Translation by Danske Bank of a statement of decision dated 17 June 2013 from the Danish Financial Supervisory Authority (*Finanstilsynet*).

Danske Bank
For the attention of the Board of Directors
and the Executive Board
CC the auditors

Ref. ls/mja/hkm/pl
File No. 6250-0044

IRB risk weights for corporate and institutional portfolios

The Danish Financial Services Authority ("FSA") has made a decision regarding the use of IRB risk weights for the corporate and institutional portfolios in capital adequacy calculations. The decision was made because according to section 20 of Executive Order No. 1399 of 16 December 2011, "Executive Order on capital adequacy" (the "Executive Order on capital adequacy"), permission to use the IRB approach in accordance with section 19 of the Executive Order on capital adequacy may be given only if the undertaking's systems for management and rating of exposures with credit risk meets the requirements in paragraphs 113-242 of appendix 8.

1. Decision and how to appeal

In accordance with paragraphs 156, 166, 170 and 225 of appendix 8 to the Danish Executive Order on capital adequacy, the FSA gives Danske Bank the following order:

- For the corporate portfolio excluding items with counterparty risk, the bank must analyse more closely the issues regarding low TTC PD values in the best rating categories, defaulted loans with individual impairment charges and the LGD models. Taking these issues into account, the bank must increase its safety margins and hence the risk weights for the corporate portfolio excluding items with counterparty risk by at least 10 percentage points in relation to the capital adequacy calculation at the end of 2012. The bank may in this connection make a corresponding reduction of its Pillar II add-ons.

The risk weights must be increased in the capital adequacy calculation at 31.12.13. Before then, the bank must inform the FSA how it will increase the risk weights.

In accordance with paragraphs 156, 166 and 170 of appendix 8 to the Danish Executive Order on capital adequacy, the FSA gives Danske Bank the following order:

- The bank must ensure that the TTC PD values for items with counterparty risk are increased in proportion to the increase for the rest of the corporate portfolio. In this connection, the bank may not reduce the Pillar II add-ons since they are not large enough to cover both the increase of the risk weights for the corporate portfolio excluding items with counterparty risk and the increase of the risk weights for items with counterparty risk.

The TTC PD values and thus the risk weights must be increased in the capital adequacy calculation at 31.12.13. Before then, the bank must inform the FSA how it will increase the TTC PD values and thus the risk weights.

Until the changes have been implemented, the bank must ensure that the risk associated with the very low TTC PD values is taken into account in Pillar II. The FSA estimates that there is a need for an add-on of about DKK 2 billion.

In accordance with paragraphs 166, 170 and 225 of appendix 8 to the Danish Executive Order on capital adequacy and section 124(1) and (4) of the Danish Financial Business Act, the FSA gives the bank the following order:

- The bank must ensure that, for the total institutional exposure in Pillar I and Pillar II, it allocates sufficient capital, which amounts to an increase in the capital requirement at mid-2012 of DKK 2 billion. The increase must be maintained at least until the FSA has considered the bank's new model for bank exposures.

This must be done in the capital adequacy calculation at 30 June 2013.

In accordance with section 124(1) and (4) of the Danish Financial Business Act, the FSA gives the bank the following order:

- In calculating the add-ons according to the Pillar I+ approach, the bank must cease reducing the add-ons by an amount that was DKK 2.8 billion at the end of Q4 2012, which corresponds to a positive difference between the allowance account and expected losses.

This must be done in the capital adequacy calculation at 30 June 2013.

In accordance with section 372(1) of the Danish Financial Business Act, decisions made by the FSA may be brought before the Danish Company Appeals Board, Langelinie Allé 17, P.O. Box 2000, DK-2100 København Ø, no later than four weeks after the bank has received the decisions. The Appeals Board charges a fee for considering complaints.

2. Summary

On 23 May 2013, the bank received a draft of this decision and commented on the draft on 3 June. The FSA comments on the bank's main comments in section 4.6 below.

The reason for this decision is that, for some time, the FSA has held the opinion that the bank had credit risks that were not adequately covered by Pillar I, which is the reason for some of the add-ons the bank has under Pillar II. The FSA's opinion is based, among other things, on the FSA's review of specific exposures in connection with credit inspections and on reviews of the bank's IRB models.

On that background, the FSA has, as described below, focused on the level of the bank's IRB risk weights in various recent analyses.

The original permission of 26 November 2007 given to the bank to use the IRB approach for capital adequacy calculations made it a condition that "Danske Bank shall continue to make improvements if required in guidelines from CEBS and the Finanstilsynet's interpretation of the Danish capital adequacy rules".

In a letter dated 5 September 2012, the FSA informed Danske Bank of its analysis of the risk weights assigned by Danish IRB banks to their corporate portfolios. The main conclusion of the analysis was that the average risk weight assigned by the bank in the capital adequacy calculation for Danish corporate customers appeared to be low. According to the FSA's report, the first findings of a Nordic analysis also showed that the level of the bank's risk weights was low.

These conclusions were also clear from the slides presented by the FSA at its concluding meeting with the bank's board of directors, executive board and auditors on 6 September 2012. The same conclusions were stated in the draft of the supervisors' Joint Risk Assessment Decision (JRAD)[1] given to the bank on 31 August 2012 and in the final JRAD dated 20 November 2012.

The bank has thus received the data supporting a need for higher risk weights. The bank did not take the initiative to respond to this.

On the basis of the findings of the data analysis, the FSA therefore entered into discussions with the bank's IRB experts to identify the background for the values used and discuss the low level of the bank's average risk weights. During the discussions, it became clear that the bank was of the opinion that the FSA's conclusions were not sufficiently robust because they were based primarily on comparisons with other Danish IRB banks. In the bank's opinion, a comparison with Nordic peers would give a fairer view. Danske Bank was of the opinion that the inclusion in the corporate portfolio of items subject to counterparty risk[2] could also produce misleading results.

In view of the above, the FSA obtained additional information in order to adjust for the volume of counterparty risk and other factors. At the same time, the Nordic analysis of risk weights was completed. The results of these analyses also show that the average risk weight assigned to the bank's corporate portfolio is low. Furthermore, the results of the EBA analysis of large corporate customers also show that Danske Bank assigns a low average risk weight.

The FSA has discussed the results with Danske Bank, after which the bank made an analysis based on other IRB institutions' Pillar III reports. The bank finds that there is no reason to consider it an outlier. During the discussions, it has been made clear that the FSA does not agree with the bank's conclusion about the analysis.

For items with counterparty risk, the FSA has received additional information for the assessment of the risk weights for the portfolio. The documentation shows that the risk weights assigned to items with counterparty risk are very low, which is attributable to a combination of low PD values and high collateral coverage.

For the institutional portfolio, the FSA received, among other things, validation results for the bank's PD model for banks in connection with the annual IRB status meeting in September 2012. The results showed that, for a lengthy period of time, the model had not functioned properly. The bank is therefore working on the development of a new model.

Hence, the bank has had the opportunity to increase the solvency need and should itself have done so in response to this.

For institutional exposures, the FSA does not have the same possibilities of making a comparison with Nordic peers as for the corporate portfolio. On the other hand, the results of the EBA's analyses in this area are more representative than the results for large corporates. The results of the EBA's analysis show that the bank's risk weights for bank exposures are very low, to a large extent owing to low PD values.

Sections 2.1 to 2.4 below describe the FSA's analyses and the bank's analysis in detail. Section 2.5 describes the bank's Pillar II add-ons that take into account the credit risks not covered by the current IRB risk weights in Pillar I. Section 3 describes the legal basis and section 4 gives the FSA's conclusion, including comments on the bank's main comments in its hearing response of 3 June 2013.

[1] The supervisory authorities from Denmark, the UK, Finland and Luxembourg.
[2] The credit risk deriving from repo transactions and derivatives.

2.1 Nordic analysis
Table 1 compares the risk weights assigned by Danske Bank group to its corporate portfolio with an unweighted average of the risk weights assigned by the Swedish and Norwegian IRB banks included in the Nordic analysis.

The risk weights stated in the table are only the risk weights for corporate exposures subject to the IRB approach. Hence, the figures do not include risk weights for the corporate exposures that the banks in question calculate using the standardised approach. The same applies to the following tables.

On the basis of the Nordic analysis, it is the FSA's opinion that the average risk weight assigned by Danske Bank group to its corporate portfolio[3] is low compared with the risk weights assigned by other Nordic IRB banks. Table 1 shows that this also applies when adjustment is made for the volume of counterparty risk and when a comparison is made only with banks that use primarily the advanced IRB approach (AIRB banks).

Table 1

	Danske Bank	All banks[4]	AIRB banks[5]
Total corporate	29	[omitted]	[omitted]
Corporate without counterparty risk	37	[omitted]	[omitted]

Note: The risk weights are stated as percentages and calculated on the basis of Q4 2011 data and Q2 2012 data (one bank). The risk weight for Danske Bank is not included in the calculation of the average figures. The all-banks average includes both banks applying the advanced approach (AIRB) and banks applying the foundation approach (FIRB). For corporate customers, total, the risk weights for all banks are calculated at the group level and include defaults. For business customers without counterparty risk for Danske Bank, the risk weight is also calculated at group level and includes defaults. For corporate customers without counterparty risk, the risk weights for the rest of the banks cover banks in the Nordic countries only – plus the Baltic states for two of the banks (one of the AIRB banks) – and are calculated excluding defaults.

