

## **MEMORANDUM**

### **The Danish Financial Supervisory Authority**

8 June 2020

## **Statement on inspection at Danske Bank A/S (impairment charges for weak business customers)**

### **Introduction**

In August 2019, the Danish Financial Supervisory Authority (the FSA) conducted an inspection of Danske Bank's handling of the loan impairment rules.

The purpose of the inspection was to assess whether the bank's impairment method was in compliance with the accounting rules so that impairment charges were adequate.

### **Summary and risk assessment**

The FSA's assessment of the bank's impairment method was based on a review of 55 randomly selected loans of minimum DKK 2 million to weak business customers that were primarily defined by being placed in the weak part of stage 2 (a significant increase in credit risk and a probability of default of more than 5%) or in stage 3 (credit-impaired). Furthermore, the FSA reviewed selected business procedures.

The FSA observed a need for additional impairment charges in the random sample. The impairment charges were increased against six exposures, especially two large loans. Prior to the FSA's review, the impairment charges of the random sample totalled DKK 142 million. The FSA assessed that the total impairment charges of the random sample should have amounted to DKK 323 million.

One reason for the additional impairment charges was that the bank had incorrectly implemented various parts of the impairment rules. For instance, for some exposures, the bank had failed to identify objective evidence that financial assets were credit-impaired (OEC) and to detect that 13% of the loans were placed in an incorrect stage.

As stipulated in the accounting rules, a customer is credit-impaired and must be placed in stage 3 when the customer's accounts and facilities are overdrawn or the customer is behind on loan repayments unless the situation is short-lived and concerns amounts that are small in relation to the customer's finances or is due to a mistake. The bank had failed to implement these rules.

The bank's implementation of when OEC existed in the form of concessions and severe financial difficulty was not in compliance with the accounting rules. This meant that the bank did not identify OEC or did so too late in regard to some exposures.

The bank was ordered to ensure that the accounting rules are correctly implemented and that it identifies OEC in compliance with the accounting rules.

The FSA also assessed that customers should have had a lower rating in 20% of the exposures of the random sample. This was due in part to the incorrect implementation of the rules. The bank was ordered to ensure that ratings are accurate.

The bank's individual calculations of impairment charges were based on standard scenarios. In regard to a few large exposures, the bank had calculated the impairment charges differently. The different method was not in compliance with the rules, and the bank was ordered to ensure that its calculations are in compliance with the rules.

In many cases, the calculation of individual impairment charges against large loans was made by the unit at the bank that, in reality, had assumed the responsibility for a customer after the customer had fallen into distress. Hence, approvals and controls were undertaken by the same unit. Pursuant to the Danish Executive Order on Management, segregation of duties must normally be implemented in the credit area. For SIFI institutions, impairment charges must generally be made by a unit that has not participated in the approval of the individual loan. If segregation of duties has not been implemented, the bank must have compensatory measures in place in the form of independent controls performed by an organisational unit outside the credit area. The FSA assessed that the bank had failed to implement segregation of duties in this area and did not have adequate compensatory measures. The bank was ordered to ensure this.

Data errors were also one reason why impairment charges were too small against some exposures. They concerned, for example, the bank's registration of collateral in respect of which collateral assets, in regard to multiple exposures, were stated at too high values. Furthermore, there was a discrepancy between the descriptions and definitions set out in the bank's method documentation and the ones set out in the business procedures. The bank was ordered to assess the need for improvements of its data governance in general, assess errors in the registrations of collateral, implement processes to ensure correct registrations and prepare or amend business procedures etc.

The FSA's review of the random sample indicated that, at 31 March 2019, a need for additional impairment charges was very likely to exist for the portfolio of weak business customers. The bank and the external auditors were therefore to review stage 2 loans to determine the need for impairment charges at 31 December 2019. They reviewed 91 large weak loans in the fourth quarter of 2019. They identified OEC for 42% of the loans and a need for additional impairment charges of DKK 370 million, which the bank recognised in the fourth quarter. The result of the review was used for assessing the need for additional impairment charges against the small loans that the bank would review on a random sample basis in the first half of 2020. It showed a need for additional impairment charges of DKK 600 million against the small loans in respect of which the bank had already recognised an amount on the basis of a management overlay. The net amount of the need for additional impairment charges against small loans was therefore DKK 160 million, which the bank recognised in the fourth quarter.

The FSA reviewed 22 of the 91 large weak loans. Overall, the FSA assesses that there is reason to believe that there is still a need for impairment charges against the largest loans and that this may also apply to small loans. In connection with future financial reporting, the bank will take into account the FSA's comments, and the bank's review of a number of loans in the first half of 2020 will show whether impairment charges against them are still needed.

The bank's auditors had not detected that the bank still needed to implement various parts of the accounting rules and that the credit process for impairment charges contained errors. The division of responsibilities between the internal and external auditors meant that the internal auditors did not independently address the implementation. The FSA found that it is also necessary for the internal auditors to familiarise themselves with the rules so as to have sufficient knowledge when they audit the credit processes. The internal auditors therefore received an order to that effect.