Danske Bank: solid financials and liquidity but governance takes priority

The money-laundering case surrounding the former non-resident portfolio of Danske Bank's branch in Estonia is far from being resolved. On 18 February, the European Banking Authority opened a formal investigation into the related supervisory work carried out by Danish and Estonian regulators into Danske Bank and whether they committed a possible breach of EU law.

Simultaneously, Estonia's FSA requested Danske Bank to shut its operations in Estonia within eight months. Danske Bank confirmed that it would comply, and that it would in addition be exiting all banking activities in the Baltic region and in Russia.

The bank (Issuer Rating A+, Negative Outlook) has indicated that as the Estonia case moves forward, it would prefer to achieve a global settlement' agreed between regulators, though this is not within its control. There is no timeline for resolving these issues nor any reliable estimate of the scale of any possible fines. Although the bank is subject to criminal investigations, it has not yet been the subject of criminal charges. But the case may well lead to financial penalties.

A preliminary report published by the bank on 19 September 2018 covered its initial findings on the case, as assessed by third-party lawyers on its behalf. Most of the non-resident portfolio was shut down in 2015 and the remainder in early 2016.

Danske Bank is currently under investigation by the following four authorities:

- The Danish FSA re-opened its investigation (first closed in May 2018), on the basis of new information after publication of Danske Bank's independent third-party report on the case in September 2018.
- The US Department of Justice has requested information, though has not been overly specific
- Estonia's FSA
- The Tribunal de Grande Instance de Paris, as of 7 Feb 2019, in relation to EUR 21.6m of transactions covering the period 2007-2014.

Related to the Estonian investigation, a number of 'suspicious activity reports' (SARs) have been submitted to Estonia's Financial Intelligence Unit (FIU), which co-operates with the FSA. Any party involved in handling cash or value commodities is required to disclose unusual or suspicious transactions to the FIU in its country, which in Estonia takes the form of an independent police unit.

If there is a suspicion of money laundering or the financing of terrorism, the FIU forwards the intelligence it has gathered to the national authority responsible for prosecution. The Danish FIU has also received a more limited number of SARs from Danske Bank, which will be investigated and if necessary, followed up through the Danish legal system. Denmark's FIU is an operationally independent unit within the Public Prosecution Service.

Scope views the Danish and US cases as potentially costlier, given the limited amount involved in the French case and the small amount legally possible for any potential fine in Estonia. Danske Bank has made clear that it intends to fully co-operate with all ongoing investigations. While this does not guarantee leniency, banks' non-co-operation with US authorities in particular has led to more punitive penalties in other cases.

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Danske Bank does not have a US banking presence, although this is not necessary for the US authorities to act. Danske Bank has significant US dollar debt programmes and maintains extensive correspondent banking relationships to serve customers abroad, including in the US. The US Treasury has the power to terminate funding and correspondent banking relationships in the US.

This was most recently demonstrated in its actions against Latvia's ABLV Bank, accused in February 2018 of institutionalised money laundering and extensive sanctions violations. Dollar funding was cut off and an intention to shut down correspondent banking relationships was announced, forcing ABLV into voluntary liquidation.

Danske Bank continues to have access to US dollar funding, albeit at a higher yield than was previously the case and has not seen any disruption in its correspondent banking relationships.

We note that many of the transactions that flowed through the Estonia branch between 2007 and early 2016 related to Russian entities. US sanctions were imposed on Russian entities during 2014. As of the date of the publication of the internal report, no sanctions violations had been identified among Danske Bank's Estonian transactions. The internal investigations continue, however, as does necessary information-sharing with authorities.

Scaling back in the Baltic countries continues

On 26 April 2018, Danske Bank announced that it would scale down its remaining Baltic banking activities to focus "exclusively on supporting subsidiaries of Nordic customers and global corporates with a significant Nordic footprint". This scaling-back has been ongoing: the Baltic banking operations are in run-down mode and have been transferred to the non-core business segment.

It is now the case that all banking business in the Baltic countries and Russia will be closed down. As of 19 February 2019, it was announced that Estonia's FSA has ordered Danske Bank to cease all banking operations in Estonia within a period of eight months. Danske Bank has agreed to comply. The Estonian FSA notes that the penalty for non-compliance would amount to 10% of Group turnover.

Separately Danske Bank has taken a decision to cease its remaining activities in Latvia and Lithuania (via branches) and in Russia (a subsidiary located in St Petersburg) – a move which has been under consideration for some time. There is no timeline for the closures outside of Estonia – this will be done giving consideration to the management of existing customer relationships.

In the context of the Group as a whole, these activities are relatively small, and the closures will have no effect on profit guidance for 2019.