For Danske Bank, defaults are included in the calculation of the risk weight in table 1 for the portfolio of corporate customers without counterparty risk, which is not the case for the risk weights calculated for the other banks. Danske Bank has informed the FSA that the effect of excluding defaults from the calculation of the risk weight for the total portfolio of corporate customers is a fall in the risk weight from 29 to 26. Consequently, the actual difference is larger than the difference shown in the table between the risk weight for Danske Bank (37) and the risk weight for other banks using primarily the AIRB approach ([omitted]).

Furthermore, the fact that Danske Bank applies a through-the-cycle (TTC) approach affects the risk weight. At the current stage of the business cycle, the TTC approach reduces the PD level and hence also the risk weight. Danske Bank has calculated the consequences for the portfolio of Danish corporate customers of applying TTC estimates rather than Point-in-Time (PIT) PD estimates. The calculation showed that the risk weight was 8 percentage points lower than the risk weight calculated using PIT estimates. Since the comparable banks in table 1 primarily use hybrid models, the effect of Danske Bank's TTC approach in comparison with the approach used by the other banks is estimated at about 4 percentage points.

Overall, this means that the effect of applying TTC and the effect of excluding defaults from Danske Bank's risk weight must be assumed to largely offset each other.

[3] Here, the total corporate portfolio is included, also Realkredit Danmark's corporate portfolio.
[4] [omitted].
[5] [omitted].

For the corporate portfolio without counterparty risk, the figures in table 1 show Danske Bank's risk weights at the group level, whereas the risk weights of the other banks only include the Nordic countries and the Baltic states.[6] This means that differences in portfolio compositions across countries must be assumed to result in natural differences between risk weights. For example, one must assume the risk weights of the Swedish and Norwegian banks to be lower than the risk weights of Danske Bank since these banks have more activities in countries where the current crisis has been milder than in Denmark. The FSA also finds that Danske Bank's exposures in Ireland have a significant effect on the total risk weight. Hence, the actual difference between Danske Bank's risk weight and those of the Swedish and Norwegian banks is larger than shown in table 1.

During the discussions about the risk weight level, Danske Bank has said that the difference between the risk weights used by the Swedish banks and Danske Bank has declined since the data analysis. According to the bank, the reason is that Swedish banks have since then received approval to apply the AIRB approach to a greater extent. The bank has also stated that it uses the AIRB approach to a larger extent than the other Nordic banks do, so these other banks may potentially achieve further reductions.

The FSA has therefore collected updated information about the risk weights of the Swedish banks. If we adjust for new model approvals, the average risk weight for the corporate portfolio, including items with counterparty risk, will fall from[omitted] at the end of 2011 to [omitted]. If we adjust the figures for the Swedish and Norwegian AIRB banks, the risk weight will fall from [omitted] at the end of 2011 to [omitted]. The changes therefore do not change the overall picture.

In this statement, the FSA has not quantified the potential for additional rollout for the banks using primarily the AIRB approach. Naturally, we recognise that the use of AIRB will reduce the risk weights, other things being equal.

But we are not of the opinion that the potential reductions will be so large that they will significantly change the conclusions (see section 2.3 below about the bank's analysis of Pillar III reports).

In the FSA's opinion, the analysis shows an overall difference in risk weights between the bank and the average of the Swedish and Norwegian AIRB banks of at least 10 percentage points when adjusted for AIRB extent, the bank's use of TTC and geographical differences in portfolio compositions.

2.2 Follow-up on the Danish analysis

To follow up on the bank's assessment that counterparty risk could result in misleading results in the FSA's Danish data analysis, the FSA collected counterparty risk data from the bank and from other Danish banks. Consequently, the FSA was able to adjust the average risk weights from the Danish data analysis. Table 2 shows an unweighted average of risk weights for Danish banks with and without adjustment for the volume of counterparty risk. The risk weight for Danske Bank was calculated only for the bank's Danish counterparties and does not include the portfolio of corporate customers at Realkredit Danmark.

[6] The risk weights for [omitted] of the [omitted] banks include the Baltic states ([omitted] AIRB bank).

Table 2

	Danske Bank	Danish banks[7]
Total corporate	21	51
Corporate without counterparty risk	34	62

Note: The risk weights are stated as percentages. The average for Danish banks does not include Danske Bank. The risk weight for Danske Bank was calculated on the basis of data from Q3 2011 and includes only Danish counterparties (with the exception of Realkredit Danmark's counterparties). The risk weight for Danske Bank does not include defaults. The remaining risk weights are calculated on the basis of data from Q2 2011 and include defaults.

A comparison of the risk weights shows that Danske Bank has low risk weights for the Danish corporate portfolio. This is the case whether items with counterparty risk are included in or excluded from the analysis. It should be taken into consideration, though, that the risk weights of the other Danish banks include defaults and that only one of the banks is an AIRB bank.

To improve the basis for comparison, the FSA collected data that cover only Danish exposures from relevant Swedish banks. Thus, as regards the corporate portfolio, the basis for comparison was extended to include figures for Danish corporate portfolios held by Swedish banks.

Table 3

	Danske Bank	Danish banks[8]	AIRB banks[9]
Corporate without counterparty risk	34	[omitted]	[omitted]

Note: The risk weights are stated as percentages. The averages do not include Danske Bank. The risk weight for Danske Bank was calculated on the basis of data from Q3 2011 and includes only Danish counterparties (with the exception of Realkredit Danmark's counterparties). The risk weight for Danske Bank does not include defaults. The remaining risk weights are calculated on the basis of data from Q2 and Q4 2011. For Danish banks, the risk weight calculations include defaults.

Table 3 shows that when the Danish IRB portfolios of Swedish banks are included in the average risk weight, which must be assumed to make the portfolios more homogeneous, the risk weight for Danske Bank's Danish corporate portfolio is still very low. [omitted].

2.3 The bank's analysis of Pillar III reports

The FSA has discussed the results of the analyses referred to in the previous sections with Danske Bank. In that connection, the bank argues that the figures used should be as up-to-date as possible. Consequently, the bank has made its own analysis of the Nordic IRB institutions' risk weights on the basis of the data presented in the institutions' 2012 Pillar III reports. The analysis, which is shown in a number of slides, states a number of reasons why differences in the institutions' risk weights must be expected.

The bank's overall conclusion is that the bank is at the same level as its peers if the factors explaining differences in risk weights are taken into account.

The FSA agrees that it is relevant to consider up-to-date data. But the FSA finds that the use of Pillar III reports entails a number of weaknesses. It is, for example, not always possible to adjust the risk weights for items with counterparty risk, for portfolio composition and for mixed use of the standardised, the FIRB and the AIRB approaches. It has to a larger extent been possible to adjust for these differences in the FSA's analyses. The FSA therefore finds that its analyses have some advantages even though they are based primarily on 2011 figures.

---

[7] The average includes four banks.
[8] The average includes six banks.
[9] The average includes three banks.

During the discussions with the bank, it has been made clear that, overall, the FSA does not agree with the bank's conclusion, and that the FSA finds that the bank's analysis of Pillar III reports for 2012 supports the opinion that the bank's risk weights are low. The FSA bases its opinion on the following:

One of the central arguments in the bank's analysis is that the bank applies the advanced IRB method to a larger share of its portfolio than the other Nordic institutions do. Danske Bank is thus of the opinion that differences in risk weights will be reduced in step with other banks' being authorised to expand their use of the advanced IRB approach. In addition, the bank seeks to quantify the expected reduction of the other IRB institutions' risk weights on the basis of the experience from a single Swedish institution that was permitted to increase the use of the advanced IRB approach from 2011 to 2012. The bank has also estimated the effect on the risk weight if it were to use FIRB rather than AIRB.

During the discussions with the bank, it has been made clear that the FSA acknowledges the bank's argument that the use of the advanced IRB approach will often result in lower risk weights than the use of the foundation IRB approach. [omitted]. Against this background, the FSA finds that the bank exaggerates the potential savings that other institutions may obtain.

The bank also argues that a comparison of IRB institutions' risk weights must take account of credit quality differences in the portfolios. The FSA also acknowledges this argument but does not find that it indicates that the bank should have lower risk weights than other Nordic IRB institutions. On the contrary, the FSA finds that the geographical differences, in particular, between the banks' portfolios indicate that Danske Bank's risk weights should be higher than its Nordic peers' risk weights, as described in sections 2.1 and 2.2. In addition, the FSA's experience from a review of Danske Bank's exposures does not indicate that the credit quality of the bank's portfolio is generally superior to the credit quality of other banks' portfolios (see also section 2.5 below on Pillar II add-ons).

In relation to the specific results, Danske Bank stated a group-level risk weight of 36% excluding items with counterparty risk at the end of 2012, and a risk weight of 32% if exposures in Ireland are excluded from the analysis. The FSA finds using the risk weight of 32% most relevant in the comparison with Nordic peers since none of these institutions have significant exposures in Ireland.

The adjustment for Ireland is the only adjustment made for geographical differences in portfolio composition. The FSA finds that in the comparison with Swedish and Norwegian IRB institutions, this may result in an underestimation of the actual differences because the Danish share of Danske Bank's portfolio is larger than the other banks' Danish portfolio shares, and Denmark is hit harder by the crisis than the other Nordic countries. However, some institutions have larger exposures in the Baltic countries, which are also hurt by the crisis.

The bank has calculated an average risk weight across all institutions of 45%. As mentioned, the Pillar III reports do not allow direct comparisons between risk weights. Consequently, the FSA considers that the average is actually higher.

