could confirm that it is still DKK 1.5-1.7 billion compliance cost that we should expect in 2023? That would be nice.

And then, as a second question, looking into the cost bits on slide 9, I wondered if you could tell us just a bit about the remaining DKK 1.0 billion transformation costs for the second half of 2020. How would that be split on investments and severance pay? Thank you.

Stephan Engels – Danske Bank – CFO

On the compliance hump, the question is, where do we expect the costs to go down between '20 and '21. That is out of basically two buckets; one is the Estonia bucket, where both the costs for forensic analysis, as well as for legal support and litigation will come down. That is mainly reflecting the end of the internal investigations, which we expect for Q4 this year. Most of that money will probably be visible in external supplier spend.

AML remediation, again, is, to a large part, working off backlogs in KYC, ODD and other stuff, which we expect to finish towards the end of the year, and in that sense, once the backlog is done, also that is costs that will come down. I confirm the 2023 DKK 1.5-1.7 billion of compliance costs.

With respect to the severance pay question for the second half of the year, I do understand that very well that you are also probably trying to get a little bit closer to how many employees we are really talking about. Let me say that much, we will have to – and that is what we also promised internally – we will have these discussions first with unions and internal bodies and then come with the real numbers. So, in general, I expect both investment activity as well as severance pay to pick up for H2.

Mads Thinggaard – ABG Sundal Collier

Okay, thanks a lot.

Operator

Thank you. And our next question comes from the line of Per Grønborg of SEB. Please go ahead, your line is open.

Per Grønborg – SEB

Yes, thank you. Two questions from my side. The first one being on your oil and off-shore where you took a quite significant trunk of the first quarter and now you are taking another significant amount in the second quarter. Can you give us some insight into what has been driving the worsening of that book? I hear that you are saying that it has become more difficult to restructure companies; but, when we look at it from the outside, oil prices are up; share prices in the industry have clearly rebounded from the low levels we had back in April. So, overall, a bit of insight into why are you taking this charge now and wasn't your provision already adequate after Q1, that was my perception that that was the message you sent at those days?

The second question related to your Danish banking operations. If I look at, of course, assuming that the report you are releasing from Realkredit Danmark is giving a fair picture, it looks like your banking operation is back at loss-making, excluding the mortgage business in Banking DK. Any thoughts on this going forward? I know that you are looking for a new head for that operation, maybe also an update on that part? Thank you.

Stephan Engels – Danske Bank – CFO

Yes, Per, on the oil and gas stuff, as I tried to allude to, what we are seeing here is basically two parts; one is the oil and gas majors, which, indeed are perceived as being stable and good credit quality, and they effectively do benefit from oil prices picking up a bit between Q1 and Q2.

The other half of it is really exploration; drilling and associated services and between – let's call it between Q1 and Q2 – I think the oil price recovery has not been good enough, and the oil price and the oil demand long-term has not been good enough to assume that we will see exploration activities at a level that all the drilling equipment that we have around the world generally will be put back into service. So, reflecting this insight, we have again backed up our allowance account for these operations. And if you look at the coverage ratios, you will find that we are pretty cautious there. It probably also reflects a little bit of a catch up on positions that we have on the books for quite a while and in that sense that is this part.

Banking DK, I am not sure whether it is smart to dissect a complete business model in separate pieces because there is always a lot of, also, let's say, process and cost-share between things. But it is obvious that in Denmark, despite the slight uptick on deposit margins, we see a general pressure on margins and currently also on cost as we go through the invest phase for Better Bank.

So, the way forward obviously, and that is what we have also said today, in today's announcement, we need to focus on cost-income ratio, which means that we need to work both on the income as well as on the cost line.

Chris Vogelzang – Danske Bank – CEO

Yes, and with regards to the succession of Banking DK, we will inform the market as soon as there is something to inform. Currently, we do not have anything to say.

Per Grønborg – SEB

Okay. Is it fair to assume that is also holding back some of the initiatives that need to be taken on Banking DK?

Chris Vogelzang – Danske Bank – CEO

No, I do not see that at all. The way we are managing Banking DK now with Glenn Söderholm in the saddle, I do not have any concerns that we are not doing the things we need to do.

Per Grønborg – SEB

Okay, thank you.

Operator

Thank you. And our next question comes from the line of Johan Ekblom of UBS; please go ahead, your line is open.

Johan Ekblom – UBS

Thank you. Just two quick follow-ups if I may? Firstly on the funding, can you confirm that you do not intend to issue senior non-preferred given the changes to MREL regulations, just as you think of funding headwinds and tailwinds over the next 12 months or so?

