*Translation from Danish by Danske Bank of a statement dated 3 July 2024 from the Danish Financial Supervisory Authority (*Finanstilsynet*). In case of discrepancies, the Danish version prevails.*

Danish Financial Supervisory Authority

MEMORANDUM

3 July 2024

File no. 23-016489
JMA

Statement on functional inspection regarding Danske Bank's management of interest rate risk in the banking book

The Danish Financial Supervisory Authority (the Danish FSA) conducted an inspection at Danske Bank A/S in February 2024. The inspection was a functional inspection focusing on the bank's management of interest rate risk in the banking book (IRRBB).

Summary and risk assessment
During the inspection, the Danish FSA reviewed the bank's handling and management of interest rate risks in the banking book, including the bank's governance documents, processes, models and reporting.

Danske Bank's interest rate risks in the banking book stem mainly from mismatches between its deposit and lending business, its liquidity holdings and issues. Danske Bank is actively managing these risks, and the bank's setup is considered complex in relation to that of other institutions.

The bank uses models that are based on customer behaviour to determine its IRRBB. Moreover, the bank uses models to determine the expected maturity of deposits and to estimate the volume of deposits that will not reprice – not even in the event of a significant change in the general level of interest rates. The interest rate risk on these deposits is hedged.

The model used by the bank for modelling deposits is inadequate and not in line with the international rules and standards applicable in the area. The bank's model results in an implicit maturity of modelled deposits that the Danish FSA considers to be long. As a consequence, the bank has been ordered to improve its modelling to ensure that it reflects the rules and standards existing in the area.[1]

The bank reports on the interest rate sensitivity of the economic value of equity (EVE) on the basis of its internal behavioural model for non-maturing deposits (NMDs) and other behavioural models. The bank's IRRBB management is based on this calculation, among other things. The results of the calculation change considerably in connection with error correction and changes in model assumptions, for instance.

The assumptions used in such behavioural models require regular adjustment and changes, and sensitivity analyses are therefore necessary in order to obtain an accurate view of the risk. The bank's risk calculation or reporting does not reflect this.

It is important that institutions that model behavioural risks allow sufficiently for the uncertainties associated with customer behaviour modelling. The bank has been ordered to ensure that the risk associated with behavioural assumptions is reflected in its IRRBB management and reporting to a higher degree than is currently the case.[2]

[1] See paragraph 3 of schedule 2 to the Danish Executive Order on Management and Control of Banks etc.

[2] See paragraphs 3 and 22 of schedule 2 to the Danish Executive Order on Management and Control of Banks etc.

The majority of the inadequacies detected in the bank's IRRBB management had not been identified by the bank's control functions in the second line of defence prior to the issue of the inspection letter. The Danish FSA is of the opinion that the bank's control functions in the second line of defence were not sufficiently critical in this respect. As a consequence, the bank has been ordered to ensure that acceptable identification, measurement, management and reporting of these risks are undertaken.[3]

The bank uses its EVE calculation as the primary input for determining its solvency need and adds a management buffer for the purpose of ensuring that the level of the total solvency need for IRRBB is considered adequate. The level of capital is considered adequate, but the method is not sufficiently risk-sensitive because it does not explicitly reflect several of the risks to which the bank is exposed, including the risk of changes in customer behaviour. The bank has been ordered to develop a more risk-sensitive method than that currently used for determining the solvency need.[4]

The inspection did not give rise to any changes in the Danish FSA's assessment of the bank's solvency need.

[3] See paragraph 6 of schedule 7 to the Danish Executive Order on Management and Control of Banks etc.

[4] Section 124 of the Danish Financial Business Act.