In addition, Danske Bank has tried to quantify the risk weights three selected peers would have if they were permitted to use the advanced IRB approach to the same extent as Danske Bank does. It estimates that the result would be an average risk weight across all institutions of 40%, which should be compared with the bank's 32%. As mentioned, the FSA finds that the bank exaggerates these institutions' potential savings and that the average is actually higher than 40%.

Hence, the FSA is of the opinion that the bank's analysis of Pillar II reports for 2012 shows a difference in the risk weights used for corporate exposures excluding exposures with counterparty risk of at least 10 percentage points when adjusted for AIRB extent, the bank's use of TTC and geographical differences in portfolio compositions. That corresponds to the result of the FSA's analyses described in section 2.1.

[omitted]

2.4 The EBA's analysis of low-default portfolios
Danske Bank supplied data for a European analysis of low-default portfolios conducted by the EBA. The low-default portfolios include governments, institutions and large corporates.

Overall, the results of this analysis show that the bank is an outlier in the case of both large corporates and institutions (see below). In the case of states, the bank uses the standardised approach, and a comparison with other banks' risk weights for this part of the portfolio was thus not relevant.

On the basis of the preliminary results, the bank was selected to participate in an interview with the EBA. This interview took place on 24 April 2013.

2.4.1 Corporate portfolio
For the analysis of large corporates, the bank submitted a list of its largest customers, which were compared with the largest corporate customers of the [omitted] other participating banks. Against this background, a number of customers that are found in more than one bank were identified. For the bank, this was the case for [omitted] customers about which the bank submitted information.

The analysis of large corporates in the EBA framework shows that the risk weights used by the bank for these customers are much lower than the risk weights used by the other IRB banks for the same customers.

Specifically, there was an analysis of risk weights for selected large corporates that shows that the bank on average assigns these companies a risk weight that is [omitted] percentage points lower than the average. This analysis covers [omitted] of the bank's counterparties and thus only a sample of the [omitted] selected counterparties.[10] This analysis shows that low PD values are the main cause of the low risk weights and LGD is a lesser but not insignificant factor.

The comparison of risk weights for specific counterparties was made both for the bank's regulatory parameter values and also for the so-called hypothetical values for LGD and maturity.[11] For the two analyses, the results for the bank were largely the same.

To obtain more knowledge about the deviation identified in the risk weight for the selected portfolio, the FSA has received more detailed information about the size of the deviations in PD in relation to other banks. This information shows that, for the bank's customers included in the analysis with PD values of the regulatory minimum of 0.03%, the bank's PD values are on average [omitted] of a percentage point lower than the average for the other banks – that is, lower by a factor of almost [omitted].[12] In comparison with the median, the PD for the other banks is higher than Danske Bank's by a factor of [omitted]. This information also shows that, for the bank's customers included in the analysis of PD values between 0.042% and 0.06%, the bank's PD values are on average [omitted] of a percentage point lower than the average for the other banks – that is, lower by a factor of [omitted].[13] For most of the other rating categories, the difference is of

[10] The analysis covers only companies that have a PD from at least four of the participating banks, and the individual banks must also have at least 15 counterparties in the analysis.
[11] For example, LGD values for unsecured loans are used so that differences in collateral coverage do not affect the results.
[12] [omitted].
[13] [omitted].

the same magnitude, but the number of companies covered by the analysis in each of these classes is very limited.

Besides these analyses, there were also a number of other analyses based on the selected counterparties. They all point to Danske Bank's risk weights being much lower than those of other banks for the same counterparties.

The bank pointed out that the EBA has stated clearly that the EBA analyses were not of a nature that made them suitable for determining the solvency requirements of individual credit institutions. The FSA agrees that solvency requirements cannot be made on the basis of EBA analyses alone. It is the FSA's assessment, however, that the EBA's analysis to a large extent supports the conclusions of the FSA's own analyses of relatively low risk weights in the bank's corporate portfolio. The EBA's analysis, however, covers only a limited selection of its large corporate customers, which is a low-default segment. Thus, only a limited number of counterparties are included in the analysis, and the counterparties are placed mainly in the higher rating categories. The findings of the analysis are therefore not necessarily representative of the bank's entire corporate portfolio. Moreover, the EBA analysis did not take into account that, in contrast to a number of the other banks, the bank uses a TTC method.

Against this background, it is the FSA's assessment, that the very large differences in the EBA's analysis cannot be applied to the total corporate portfolio. Danske Bank's risk weights for the corporate portfolio are thus lower than those of comparable banks, but not to the extent set out in the EBA's analysis of low-default portfolios.

The EBA's analysis thus indicates that, in comparison with other banks, the bank uses very low PD values for the best counterparties. The FSA's own analyses also point in this direction.

2.4.2 Institutional portfolio

For exposures to institutions, the EBA made the same analysis as for large corporates. This means that Danske Bank's risk weights for institutional exposures have been compared with the risk weights of other banks for the same institutions. The results of these analyses show that the bank is also an outlier with respect to the institutions covered.[14] The analyses show that, on average, the bank allocates risk weights to the selected institutions that are [omitted] percentage points lower than the average risk weights allocated by other banks to the same institutions.[15] It is particularly low PD values that cause the lower risk weights. The analyses also show, however, that Danske Bank has a higher level of collateral coverage for exposures to institutions than its European peers have.

For this portfolio, the FSA also sought more detailed information about PD. This information shows that, for institutions with PD values of the regulatory minimum of 0.03%, the bank's PD values are on average [omitted] of a percentage point lower than the average for the other banks – that is, lower by a factor of almost [omitted].[16] In comparison with the median, the PD for the other banks is higher than Danske Bank's by a factor of [omitted] for institutions with a PD value of 0.03%. For most of the other rating categories, the difference is of the same magnitude, but the number of institutions in each of these classes is very limited.

In comparison with the analysis of large corporates, the EBA's analysis of institutions covers a much greater percentage of the bank's portfolio. About half of the bank's institutional exposures

[14] The bank reported information for [omitted] institutions, all of which are included in the analysis. These institutions are thus customers of at least four other banks.
[15] The reason for the range indication is that the difference is greater when the bank regulatory values are used than when the hypothetical values are used.
[16] [omitted].

are included in the analysis, while the corresponding figure for the portfolio of large corporates is less than 5%. In addition, the institutions were not selected to cover only a portion of the rating scale, as is the case with the corporate portfolio. Against this background, the FSA believes that the results of the EBA's analysis can be assumed to be representative of the bank's total institutional portfolio to a much greater degree than is the case with corporate portfolio.

2.4.3 AIRB vs FIRB and TTC vs PIT and hybrid PIT and hybrid

Since all the analyses of exposures to large corporates and institutions cover both AIRB and FIRB banks, Danske Bank must be expected to show some instances of a lower-than-average risk weight. The EBA has made some overall analyses of AIRB institutions separately, however. These analyses have not changed the bank's placement with both lower PD and lower LGD than average.

Against this background, the FSA believes that the results of the EBA's analyses are relevant, even though they do not always distinguish between AIRB and FIRB banks. This is especially true since it is particularly the bank's low PD values that have caused the deviations.

[omitted]

In any case, it is clear that the big difference between Danske Bank and the average can only to a small extent be explained by differences in ability to reflect cyclical effects.

2.5 The bank's Pillar II add-ons

When calculating the group's solvency need, Danske Bank uses, among other things, a Pillar 1+ method that corresponds to the 8+ method in the guidelines of 7 February 2013 on adequate capital base and solvency need for capital institutions. Accordingly, there are various add-ons to the IRB risk weights and the other Pillar I risk weights to cover risks that are not considered to be adequately covered by the risk weights in Pillar I.

One of these add-ons is DKK 7.8 billion to account for macroeconomic uncertainty. Danske Bank introduced this add-on in 2009 because the FSA was of the opinion that the bank's IRB weights and weights for exposures covered by the standardised approach did not fully account for the group's credit risk. The FSA's assessment was based on reviews of exposures during credit inspections and on reviews of the bank's IRB models.

Since 2009, the bank has made adjustments to the add-ons as a result of macroeconomic developments and the bank's impairment charges. On several occasions, the FSA has compared the add-on with the results of credit inspections and IRB reviews to ensure that it remains adequate.

In addition, the group has an add-on of DKK 3.0 billion to cover uncertainty related to new LGD models. The background for this add-on is that the FSA accommodated the bank's application for the LGD models that the bank currently uses. The FSA approved the bank's use of the models for capital adequacy purposes, but the FSA made it a condition that the bank includes a DKK 3.0 billion add-on in its Pillar I+ calculation to account for uncertainty not covered under Pillar I.

It has thus been the FSA's assessment for some time that there have been risks that are not sufficiently covered in Pillar I. It must be noted, however, that the add-on of DKK 7.8 billion to account for macroeconomic uncertainty mentioned above covers not only the corporate portfolio for which the IRB approach is used. It also covers exposures to personal customers for which the IRB approach is used and exposures to corporate and personal customers for which the standardised approach is used. Furthermore, the add-on of DKK 3 billion to account for uncertainty related to new LDG models covers exposures to both corporate and personal customers for which the IRB approach is used.

The figures in tables 1-3 above show only the IRB risk weights; that is, they do not take into account Pillar II add-ons. As part of its Nordic analysis, the FSA conducted an analysis that takes into account the Pillar II add-ons that relate to the corporate portfolio. This analysis shows that the bank would be in greater conformity with the market if we take into account the Pillar II add-ons in Pillar I.

