Translation from Danish by Danske Bank of a statement of inspection dated 26 October 2014 from the Danish Financial Supervisory Authority (FSA). In case of discrepancies, the Danish version prevails.

Statement of inspection of Danske Bank (Asset Quality Review and stress test)

1. Introduction

On the recommendation of the European Banking Authority (EBA), the Danish Financial Supervisory Authority (FSA) has conducted an Asset Quality Review (AQR) of Danske Bank A/S and Realkredit Danmark A/S and a stress test of Danske Bank Group in the first three quarters of 2014.

The purpose of the review was to assess the quality of the most important assets that, in the opinion of the FSA, posed the greatest risk of being overvalued (a risk-based focus). The AQR covered the following:

- Loan impairment charges (assessed individually and collectively) and solvency need for a number of portfolios of loans to business and personal customers
- The identification of objective evidence of impairment (OEI), the offering of lenient lending terms to weak customers, and the categorisation of defaulted credit exposures
- The valuation of real property used as collateral for loans
- The valuation of selected parts of the trading book involving derivative financial instruments without observable market data (level three assets)
- Credit value adjustments (CVA) associated with derivative financial instruments

The FSA coordinated the review with the group of foreign banking authorities (the supervisory college) involved in the supervision of the bank's foreign activities.

The FSA's review covered loan portfolios from the bank's Danish activities and from foreign branches with a significant volume of lending. For the bank's Swedish branch, the Swedish banking supervisory authority conducted a review of selected loan portfolios on behalf of the Danish FSA.

For the bank's foreign subsidiaries with a significant lending volume in relation to the bank's total lending, the national banking supervisory authorities conducted separate assessments. The UK banking supervisory authority recently assessed important parts of the loan portfolio at the subsidiary in Northern Ireland. In addition, the Finnish supervisory authority, under the leadership of the European Central Bank, conducted a review of the asset quality at the subsidiary in Finland. The results of these reviews are included in the data for the stress test in this statement but do not appear in the summary and risk assessment.

2. Summary and risk assessment

Altogether, the FSA assessed that the bank's common equity tier 1 capital, which is used in the pan-European stress test, should be reduced by DKK 2.2 billion before tax before the group's stress test was conducted. The adjustment was broken down into DKK 1.6 billion in increased impairment charges and DKK 0.6 billion in credit value adjustments.

For the assessment, the FSA selected 949 loans to business customers and 1,050 loans to personal customers from the bank's and the mortgage credit institution's loan portfolios in Denmark, Ireland, Norway and Sweden. The assessment of the business loans covered the largest loans and loans for the financing of commercial property. For Denmark, the assessment also covered loans to business customers in shipping, agriculture and cooperative housing. With the exception of the largest loans to business customers, the exposures were selected from the bank's customers with weak credit quality and portfolios of customers with increased risk of losses.

The loan portfolios from which the FSA assessed the weakest and largest exposures amounted to 77% of the bank's and the mortgage credit institution's risk-weighted assets for loans and guarantees at the end of 2013.

The FSA assessed that, at the end of 2013, for the loan portfolios reviewed, there was a need for additional impairment charges totalling DKK 1.6 billion.

The need for impairment charges was broken down into DKK 393 million for Danish personal customers, DKK 325 million for Irish personal customers, DKK 22 million for Swedish personal customers, DKK 458 million for Irish commercial property customers and others, DKK 309 million for loans for shipping, and DKK 85 million for collective impairment charges.

The most important reason for additional impairment charges in most areas was a lack of identification of OEI on the basis of signs of weakness in customers. The lack of identification of OEI was more pronounced than at other large Danish banks. An overly positive valuation of real property was also a contributing factor.

Additional collective impairments were needed because the bank had not made a collective assessment of the loans for which the bank had identified OEI but for which individual assessment had not resulted in impairment.

The bank has stated that an amount of DKK 876 million of the assessed impairment need was booked during the first three quarters of 2014, whereas the remaining amount of DKK 716 million would be expensed in the fourth quarter of 2014.