Compliance spending will increase

Danske Bank's compliance functions have expanded significantly in recent years. Headcount within the bank's compliance functions rose from c. 350 in 2014 to 820 in 2017 and in 1,400 at the end of 2018. Danske Bank has identified the need to accelerate digitalisation of many compliance processes, some of which are conducted manually at present, and is electing to devote more resources to these efforts.

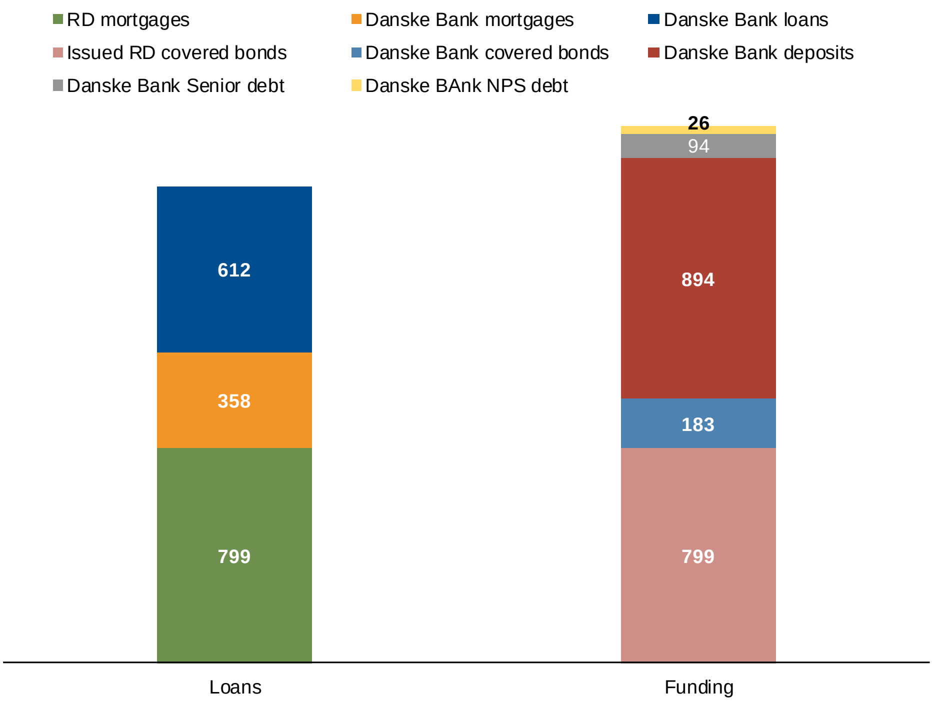
In some instances, processes are already digitalised (for example the case-handling system). In the meantime, improving processes will rely somewhat on the additional staff numbers. Up to DKK 2bn has been allocated to boost anti money-laundering processes over the next three years. The expense impact in 2019 is expected to be approximately DKK 300m.

Detailed plans relating to development of compliance systems are under discussion and will be published during 2019. This follows the appointment of a new head of compliance and executive board member, Philippe Vollot, who commenced duties in November 2018. The previous head of compliance resigned in July 2018, as the full scale of the Estonian money-laundering case became clear. The post of chief compliance officer was elevated to executive board level in 2018, with a direct reporting line to the board of directors and day-to-day to the CEO.

Liquidity appears reassuring

Although the bank has seen an increase in unsecured funding costs in particular, the Group's overall liquidity appears reassuring, which in large part reflects the structure of its balance sheet. As of year-end 2018 the bank's specialised Danish mortgage lending subsidiary, Realkredit Danmark (RD, A+ Negative Outlook) accounted for about a quarter of the Group's assets and 69% of its debt in issue (which includes covered bonds, senior unsecured debt and non-preferred senior debt but excludes subordinated instruments), as demonstrated in Figure 1.

Figure 1: Danske Bank and Realkredit Danmark: loans versus funding (DKK bn) at YE18



Source: Company reports, Scope Ratings

Scope estimates that Danske Bank holds a further DKK 68bn of un-issued RD covered bonds on its own balance sheet. These are not eligible to be included within the investment portfolio that forms part of the bank's liquidity coverage for regulatory purposes, but nonetheless form a material additional liquidity cushion.

Whether as a source of present or potential funding, the Danish covered bond market is deep and liquid; historically it has proved to be a stable source of funding. RD's balance sheet is completely match-funded, and not part of the equation when considering the bank's increase in funding costs. RD has no association with the Estonia case and is primarily focused on Denmark.

A further 18% of the Group's debt funding is covered bonds issued by Danske Bank. As shown in Figure 1 and unlike RD, not all of Danske Bank's mortgage loans have been used to back covered bond issuance, thus the bank has additional capacity to issue up to DKK 175bn in covered bonds if needed (though it may be the case that not all loans are eligible to be part of the cover pool).

Danske Bank's loan-to-deposit ratio (excluding RD) based on unsecured loans and unsecured senior debt funding equalled 68% at YE18. Expanding this calculation to include all loans and adding in covered bonds as a source of stable funds, loans as a percentage of stable funding equalled 90% at YE18.