The group's Pillar 1+ add-ons are calculated net, since they cover a reduction that amounted to DKK 2.8 billion at the end of Q4 2012 because the allowance account etc. exceeded expected losses. Section 27(1)(4) of the Danish Executive Order on the calculation of the capital base states that positive differences between the allowance account etc. and expected losses up to a fixed limit can be added to the capital base. The bank could therefore make an addition to the capital base, but it has instead chosen to make a reduction in Pillar II.

3. Legal basis

3.1 Requirements for calculating an adequate capital base and a solvency need

Section 124(1) of the Danish Financial Business Act states that "the boards of directors and executive boards of banks and mortgage credit institutions must ensure that the institution has an adequate capital base and has internal procedures for risk measurement and risk management to enable it to assess and maintain, on an ongoing basis, a capital base that is adequate in terms of size, type and composition to cover the risks to which the institution is exposed".

According to section 124 (4), "the boards of directors and executive boards of financial institutions and mortgage credit institutions must, on the basis of the assessment pursuant to subsection (1), calculate the individual solvency need of the bank or mortgage-credit institution. The solvency need must be expressed as the adequate capital base as a percentage of the risk-weighted items. The solvency need may not be less than the solvency requirement pursuant to subsection (2), No. 1 and the minimum capital requirement of subsection (2), No. 2."
Like the other points about the legal basis, this is the result of the Danish implementation of the capital requirements directives (CRD). Other European banks are thus subject to similar requirements.

3.2 General requirements for the use of the IRB approach

Pursuant to section 20 of the Executive Order on capital adequacy, "permission to apply the IRB approach under section 19 can be given only if the company's systems for management and rating of exposures with credit risk meet the requirements of paragraphs 113 to 242 of appendix 8".

Pursuant to section 20(2) of the Executive Order on capital adequacy, "the FSA may, if an undertaking is part of a group, permit the undertaking to comply with the minimum requirements in paragraphs 113-142 of appendix 8 for the group's parent company and its subsidiaries as one".

3.3 Requirements for IRB models and for estimation and safety add-ons

According to paragraph 156 of appendix 8 to the Executive Order on capital adequacy, "an undertaking that uses statistical models and similar methods to allocate ratings to counterparties, exposures or pools, must comply with the following requirements:

a) The undertaking must be able to substantiate to the FSA the high-quality forecasting ability of the model and show that the use of the model does not result in a misleading capital requirement calculation. The input variables must constitute a sensible and effective basis for the forecasts. The model may not have material systematic errors.

…

e) The undertaking must supplement the statistical model with qualitative assessments, review the model-based ratings and ensure that the model is used correctly. The business procedures for such reviews must aim at identifying and limiting errors due to weaknesses in the model. The qualitative assessments must take into account all relevant information that is not processed by the model. The undertaking must document how the qualitative assessments and the model results are combined."

According to paragraph 166 of appendix 8 to the Executive Order on capital adequacy, "own estimates of risk parameters must be based on all relevant data, information and methods. The estimates must be credible and intuitive and must be based on the factors that exercise the most influence on the respective risk parameters. The estimates must be based on both historical experience and empirical data and may not be based solely on judgement. The fewer data an undertaking has at its disposal, the more conservative the estimates must be."

According to paragraph 170 of appendix 8 to the Danish Executive Order on capital adequacy, "an undertaking must add a safety margin to its estimates, related to the expected margin of error associated with the estimation. If the methods and data applied by the undertaking are less safe and a large margin of error is expected, the undertaking must set a larger safety margin."

3.4 Benchmarking

According to paragraph 225 of appendix 8 to the Executive Order on capital adequacy, "the undertaking must also use other quantitative validation tools and comparisons with relevant external data sources (benchmarking). The analyses must be based on data which are relevant to the portfolio, updated at regular intervals and cover a relevant period of observation. The undertaking's internal assessments of the performance of its rating systems must be based on the longest possible period of time."

3.5 Changes rules on solvency need

The Danish Financial Business Act was amended on 20 December 2012. Before the amendment, the procedure was to give any Danish bank whose actual solvency was lower than the calculated solvency need a short period of time to remedy this situation. If the bank failed to remedy the situation, the FSA would revoke the bank's licence.

In the other Nordic countries, as in many other countries, the solvency ratio would however have to fall below 8% before a bank would be given a period of time to remedy the situation or have its licence revoked. If a bank's actual solvency is below its calculated solvency need but above 8%, the supervisory authority will order the bank to take the steps necessary to ensure that its actual solvency again exceeds the solvency need.

Hence, formerly, the consequence for a Danish bank of falling below the sum of the Pillar I and the Pillar II requirements was similar to the consequence for a bank from another Nordic country of falling below the Pillar I requirement.

For banks with an actual solvency above 8% but below the solvency need, the amendment to the Danish Financial Business Act introduced rules in Denmark similar to the rules in the other Nordic countries.

Section 225(2) of the Danish Financial Business Act now reads as follows: "If a bank or mortgage-credit institution that complies with the capital requirements of section 124(2) or (3) but does not comply with the individual solvency requirement calculated according to section 124(5) must take the necessary measures to comply with this solvency requirement. The FSA may order the institution to take the necessary measures before a time limit set by the FSA. Such time limit may be prolonged. The FSA may on an ongoing basis determine additional measures to be taken if such measures are considered necessary. According to subsection 1, the FSA may set a time limit for compliance with the individual solvency requirement determined in accordance with section 124(5). After the expiry of such a limit set according to subsection 1, the licence will be withdrawn if the institution does not take the necessary measures according to paragraphs 2 and 3."

3.6 Assessment of adequate capital and the solvency need

About methods for calculating the adequate capital base, paragraph 27 of appendix 1 to the Executive Order on capital adequacy states that "irrespective of the method applied, the board of directors and the executive board must assess whether the method gives a reasonable result".

Paragraph 28 of appendix 1 to the Executive Order on capital adequacy states that "the assessment of the adequate capital base must include all material risks to which the undertaking is exposed. The undertaking must therefore make its own assessment of the material risks to which it is exposed."

3.7 Difference between the allowance account etc. and expected losses

Section 27(1)(4) of the Executive Order on the calculation of the capital base states that "the supplementary capital of banks, mortgage credit institutions, investment firms and asset management companies consist of:

…

4) A positive amount resulting from the deduction from the value adjustments and provisions for assets and liabilities not included in the trading portfolio with the exception of shares, assets covered by securitisation, securitisation positions and tangible assets without counterparties of the calculation of expected losses on these assets and liabilities (in accordance with appendix 8 to the Executive Order on capital adequacy).

…"

Section 27(3) of the Executive Order on the calculation of the capital base further states that "the supplementary capital according to subsection 1(4) is included only for assets and liabilities where risk-weighted items not included in the trading portfolio are calculated by using an internal method pursuant to section 143(3) of the Danish Financial Business Act and that the supplementary capital may not exceed 0.6% of the risk-weighted items for assets and liabilities subject to the internal method. When this percentage is calculated, securitisation positions with a risk weight of 1.250% may not be included."

This means that positive differences between the allowance account etc. and expected losses up to a set limit may be added to the capital base.

Neither the Executive Order nor the FSA's guidelines on adequate capital base and the solvency need of credit institutions of 7 February 2013 state that institutions that do not include such an addition in their capital base may instead make a deduction from the solvency in Pillar II calculations.

On the contrary, the general 8+ principle of the guidelines is, as the point of departure, to use the minimum requirement of 8% of the risk-weighted items (Pillar I) with add-ons for risks and circumstances not fully taken account of in the calculation of the risk-weighted items. Ordinary risks are thus assumed to be covered by the 8% requirement, and the calculations must take account of whether an institution has additional risks requiring an add-on in the solvency need calculations (Pillar II).

3.8 Different estimates for risk weights and for internal purposes

Paragraph 171 of appendix 8 to the Executive Order on capital adequacy states that “if an undertaking uses different estimates for the calculation of risk weights and for internal purposes, it must document this, and the undertaking must be able to substantiate to the FSA that the estimates are appropriate”.

4. Conclusion

4.1 The corporate portfolio excluding items subject to counterparty risk

The FSA has collected additional information about the weaknesses of the analysis of corporate portfolios across Danish banks of 5 September 2012 that Danske Bank pointed out and has included Nordic IRB banks in the comparison with Danske Bank’s risk weight. These additional analyses show that the risk weight of the bank’s corporate portfolio is still very low.

The FSA finds that the bank’s analysis of Pillar III reports for 2012 does not change these conclusions. Consequently, the FSA assesses that this analysis shows a difference in the risk weights used of at least 10 percentage points when adjusted for AIRB extent, the bank’s use of TTC and geographical differences in portfolio compositions.

In addition, the EBA’s analysis shows that, for large corporate customers that the bank has in common with other banks, the bank assigns much lower risk weights than do the other banks covered in the analysis. This is owing particularly to very low PD values, and low LGD values also contribute to this effect.

According to the rules on the IRB approach that follow from the CRD directive, the IRB estimates must be prudent. Hence, paragraph 166 of appendix 8 to the Executive Order on capital adequacy states among other things that “the fewer data an undertaking has at its disposal, the more conservative the estimates must be”. Paragraph 170 further states that “an undertaking must add a safety margin to its estimates, related to the expected margin of error associated with the estimation. If the methods and data applied by the undertaking are less safe and a large margin of error is expected, the undertaking must set a larger safety margin.”