And secondly, just to come back to the AML, you said that you do not intend to report anything more to the public, but if something material was to come out, you would make that known. Can you just remind us what your view is on potential sanctions violations there? Is that something that would automatically have to be reported to the market if it was found, or not? Thank you.

Stephan Engels – Danske Bank – CFO

Hi, Johan. On financing, we will still issue a mix of funding instruments, including most likely senior non-preferred to meet our MREL and our subordination requirement. You know that there has been a slight change from the Danish FSA, which has given us a little bit more leeway, but, in principle, I would still assume that senior non-preferred is an instrument that we would use going forward.

Under AML, as Chris has said earlier, if there would be something materially, we would obviously need to comply with our market abuse regulation announcement requirements, which, in turn, means, since we have not announced anything on sanction breaches or the likes, we have not seen any material issues in this matter.

Johan Ekblom – UBS

Thank you.

Operator

Thank you. And our next question comes from the line of Robin Rane at Kepler Cheuvreux. Please go ahead. Your line is open.

Robin Rane – Kepler Cheuvreux

Yes, hi. So, in the fact book, I saw that the number of branches in Finland was reduced from 31 at the end of Q1 to 19 in Q2, so, can you – I guess this is part of the cost reduction programme, but could you elaborate a bit on how you see your position in Finland going forward?

And then, secondly, on the fees, could you give some colour on the drivers behind the quarterly movements in the pension and insurance line, please?

Chris Vogelzang – Danske Bank – CEO

Okay, you said in the pension and -?

Robin Rane – Kepler Cheuvreux

And insurance line; I mean for the fees.

Chris Vogelzang – Danske Bank – CEO

Let's start off with Finland. What we are doing in Finland is we are focusing, and we have been publishing that widely in Finland, we are focusing our retail presence there on specific segments, which means that we do not need all the branches we currently have in some of the places where those segments are less present. So, in that sense, it is completely customer-driven, and, in general, you can say that about branches.

Branches are there when clients want branches in order to serve them well, and in Finland, we did not see that as a necessity, or especially, our clients did not see that as a necessity. So, it is not in any way pulling back from Finland, but we are there focused on what we call urban achievers, and then you do not have to be in every village around the country.

The second question is for you, Stephan.

Stephan Engels – Danske Bank – CFO

Yes, that is, if I got it right, fee income around pension and insurance, which has a good bit to do with reversal of one-offs from Q1, mainly on guarantee provisions, which we needed to take in Q1 given the market performance, and which basically, reversed in Q2.

Robin Rane – Kepler Cheuvreux

Okay, thank you very much.

Operator

Thank you. And our next question comes from the line of Sofie Peterzéns of J.P. Morgan. Please go ahead. Your line is open.

Sofie Peterzéns – J.P. Morgan

Yes, hi, here is Sofie from J.P. Morgan. So, just a quick follow up on the fees from Danica Pension, the guarantee reversal. Is it fair to assume that the first half fees in Danica Pension, or the insurance fees, are now at normalised levels?

Then, you took reversals in your provisions in the first quarter from the macro scenarios. However, we saw some reversals now in the second quarter from the provisions you took in the first quarter. How should we think about further releases from these provisions that you took in the first quarter? How should we think about these? Basically, my question is, what are the main drivers?

And then, I would also, if you could just remind us if you take all the SME benefit, SME supporting structure benefit, in the second quarter or should we expect some more to come in the third quarter, fourth quarter? And also if you could remind us what the software, IT, intangible benefits will be for Danske? Thank you.

Stephan Engels – Danske Bank – CFO

Okay. I will try to answer the model thing. What we did in Q1 basically, since there were no real bespoke Covid-19 scenarios is we worked with the original stress-test scenarios. So, these scenarios have now been updated by more bespoke Covid-19 scenarios in Q2, which do, for example, have a more downward scenario on GDP between the years but are also adjusted a little bit for the house price experience that we have seen so far and which is forecasted going forward.

This led to a certain reversal out of the model. At the same time, throughout the models, or across the models, we have done certain post-model adjustments. Basically, coming from a very thorough and stringent internal process, where we try to cover risks that we believe might not be fully captured by the models. And these post-model adjustments, as well as the models themselves, are obviously under review on a quarterly basis. So, if certain developments might not happen the way we have put it into assumptions, that might again lead to certain reversals.

The other question, if I understood it right, was the new, or the most likely new upcoming treatment of deductions from capital of intangible assets. I think the effect on us will most likely be positive but only slightly, but we would wait to see what the final set up really looks like and how, and if it is translated into the Danish environment.

And then, if I remember correctly, you had a question on how fee income on Danica would – maybe you can repeat that question? I am not sure exactly what that exactly was about?