The FSA did not find reason to conclude that Danske Bank had undervalued the portion of the solvency need attributable to the selected exposures at 31 December 2013.

As part of the assessment of asset quality, the EBA has recommended that the new definitions be used, to the extent possible, for reporting the offering of lenient lending terms (forbearance) and defaulted (non-performing) exposures. The new definitions must be applied for reporting purposes as from 31 December 2014. At the inspection, the FSA observed that the bank was unable to provide the information requested for inspection purposes. This means that the published source data in connection with the AQR assessment, including for the purposes of comparison with the results of other banks, are subject to some uncertainty. The bank has stated that reporting in accordance with the definitions as required will take place at the end of 2014.

For the assessment of loans for real property financing, the FSA had selected random samples of property provided as collateral for the purposes of testing the bank's valuation. A total of 601 properties were reviewed in the following categories: commercial rental property, agriculture, cooperative housing and owner-occupied property.

According to the FSA's assessment, the bank had overvalued a total of 54 properties (9%). The effect of this overvaluation is included in the FSA's assessment of the bank's impairment and solvency needs. The bank was ordered to improve its business procedures for valuing Irish and Norwegian property so that they clearly describe the requirements for the content of assessments.

In general, in the opinion of the FSA, the bank's credit management is satisfactory and generally in line with that of other large Danish banks. However, the FSA found that the bank had not, to a sufficient extent, identified OEI and made impairments for weak Danish, Irish and Swedish personal customer exposures.

The bank was ordered to ensure that it has methods that enable it to make sufficient impairments.
The bank's impairment calculations for customer relationships that are based on customer assets where customers are subject to OEI but not in default took into consideration only the fair value of the financed assets with a deduction of costs, whereas the mortgage credit institution included an expected repayment on the basis of its average loss experience.

The FSA issued an order stating that the group must apply the same method as the one used by the bank for impairment of all customer exposures based on customer assets. The effect of this is included in the FSA's assessment of the group's impairment and solvency needs.

Credit value adjustments (CVA) reflect the risk arising from a deterioration of counterparty creditworthiness in trades involving derivatives which at the time of calculation have a positive market value in the form of an amount owed to the bank. So far, the bank has relied heavily on internal calculation parameters based on the bank's loss history when calculating CVA.

It was the FSA's opinion that the bank, when calculating CVA, should use observable credit-related market data to the widest extent possible, as well as approximate values deriving from these data for counterparties for which no observable data exist. In its asset quality review, using some parameters corresponding to parameters applied by the ECB, the bank calculated that at end-2013, this approach would increase the group's CVA by DKK 616 million. If parameters for accounting purposes were applied, the result of the CVA calculation would be lower.

The FSA ordered that the bank use observable market data to the widest extent possible when calculating and booking CVA. The effect on the income statement will to a certain extent be neutralised by the booking of the credit part of the earnings margin from the derivatives. The FSA also ordered that the bank establish business procedures providing an overview of the calculation and booking of CVA.

Following EBA guidelines, the FSA conducted a stress test of the banking group, under which total capital was projected for the years 2014-16 in both a baseline and an adverse scenario. The stress test was coordinated by the EBA, while the FSA was responsible for the quality assurance of the results and for incorporating them in the results of the preceding AQR.

At 1 January 2014, the bank's solvency ratio was 20.0% and the common equity tier 1 capital ratio was 13.7% after adjustments following the outcome of the FSA's AQR, which took into account tax effects. In the baseline scenario, the common equity tier 1 capital ratio rose to 14.5% at end-2016, whereas in the adverse scenario, the same ratio was 11.7% at end-2016. In both scenarios, the bank clearly exceeded the EBA's threshold values of 8% and 5.5%, respectively.

Assuming a full phase-in of CRR/CRD4, the bank's common equity tier 1 capital ratio would be 14.0% in the baseline scenario and 11.1% in the adverse scenario at end-2016.