Consequently, a larger safety margin must be expected for, among others, the good corporate customers included in the EBA's analysis, since the data base in the form of identified defaults is limited. Hence, this requires a higher safety margin.

It is the FSA’s impression that the bank generally does not incorporate a larger safety margin in its estimates, since the bank rather attempts to calculate the estimates as precisely as possible, regardless of whether or not the data are limited, for example. The analyses referred to above confirm that when estimating corporate exposures other banks add a safety margin that is substantially larger than the margin added by Danske Bank.

It has been the FSA’s assessment for some time that there have been risks that are not sufficiently covered in Pillar I. The bank therefore has a number of add-ons in Pillar II. The FSA’s own analyses, the bank’s analysis and the EBA’s analyses confirm the need for these add-ons. It is also the FSA’s assessment that the bank will stand closer to the level of its peers if the add-ons regarding the IRB portfolios are moved to Pillar I and a greater portion of all the credit risks on the IRB portfolios are covered in Pillar I.

The FSA considers such benchmarking relevant. According to paragraph 225 of appendix 8 to the Executive Order on capital adequacy, “the undertaking must also use other quantitative validation tools and comparisons with relevant external data sources (benchmarking)”.

In addition, paragraph 156(e) states that “the undertaking must supplement the statistical model with qualitative assessments, review the model-based ratings and ensure that the model is used correctly. The business procedures for such reviews must aim at identifying and limiting errors due to weaknesses in the model. The qualitative assessments must take into account all relevant information that is not processed by the model. The undertaking must document how the qualitative assessments and the model results are combined.” Qualitative assessments and all relevant information include benchmarking.

Finally, paragraph 166 states that “own estimates of risk parameters must be based on all relevant data, information and methods”, and this includes benchmarking.

Of the total Pillar II credit risk add-on of DKK 10.8 billion, DKK 6-7 billion concern the bank’s corporate exposures for which the IRB approach is used. The remaining add-ons relate to personal customers for whom the IRB approach is used and exposures to corporate and personal customers for which the standardised approach is used.

If the DKK 6-7 billion is moved to Pillar I, it will increase the average risk weight for the corporate portfolio excluding items subject to counterparty risk by about 10 percentage points.

The FSA’s previous implementation of the rules on Pillar II meant that it was not crucial whether the risks were covered in Pillar I or Pillar II. The change in the implementation has made it more important for the risks to be covered in Pillar I.

The FSA is of the opinion that, before the amendments to the Danish Financial Business Act on 20 December 2012, it was relevant to include Danske Bank’s Pillar II add-ons in the overall assessment of whether the group’s IRB risk weights were at a suitable level. After the amendment, however, the FSA no longer considers it relevant to include the bank’s Pillar II add-ons in this assessment.

The FSA’s slides presented at the final meeting with the bank’s board of directors, executive board and auditors on 6 September 2012 and the supervisory authorities’ JRAD of 20 November 2012[17] include the following about the Pillar II add-ons:

“Finanstilsynet will examine the possibility of including add-ons in pillar 1 instead of pillar 2 in order to have the uncertainty reflected in the estimates and to make it more comparable with banks from other countries.”

Against the background of the amendment to the Danish Financial Business Act and the results of the analyses mentioned above, the FSA finds that the add-ons should now be moved from Pillar II to Pillar I. The FSA is aware that at least three factors must be addressed in connection with the bank’s transfer of the add-ons.

First, the FSA has observed that, in the best rating categories, TTC PD is very low. For example, the regulatory minimum value of PD of 0.03% is used in several of the bank’s rating categories. In addition, the EBA’s analysis shows that the PD values are very low in the best rating categories in comparison with other European banks' assessments of PD for the same customers. It is the FSA’s

[17] The supervisory authorities from Denmark, the UK, Finland and Luxembourg.

view that the low PD values are related to the bank's method of converting PIT PD values to TTC PD values, including placing both small and large corporate customers in the same segment.

Second, the FSA has observed that the bank's RWA for defaulted loans with individual impairment charges is very low. The capital requirement for these loans amounts to 3.5% of the impairment charges, which the FSA finds very low – particularly in light of experience with the trend in impairment charges in Ireland, among other markets. The experience has been that impairment charges on defaulted loans can rise much more than 3.5% of the impairment charges that were previously booked against the exposure. This should be seen in relation to the fact that impairment calculations are based on a principle of neutrality, whereas calculations of risk-weighted items must be based on a principle of caution. A difference of 3.5% does not reflect the difference between these two principles.

Third, as mentioned in section 2.5 above, since the approval of the bank's current LGD models, the FSA has assessed that there was uncertainty about the models that was not sufficiently taken into account in Pillar I. There is therefore an add-on in Pillar II. The FSA finds that the risk related to the LGD models should now be reflected in Pillar I.

The FSA has considered whether the order should state a minimum increase in the risk weights. The FSA finds that it is relevant to include in the order that the risk weights for the corporate portfolio excluding items with counterparty risk must be increased by at least 10 percentage points over the capital adequacy calculation at the end of 2012.

Hence, sections 2.1 and 2.3 state that the FSA is of the opinion that both the FSA's analyses and the bank's analysis of 2012 Pillar III reports for Nordic peers shows a difference in the risk weights used for corporate exposures excluding exposures with counterparty risk of at least 10 percentage points when adjusted for AIRB extent, the bank's use of TTC and geographical differences in portfolio compositions.

In addition, there are EBA analyses which, seen in isolation, do not enable a quantification of the need to increase the risk weights but which identify very low risk weights for the low-default exposures included and show that the bank's risk weight is [omitted] percentage points below average.

As mentioned above, the FSA finds that the DKK 6-7 billion that concerns the bank's corporate exposures for which the IRB approach is used must be moved from Pillar II to Pillar I. That increases the average risk weight by about 10 percentage points.

Until now, when assessing IRB models and in particular when assessing the credit risk during on-site investigations, the FSA has focused on weak exposures. Hence, the add-ons to the solvency need reflect the credit risk on weak exposures not taken sufficiently into account in the risk-weighted items. When assessing the need for Pillar I and Pillar II add-ons, on the other hand, the FSA did not give similar attention to determining whether adequate capital had been set aside for customers with low risk but high volume.

The bank must therefore consider whether the existing Pillar II add-ons for the corporate portfolio excluding items with counterparty risk take the very low PD of low-risk customers sufficiently into account.

Very thorough analyses have thus been carried out and long discussions have been held with the bank. On the basis of the above, the FSA therefore finds that the bank must analyse more closely how the risk weights for the corporate portfolio can be increased and must present a concrete proposal to the FSA. The bank must, as a minimum, make adjustments to the areas mentioned above, and it must increase the safety margins and thus the risk weights for the corporate portfolio excluding items with counterparty risk by at least 10 percentage points in relation to the capital adequacy calculation at the end of 2012. The bank may in this connection make a corresponding reduction of its Pillar II add-ons.

4.2 Items with counterparty risk

Regarding items with counterparty risk, the FSA has received supplementary material from the bank. The FSA has determined that the risk weights for items with counterparty risk are very low, particularly for repo agreements. On the basis of the supplementary material, the FSA assesses that the low risk weights are owing to high collateral coverage and the fact that this portfolio is concentrated in the better rating categories.

The FSA finds that it is also problematic for the portfolio of items with counterparty risk that the bank uses very low PD values for the better rating categories.

The bank must therefore ensure that the TTC PD values for items with counterparty risk are increased in proportion to the increase for the rest of the corporate portfolio. In this connection, the bank may not reduce the Pillar II add-ons since they are not large enough to cover both the increase of the risk weights for the corporate portfolio excluding items with counterparty risk and the increase of the risk weights for items with counterparty risk.

As described in section 4.1, the reason is that when assessing the need for add-ons in particular to Pillar II, the FSA focused on weak exposures and not on the customers in the higher rating categories – which constitute the largest share of items with counterparty risk.

As no capital has been set aside for the risk associated with the very low TTC PD values, the FSA finds that, until the changes have been implemented, the bank must set aside capital in Pillar II for this risk. The FSA estimates that there is a need for an add-on of about DKK 2 billion.

4.3 Institutional exposures

In connection with its ongoing supervision, the FSA has determined that the bank's PD model for banks has not functioned well. The bank itself is aware of the issue and is working to develop a new model. The FSA is sceptical, however, that it is possible to develop a well-functioning model with the existing data foundation.

The EBA's analysis shows that, for exposures to institutions that the bank has in common with other banks covered by the analysis, the bank generally assigns significantly lower risk weights than the other banks. This is owing mainly to very low PD values. It is therefore the FSA's assessment that the EBA's analysis supports the view that the bank's PD model for banks does not work appropriately.

The analysis also shows, however, that Danske Bank has a higher level of collateral coverage for exposures to institutions than its European peers have.

About half of the bank's institutional exposures are covered by the EBA's analysis. The FSA therefore finds that the results of the analysis can be considered representative of the bank's entire portfolio of exposures to institutions.

Because of the bank's large volume in the area, the FSA finds that it is essential that the bank has well-functioning models, including that the sufficient capital is allocated to exposures to other banks. In light of the problems with the model, the FSA finds that it has not been demonstrated that the bank should use lower risk weights than its European peers. The FSA finds, however, that it is reasonable to take into account the bank's higher collateral coverage.