Sofie Peterzéns – J.P. Morgan

So, basically, sorry, basically, it was just a follow up from the previous question. So, you had very big swings, and you had reversal in the guarantee provision in the second quarter versus the first quarter. But I was just thinking, how should we think about this line within fees going forwards? Will it be – is the first half number a good run rate going forward, or should we expect that to be lower or higher, i.e. will there be more reversals, or do we need to do – or should we expect more provisions?

Stephan Engels – Danske Bank – CFO

First of all, it is hard to predict what the second half of the year will really look like, to begin with. Secondly, I would probably more average out between the quarters rather than taking the second quarter as the starting point for your H2 assumptions.

Sofie Peterzéns – J.P. Morgan

Okay, perfect. Thank you very much.

Operator

Thank you. And our next question comes from the line of Maria Semikhatova of Citibank. Please go ahead. Your line is open.

Maria Semikhatova – Citi

Yes, hello, thank you for taking my questions. Two follow-ups; first of all, one to start on AML costs. I understand you are looking for a higher Estonia-related and AML damages cost this year, but you also increased your expectations by around DKK 600 million for 2021. So, just curious what drove that increase?

And, since you confirmed your outlook for 2023, do you still maintain the expectations for compliance and AML costs for 2022, I believe it was between DKK 1.7 and 1.9 billion?

And the second question on REA inflation. You mentioned that you expect 3% increase in the second half from revised EBA guidelines. Do you have any visibility of growth in 2021 from this?

Stephan Engels – Danske Bank – CFO

Let's start with the EBA guideline. I think that is a reflection of the general guidance that we have given that the bank will start to develop through or develop towards Basel IV compliance. Now, we all know that Basel IV is a bit, kind of moved back. So, looking at 2021 is probably a bit too early right now. But again, we are taking I think the prudent steps to start implementing some of the EBA guideline this year, which, as I said, will lead to a probably 3% increase in REA for the second half of the year, everything else being equal.

AML costs, again for 2023, we expect to be between DKK 1.5 and 1.7 billion. They still will be slightly elevated in 2021, but far lower than we have seen them in 2020.

Maria Semikhatova – Citi

In 2022, you are still expecting slightly more elevated versus your normalised levels. Do you still see these levels, or this inflation is going through 2021 and 2022?

Stephan Engels – Danske Bank – CFO

I suggest we speak about 2022 when we have finished 2021. And then, for the ease of reference, you probably kind of assume some sort of a linear trajectory.

Maria Semikhatova – Citi

Okay, thank you.

Claus Ingar Jensen – Danske Bank – Head of Investor Relations

Can we have the final question, please?

Operator

Thank you. The next question comes from the line of Riccardo Rovere from Mediobanca. Please go ahead. Your line is open.

Riccardo Rovere - Mediobanca

Thanks for taking my question and good afternoon to everybody. Just one question from my side if I may? Getting back once again to the DKK 500 million release. It is not very clear to me, and sorry for that, what are the drivers behind such a reversal? Because, at the end of the day, everyone, well many institutions have actually revised downward the GDP assumptions, at least for 2020. So, I am a bit surprised to see that you have released DKK 500 million. So, what has been the driver here to do that? Sorry, but it is not clear to me.

Stephan Engels – Danske Bank – CFO

Yes, what we did in Q1, and that is why we did stick out in comparison to the market, is we applied the scenarios that we had at hand at the time for the IFRS models, and these were the stress-test scenarios, which had pretty strong assumptions on house prices going down.

Now, we all have more bespoke Covid-19 scenarios, which look different to the scenarios that we have used in the stress test, so they are more downward on the GDP, but they are also a lot less onerous on the house pricing stuff, so that led to this release from the model that is just simply the mechanics of these IFRS setups. But, as I have mentioned before, we have also taken post-model adjustments, reflecting possible uncaptured risks around retail customers and commercial real estate.

Riccardo Rovere – Mediobanca

Okay, now, I see. So, it is basically the LGD of the collaterals?

Stephan Engels – Danske Bank – CFO

Yes.

Riccardo Rovere – Mediobanca

Okay, okay, now it is clear. Thank you very much.

Operator

Thank you, and as there are no further questions on the line, I will hand back to our speakers for the closing comments.

Chris Vogelzang – Danske Bank – CEO

Okay, thank you all for your interest in Danske Bank and for your questions. As always, you are welcome to contact our IR department if you have more questions after you have time to look at the financial results in more detail. And, again, as usual, transcript of this conference call will be added to our website, into the IR app within a few days.

If I do not see any of you – and we are doing a little bit over the next few days, but if I do not see any of you – some of you, not any more for the next few weeks, I wish you a really good summer, and I hope you enjoy your holiday. Thank you very much.