The FSA believes that, with a model that does not function, the contribution to risk-weighted items is too small. The bank has also not compensated for this with an add-on in Pillar II. Until the FSA had made a decision on the bank's new PD model, however, the FSA expects that the bank, as a minimum, will allocate as much capital in Pillar II to the unsecured portion of the portfolio that the bank overall comes up to the level of its European peers at the time of the data foundation for the EBA's analysis. That will correspond to an add-on of DKK 2 billion at mid-2012, which is the time when the EBA data on institutional exposures were calculated.

4.4 The bank's reduction in Pillar II

The bank's Pillar I+ add-ons are calculated net and covered a reduction that amounted to DKK 2.8 billion at the end of Q4 2012 because the allowance account etc. exceed expected losses. Section 27(1)(4) of the Executive Order on the calculation of the capital base states that positive differences between the allowance account etc. and expected losses up to a fixed limit can be added to the capital base. The bank could therefore make an addition to the capital base, but it has instead chosen to make a reduction in Pillar II.

The FSA's guidelines of 7 February 2013 on adequate capital base and the solvency need of credit institutions describe the 8+ method, which corresponds to the bank's Pillar I+ method. These guidelines do not state that banks may reduce the add-ons in such a way. Furthermore, such a reduction is not well justified (see below). The FSA therefore finds that the bank must remove the reduction in the Pillar I+ calculation.

The FSA also finds that it follows from the 8+ method that, if the bank instead had chosen to have an add-on in the capital base for positive differences between the allowance account etc. and expected losses, this should be matched by a corresponding add-on in the solvency need.

An add-on in the capital base for positive differences between the allowance account etc. and expected losses thus reflects an assumption in the IRB rules that impairment charges are too large, even if they are prudently calculated as is necessary for solvency purposes. The impairment charges are the best estimate of losses according to both IFRS and Danish accounting rules, however. The impairment charges are thus to be considered lost, and institutions cannot apply a portion of them to cover other future losses – certainly not in a solvency need calculation, which must be conservative. The 8+ method implies that the bank must assess whether there are special risks that are not adequately covered by the Pillar I requirement. In the FSA's opinion, an add-on for positive differences between the allowance account etc. and expected losses constitutes such a risk and must therefore result in a corresponding add-on in the solvency need.

In calculating the add-ons according to the Pillar I+ approach, the bank must therefore cease reducing the add-ons by an amount that was DKK 2.8 billion at the end of Q4 2012, which corresponds to a positive difference between the allowance account etc. and expected losses.

4.5 Hearing

On 23 May 2013, the FSA sent the bank an earlier version of this decision for comments. The bank sent the FSA its response on 3 June 2013. The bank states in its response that it disagrees with all the FSA's orders and also with the FSA's decision of 27 May 2013 about access to the documents in the case.

The FSA comments on the main arguments of the bank below. In addition, the bank made some more detailed comments that the FSA has taken into account in the relevant sections of this decision.

4.5.1 Order on the basis of comparisons

The bank points out, among other things, that the FSA bases its orders on the corporate portfolios almost exclusively on a number of comparisons with other credit institutions in Denmark, the Nordic countries and the EU. The bank finds that such comparisons cannot be used for setting risk weights when applying the IRB approach since the risk weights must be set on the basis of an individual assessment of the concrete risks.

First of all, the FSA wants to make a general point that applies to many of the FSA's comments. The FSA finds that permission to apply IRB models implies a high degree of freedom of choice as regards the methods used by the institutions, but it does not allow the institutions to set their own capital requirements. Consequently, the FSA must therefore play a significant part in relation to ensuring an adequate level of capital on an ongoing basis (see sections 19 and 20 of the Executive Order on capital adequacy on permission from the FSA to apply the IRB approach). Hence, these provisions imply that the FSA has not only the legal authority but also a duty to react if the FSA considers the level of capital too low. In this connection, the FSA considers it both natural and necessary to include both general considerations about the overall level of capital in relation to the specific portfolio and more detailed observations about specific models and exposures.

The FSA also wants to point out that in Danske Bank's case, the FSA has required add-ons to Pillar II specifically to ensure a level of capital that is adequate in relation to the FSA's knowledge of the bank's portfolio.

The FSA therefore does not agree that the orders are almost exclusively based on comparisons with other banks. To the contrary, as mentioned in section 2.5, it has been the FSA's view for some time that the bank's IRB risk weights are too low to take account of the bank's overall credit risks, and this is the reason for some of the add-ons that the bank makes in Pillar II. The FSA's opinion is based, among other things, on a review of specific exposures in connection with credit inspections and on reviews of the bank's IRB models.

Consequently, these are known issues on the basis of assessments of specific matters at Danske Bank, but the comparisons with other IRB institutions support the need for the add-ons.

To this should be added that the EBA analysis compares customers that Danske Bank shares with other European banks. Hence, the very large differences in risk weights are based precisely on very different ways of handling the concrete risks in capital adequacy calculations.

In addition, the FSA wants to point out that comparisons with external data sources are part of the requirements to the validation processes of IRB banks. According to paragraph 225 of appendix 8 to the Executive Order on capital adequacy, "the undertaking must also use other quantitative validation tools and comparisons with relevant external data sources (benchmarking)".

The bank complies with this requirement in part by participating in the PECDC collaborationFN18 which facilitates the sharing of data across institutions. The analyses described in the sections above, including the bank's own analysis of Pillar III reports, may also be considered a kind of validation that supplements the benchmarking and other validation the bank makes. As described in section 2.3, however, the FSA's analyses have certain advantages because the FSA has been able to adjust for matters such as items with counterparty risk, portfolio composition, and the use of a mixture of the standardised approach, the FIRB approach and the AIRB approach.

The FSA thus finds that comparisons across institutions are relevant as a supervisory method and validation tool.

Finally, it should be mentioned that the use of comparisons will be intensified with the introduction of the CRD IV rules. Article 78 of CRD IV, which is not implemented yet, provides for IRB institutions to make annual calculations of the capital requirement for some so-called benchmark portfolios defined by the EBA and report the results to the competent authorities. Against that background, the authorities must identify undertakings that have underestimated their capital requirement and ensure that the situation is remedied.

4.5.2 Access to the documents of the case

As appendix 5 to its hearing response of 3 June 2013, the bank enclosed Kromann Reumert's memorandum of 29 May 2013. The memorandum states that section 15 of the Danish Public Administration Act does not allow the exemption of documents in their entirety but only to extract specific information in the documents available. Finally, it is stated that in the current matter, the FSA has applied the provision of the Danish Public Administration Act as if it gave authorisation to exempt entire “categories of documents”.

The FSA agrees that section 15 of the Danish Public Administration Act allows exemption from disclosure only in certain situations and adds:

According to the FSA’s decision of 27 May 2013 about the bank’s access to the documents of the case, the FSA would, if so requested by the bank, as soon as possible provide copies of the documents of the case in extract in such a manner that all institution-specific, non-public information would be extracted [translator’s note: sic; should it say “excluded” instead of “extracted”?]. The bank has not subsequently requested the documents in extract. Nor has the bank appealed the decision to the Danish Companies Appeal Board.

See also appendix 1 for the FSA’s more detailed comments on this part of the hearing response.

4.5.3 Methodological errors and updated comparisons

In its response, the bank states that the FSA’s comparisons exhibit a number of methodological errors. The bank has therefore enclosed updated calculations that the bank finds more correct than those used by the FSA.

Overall, the FSA does not agree with the bank, and the FSA does thus not find that the arguments give reason for changing the FSA’s conclusions. The FSA has already commented on most of the bank’s arguments in the preceding sections. For the sake of good order, the FSA also comments on most of the bank’s arguments below.
Among other things, the bank states that the comparisons do not take the bank’s use of a TTC method into account. The method causes TTC PD to be relatively lower for customers with a good PIT rating and higher for customers with a poor PIT rating.

The FSA is aware that the TTC method has this effect but it finds that the method has proved to result in TTC PDs that are so low in the best rating categories that adjustment of the method is required. That is why this issue is explicitly included in the first of the FSA’s orders. Against this background, the FSA does not find that the bank can use this issue as an argument to prove that the FSA’s comparisons are flawed.

The bank also argues that at the current stage of the business cycle, the use of the TTC PD method results in PD values that are lower than they would have been if the bank had used PIT PD values. The bank states that the FSA’s comparisons do not take this into account.

But the FSA has taken this into account in the comparisons, and it has asked the bank to calculate the specific effects of the use of PIT and TTC (see section 2.1). The FSA also finds it important to emphasise that for corporate exposures, the use of PIT PD is uncommon. Most institutions use models that can be seen as hybrids between PIT and TTC, and many of these hybrid models are more TTC than PIT. Section 2.4.3 mentions the ability to reflect cyclical effects of the models used in the EBA's analysis.

The bank also states that, as a minimum, the comparisons must be adjusted for the portfolio compositions of the individual credit institutions. The FSA agrees, but as described in section 2.3, the FSA does not find that this is an argument in favour of the bank. Rather, geographical differences and the experience from the FSA's credit inspections indicate that Danske Bank's risk weights should be higher than the weights used by otherwise comparable banks.

The bank further states that credit institutions using the AIRB approach to a greater extent will normally have lower risk weights than credit institutions making more use of the FIRB approach, and that the FSA's comparisons do not take sufficient account of this. Section 2.1 shows that the FSA has taken this into account. As described in section 2.3, the FSA finds that the bank overestimates the effect of shifting from FIRB to AIRB. The FSA is thus of the opinion that the experience from the crisis has caused supervisory authorities to be less accepting than before of reductions in risk-weighted items as a result of a transition from FIRB to AIRB.

It also appears that the bank finds that the comparison should be made on the basis of updated figures. In this connection, the bank has submitted updated figures for its Danish corporate portfolio showing that the bank's risk weight has risen from 34% to 45%.

But the bank fails to mention two material issues that, in the FSA's opinion, must be taken into account in an assessment of the updated figures. First, as mentioned, the figures cover the Danish corporate portfolio, for which the risk weight has increased. However, during the same period, the risk weight for the rest of the corporate portfolio has fallen so much that the risk weight for the aggregate corporate portfolio has decreased marginally. Second, part of the increase for the Danish corporate portfolio is the result of circumstances that may be expected to be temporary. For example, the risk weight has risen in Denmark because the FSA has published an interpretation of the rules on the calculation of maturities that meant that the bank had to change its calculation. But the bank is working actively on changing the conditions of its customer agreements to allow it to reduce maturities again.

The bank refers to an analysis it has made on the basis of information published (Pillar III reports) for 2012. The bank concludes that differences in risk weights derive mainly from the IRB approach used. The FSA has already commented on the analysis in section 2.3, stating why it finds that the bank's analysis supports the results of the FSA's own analyses.

4.5.4 Effect of the orders

In its response, the bank states that the effect of the orders is probably much larger than stated by the FSA but that the bank is not able to verify the FSA's calculations. The bank's assessment of the much larger effect is attributable to the fact that the bank estimates that the add-ons in Pillar II are temporary and must now be replaced by permanent increases of the risk-weighted items in Pillar I.

As described above, it has been the FSA's assessment for some time that there have been risks that were not sufficiently covered in Pillar I, and this has caused a number of add-ons in Pillar II.

For example, during its on-site inspections, the FSA has assessed the amounts of these add-ons. On several occasions, the FSA has informed the bank that, in the FSA's view, these add-ons are not temporary.

In light of the bank's response, the FSA also sent a specification of the calculation of the effects at a later date. The bank commented that it finds the FSA's estimate, at about DKK 2 billion, of the effect of the order concerning items with counterparty risk far too conservative. The FSA recognises that the estimate is subject to uncertainty. At the same time, it is the FSA's opinion that the EBA's analysis of the low-default portfolio, for example, clearly shows that the TTC PD values for the best rating categories are too low by a significant amount.

The bank has also stated that it finds that its Pillar II add-ons are sufficiently large to cover the larger Pillar I requirement that is a result of the FSA's order to increase the risk weights for items with counterparty risk.

As the preceding sections show, the FSA does not find that the bank can set off the amounts in this way. For example, the bank's Pillar II add-on for credit risk totals DKK 10.8 billion but the full amount is not available in this connection.

For example, the bank has an add-on of DKK 1.7 billion in relation to Northern Ireland. Since it does not use the IRB approach for exposures at its subsidiary bank in Northern Ireland, this amount cannot be set off against an increase in the risk-weighted items calculated using the IRB approach.

Furthermore, the bank has add-ons of DKK 6.1 billion in relation to Denmark and Ireland and of DKK 3.0 billion in relation to its LGD models. Part of these add-ons concerns exposures to personal customers, however. Since the orders concern corporate exposures, exclusively, the full amount cannot be set off. The FSA estimates that the amount that can be used is DKK 6 to 7 billion, which reflects that about a quarter of the add-ons mentioned above is earmarked for personal customers.

4.5.5 Existing safety margins

In its response, the bank states that it is of the opinion that it complies with all requirements for safety margins in the Executive Order on capital adequacy, and that the FSA has approved the bank's calculation of safety margins.

The FSA emphasises that, even though it is correct that it has approved the bank's safety margins, a number of these margins were introduced on the instructions of the FSA (which is also made clear, to some extent, in the response). The FSA is therefore not of the opinion that the bank operates with adequate prudence in its estimates at its own initiative. Neither is the FSA of the opinion that the safety margins applied reflect a particularly conservative approach. On the contrary, the FSA finds that the safety margins are low, and it accepted them only because the bank also had considerable add-ons in Pillar II.

Finally, the FSA finds that it is an important matter of principle that the FSA may make stricter requirements for example when new information becomes available. This is also made clear in the conditions of the initial approval for the use of the IRB approach for capital adequacy purposes dated 26 November 2007: "Danske Bank shall continue to make improvements if required in guidelines from CEBS and Finanstilsynet's interpretation of the Danish capital adequacy rules".

In the matter at hand, benchmarking has shown that there is a need to transfer safety margins made so far in Pillar II to Pillar I.

4.5.6 Internal management

In its response, the bank also states that the FSA's orders imply a discontinuation of the methods used by the bank for credit assessment, capital allocation, pricing, reporting and general risk management. According to the bank, this can have significant adverse consequences for the bank's internal management and operations and in other respects.

The FSA does not agree with the bank that there will be significant adverse consequences for the bank's management etc.

First, the FSA finds that it is also important in the bank's internal management that the bank operates with sufficient prudence. In this connection, there is a risk that in its approval, pricing and management reporting, the bank does not adequately take account of the risk it takes on. The FSA is therefore of the opinion that the orders are more likely to result in a management improvement.

In addition, the bank's internal management is not always based on the same estimates as those used for the calculation of risk-weighted items. For example, the internal management is to a large extent based on PIT PD estimates, whereas the risk-weighted items are based on TTC PD. This is in accordance with regulatory requirements since paragraph 171 of appendix 8 to the Executive Order on capital adequacy allows the use of different estimates for internal purposes than those used for the calculation of risk-weighted items, provided that this procedure is documented and that the undertaking substantiates to the FSA that the estimates are appropriate.

4.5.7 The bank's request for an additional review

In its response, the bank states that it will not oppose an independent analysis of whether the bank's safety margins on its corporate portfolio comply with the requirements for safety margins in paragraphs 166 and 170 of appendix 8 to the Executive Order on capital adequacy. In the bank's opinion, the analysis can be made in accordance with the procedure in section 347 b of the Danish Financial Business Act.

As the preceding sections show, the FSA has made a thorough assessment of the bank's IRB risk weights. The review is based, among other things, on the FSA's extensive knowledge about the IRB area, from the supervision of the bank and other IRB institutions, and on knowledge-sharing with non-Danish supervisory authorities. It is also based on the FSA's general knowledge of the bank's credit risks, obtained through a number of on-site inspections. There is therefore no need for the orders to be postponed until yet another independent review has been made.

4.5.8 Orders regarding changes

In its response, the bank states that it finds the order on an annual statement on changes impossible to understand because it exactly reflects the current practice. The bank refers to the IRB meetings held once a year where the bank submits all planned changes to its IRB approach so that the FSA can decide which changes are material and thus require a proper application for approval.

The FSA recognises that the version of the order that the bank received for comments did not reflect the existing procedure on planned changes. The FSA finds that this procedure generally works as intended and the FSA thus agrees that there is no need for mentioning planned changes in the order.

The order is therefore withdrawn.

4.5.9 The bank's reduction in Pillar II

In its response, the bank states that it agrees with the FSA that, using the Pillar I+ method, the bank cannot reduce the Pillar II add-ons by DKK 2.8 billion equivalent to a positive difference between the allowance account etc. and expected losses. On the other hand, the bank does not agree that it follows from the 8+ method that, if the bank instead had chosen to have an add-on in the capital base for positive differences between the allowance account etc. and expected losses, this should be matched by a corresponding add-on in the solvency need.

Among other things, the bank comments that if that was always the case, it would mean that the FSA had in fact revoked section 27(1)(4) of the Executive Order on the calculation of the capital base, which mentions the possibility of including the amount in the capital base. This rule is now included in the Capital Requirements Directive, and it will be included in the CRR when the CRR enters into force. The bank states that as the CRR is a regulation, the Danish FSA cannot revoke the provision after it enters into force.

As described in section 4.5, such an add-on to the capital base reflects an assumption in the IRB rules that the impairment charges are too large – even when a prudent calculation is required for solvency purposes. The bank notes in this respect that it does not agree with the FSA that impairments made in the accounts of the bank must be considered lost and that a portion of them cannot be used to cover other future losses. In the bank's opinion, that must depend on a specific assessment of each impairment charge.

The FSA finds it important that, during its inspections at the bank, it has made specific assessments of a large number of exposures. During some investigations, the FSA has noted that the level of impairments complied with accounting rules, and in other investigations it has determined a need for additional impairments. In contrast, the FSA's investigations at the bank have not revealed that, generally, the impairments included a buffer to cover other future losses. The FSA therefore still disagrees with the bank's opinion, not least because, unlike the accounts, the solvency need calculation must be prudent.

It is the Capital Requirements Directive that authorises the individual supervisory authorities to determine capital add-ons in Pillar II. This is maintained in CRD IV and not in the CRR. The FSA finds that there is no need to amend the existing guidelines on an adequate capital base and the solvency need of credit institutions as a result of the entry into force of the CRD IV and the CRR. The guidelines imply an 8+ approach, which means that the point of departure is the minimum requirement of 8% of the risk-weighted items (Pillar I) with add-ons for risks and circumstances not fully reflected in the calculation of the risk-weighted items. Ordinary risks are thus assumed to be covered by the 8% requirement, and the calculations must take account of whether an institution has additional risks requiring an add-on in the solvency need calculations (Pillar II). As the bank mentions, the guidelines do not explicitly state that the add-on referred to above constitutes such a risk for the bank if the bank chooses to include it in the capital base. As described above, the FSA finds that this is clearly the case, however.

4.5.10 The FSA's legal authority regarding Pillar II

In its hearing response, the bank states that, upon calculating the solvency need, the institutions can choose the method they use, but according to the explanatory notes to the provision, the FSA must calculate the individual solvency requirement using the 8+ method described in the guidelines.

The FSA finds that the institutions' freedom to choose their methods is limited by a number of requirements in the Executive Order on Capital Adequacy, appendix 1, on adequate capital base and solvency need. Point 27 states, among other things, that regardless of what method is used, the board of directors and the executive board must assess whether the method produces a reasonable result. Point 28 of appendix 1 to the Executive Order on Capital Adequacy states that the assessment of capital adequacy must include all material risks to which the undertaking is exposed.

The guidelines on capital adequacy and solvency need for credit institutions also describe the 8+ method, which is the benchmark for assessing the institutions' methods. Danske Bank uses the Pillar I+ method, which corresponds to the 8+ method. The bank also uses other methods, but the Pillar I+ method gives the greatest solvency need. It is therefore this method that is binding for the bank if one disregards the transitional rule that the capital base must amount to 80% of the capital requirement in accordance with the rules that were applicable before it was possible to use the IRB method.

The FSA therefore assesses that the bank cannot use the Pillar I+ method so that it corresponds to the 8+ method but thus that in some areas it is less conservative without its being compensated by greater conservatism than the 8+ method in other areas. The bank thus cannot us the Pillar I+ method in a form where it is equivalent to the 8+ method but deviates from it in that there is no add-on to the solvency need that is equivalent to a positive difference between the allowance account and expected losses. [translator’s note: meaning uncertain.]

4.5.11 Order on institutional exposures

The bank points out in its hearing response that it is surprised that its method for institutional exposures can give rise to an order from the FSA. The bank states that, as stated in the draft, it is in the process of developing a new method for the rating of banks that constitute part of the institutional portfolio. The bank therefore does not understand why the FSA finds cause for issuing an order to the bank in mid-process.

The bank also points out in the hearing response that, in the bank’s opinion, the DKK 2 billion add-on, corresponding to risk-weighted items of DKK 25 billion, does not at all reflect the increase in risk-weighted items that is expected to be the result of the changed approach for institutional exposures. The order to increase the risk-weighted items corresponding to a DKK 2 billion increase in the solvency requirement is therefore, according to the bank, not commensurate with the actual risks in the institutional portfolio.

The FSA believes that, with a model that does not function, the current contribution to risk-weighted items is too small. The bank has also not compensated for this with an add-on in Pillar II. Finally, at this time it is not clear whether the bank can develop a new model that fulfils the IRB rules, and it is not clear, in such case, how large the risk-weighted items that the model results in will be.

In its decision, however, the FSA has assumed that the bank can develop a new model that corresponds to the average for the banks that participated in the EBA analysis. As mentioned in section 2.4.2, the FSA believes that the results of the EBA’s analyses can be assumed to be representative of the bank’s total institutional portfolio to a much greater degree than is the case with the corporate portfolio. The assumption that the bank can develop a new model implies that the FSA finds it acceptable that the bank can choose to set aside capital in Pillar II.

4.5.12 Deadline for the orders

In the version of the current decision that the bank received for comments, the FSA set a deadline for the fulfilment of the first two orders at 30 June 2013. It stated, however, that the FSA would accept that, for a short period, the bank could use a relatively simple solution to increase the risk weights. After sending the hearing response, the bank pointed out that this deadline would make it difficult for the bank to implement the orders in an appropriate way.

The FSA agrees that it is important that the orders are implemented in an appropriate way, and the FSA has therefore extended the deadline for the two orders until 31 December 2013. The FSA has also added, however, that until then the risk regarding low TTC PD values in connection with order 2 must be reflected in Pillar II. In connection with order 1, the risks are already covered in Pillar II.

4.6 Expected effect of orders

The total effect of the orders is estimated to be a rise in the 8% capital requirement (the Pillar I requirement) from DKK 64 billion to DKK 72 billion calculated at 31 March 2013. In addition, it is estimated that the solvency need, before taking the transitional rule in connection with the IRB approach into account, will rise from DKK 81 billion to DKK 87 billion.

At 31 March 2013, Danske Bank Group's actual total capital ratio was 21.6% and its solvency need (Pillar II requirement) was 10.1% before taking the transitional rule in connection with the IRB approach into account. The transitional rule resulted in a solvency need of 11.4% at 31 March 2013. According to the transitional rule, the capital base must amount to 80% or more of the capital requirement according to the rules in force until the current rules, which allow the use of the IRB method for capital adequacy purposes.

The orders stated above will result in a fall in the actual total capital ratio and in the solvency need before and after taking the transitional rule in connection with the IRB approach into account. The reason that the ratios fall, even though the solvency need grows, for example, in terms of kroner is that the ratios are measured in relation to risk-weighted items. The risk-weighted items will rise as a result of the orders.

The estimated effect of the orders is that the total capital ratio will amount to about 19.1% at 31 March 2013 and that the solvency need, before the transitional rule in connection with the IRB approach is taken into account, will amount to 9.7%. When the transitional rule in connection with the IRB approach is taken into account, the estimated solvency need will be 10.1%.

A copy of this letter has been sent to Danske Bank's auditors.

Yours faithfully

Lars Stage

Appendix 1: Request for access to the documents of the case

Kromann Reumert states in its memorandum that the FSA, upon delivering a copy of the documents of the case, including the extracted documents, is obligated to satisfactorily justify all extracts. It is here noted that the FSA's extractions, without exception, will be justified in considerations of competition to other banks and in consideration of the FSA's future work, including its controlling work. Since these considerations are closely related, it will not be possible to distinguish between them in relation to the individual extracts. See the remarks on the underlying considerations immediately below.

By way of introduction in the memorandum, Kromann Reumert states that the FSA has justified its decision on IRB risk weights for the corporate and institutional portfolios at Danske Bank with reference to "a number of peer reviews, benchmarks and other information".

The FSA does not agree that the orders are almost exclusively based on comparisons with other banks. To the contrary, it has been the FSA's view for some time that the bank's IRB risk weights are too low to take account of the bank's overall credit risks, and this is the reason for the add-ons that the bank makes in Pillar II. The FSA's assessment is based on a review of specific exposures in connection with credit investigations, among other things. The FSA's assessment is also based on a review of the bank's IRB models.

As a supplement to the statement on paragraph 15 of the Danish Public Administration Act in the FSA's decision of 27 May 2013, please note the following:

According to the provision in section 15(1) in the Danish Public Administration Act, the consideration of whether there should be given access to the documents, includes, on one hand, the party's interest in being able to use knowledge of the documents of the case to safeguard its interests and, on the other hand, a decisive consideration of the party itself or other private or public interests.

It is the FSA's perception that Danske Bank's right to access to the documents that contain information about specific institutions must give way to decisive competitive considerations regarding the financial businesses whose information appears in the documents.

Besides the nature of the information about specific institutions, it is also the FSA's perception that the more stringent confidentiality that the FSA's employees are subject to in accordance with paragraph 354 of the Danish Financial Business Act is a factor that must be given weight in the consideration according to section 15 of the Danish Public Administration Act.

As far as consideration of the FSA's future work is concerned, including its controlling work, note that the FSA believes it is absolutely crucial for its supervisory effectiveness that it receives all the necessary information in a given case. This means that the financial businesses under supervision do not have an incentive to withhold information of significance for the FSA's work. It is the FSA's perception that this alone can be ensured if the financial businesses (and their customers) can have confidence that the FSA does not pass on confidential information about specific institutions to competing businesses.

Regarding Kromann Reumert's reference to the Danish Parliament's ombudsman's statement FOB 1989.241, note that this concerns an exchange of letters between the Danish tax authorities and the US authorities. The statement does not appear to be relevant to the current case since this case involves a situation in which the material that one wants access to is information from competing businesses that is subject to the obligation of confidentiality.

In addition, note that, on the basis of executive order and law, information about businesses under supervision can be exchanged between supervisory authorities and remain confidential.

In its remarks on the FSA's draft decision of 23 May 2013, the bank has requested that the Financial Council reconsider the FSA's decision on access to documents and postpone the response to the draft. Note that if the bank disagrees with the FSA's decision regarding access to documents, the bank can bring the case to the Company Appeals Board.

It is the FSA's view that there is no basis for accommodating the bank's request to postpone the processing of the case. In this connection, see the FSA's decision of 27 May 2013, which states that the FSA has delivered information in summary form. That is why the delivery of extracted documents will not give the bank new information in the case. As mentioned above, the bank has not requested to receive a copy of the documents of the case in extract form.

In conclusion regarding Kromann Reumerts' considerations on the publication of information about specific institutions, the following appears in the comments on the change of section 354 of the Danish Financial Business Act, which was passed on 19 December 2012 (excerpt):

"The published response of the FSA will contain the names of the businesses involved. On the other hand, all confidential information about customer relationships, or information about possible purchasers of a distressed business in a case where an acquisition is not carried out, will not be published.

This also applies to confidential information about the business's internal circumstances of essential significance for the business. For example, unpublished, accessible information about its construction and organisation, its financial standing and situation, its customer base and its business partners will be removed before publication unless the information is necessary for the understanding of the FSA's response. [...]."

In accordance with this, upon the publication of the decision under discussion about IRB risk weights for the corporate and institutional portfolios, consideration will be given to the nature of the information treated in the decision.