The Group maintains a liquidity reserve, consisting of unencumbered liquid assets available in a stress scenario. As of YE18, this consisted of DKK 447bn, of which 35% was made up of central bank deposits and 40% highly-rated covered bonds. The majority of the covered bonds are likely to be from other Danish issuers.

As noted above, the total as calculated for regulatory purposes excludes retained bonds issued out of RD. The Liquidity Coverage Ratio at YE18 equalled 121%, down from 171% at YE17. The change is deliberate (related to the scaling down of a previous USD carry trade) and Danske Bank aims to maintain the ratio around this level for the foreseeable future.

Front-loading senior non-preferred issuance to comply with expected MREL requirements before 2022

By 1 July 2019 the Group must meet both an MREL requirement for Danske Bank and a separate debt buffer requirement for RD. Danish mortgage banks are excluded from MREL, and instead subject to a debt buffer requirement equivalent to 2% of loans. RD is not part of the calculation for determining Danske Bank's MREL requirement. The capital and debt buffer requirements applied to RD are deducted from liabilities and own funds used to fulfil Danske Bank's MREL requirement.

Danske Bank is preparing to meet an MREL requirement amounting to about 36% of its risk exposure amount (REA). This is expected to rise from the current 33.2% due to current capital requirements being phased in early. The Danish FSA is expected to issue an updated figure in February 2019. Danske Bank intends to replace senior unsecured debt as it rolls off by issuing senior non-preferred debt (SNP).

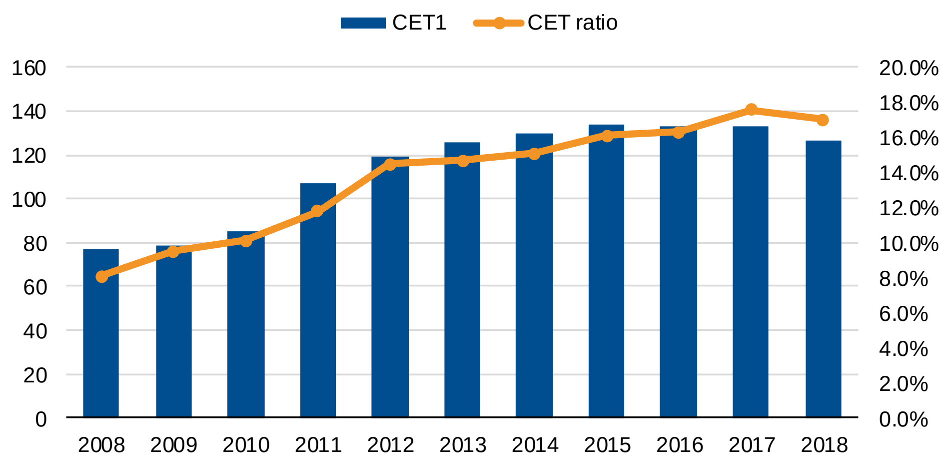
Senior unsecured debt issued prior to January 2018 will qualify as MREL until 1 January 2022, provided it has a remaining term greater than one year. The bank estimates that it needs to raise about DKK 65bn in SNP by 2022, having raised DKK 46bn to date. This includes a USD 3bn transaction executed in January 2019. The bank does not intend to issue benchmark bonds in senior preferred format; it is expected that most senior unsecured debt issues will eventually be in SNP format, including private placements.

The funding plan for 2019 amounts to an estimated DKK 70bn-90bn for Danske Bank, excluding RD, with a large part targeted to be raised in the Group's Nordic lending currencies. Of this amount, about half will be SNP and the balance in covered bonds. Like other Danish banks, Danske Bank is front-loading SNP issuance – it could raise up to DKK 45bn in the current year, although senior debt rolling off amounts to just DKK 26bn. The USD transaction executed in January was equivalent to about DKK 20bn, so almost half the year's SNP budget has already been met.

Capital buffers to be maintained or boosted; share buyback programme ceased for the moment

The acquisition by Danske Bank subsidiary Danica Pension of SEB Pension Danmark lowered the Group's capital ratios during 2018 due to the rules for deducting investments made in insurance subsidiaries (see Figure 2).

Figure 2: Danske Bank: evolution of CET1 capital, 2008-2018



Source: Company reports, Scope Ratings

Danske Bank is currently seeking to maintain and build on its capital buffers as a bulwark against any potential regulatory fines related to the Estonia case. No provisions have been made for this purpose. However, the Danish FSA has imposed additional capital requirements. First, on 3 May 2018, the bank was required to adjust its solvency need by applying a Pillar 2 add-on amounting to DKK 5bn or about 0.7% of the bank's risk exposure amount (REA). In October 2018, the FSA reassessed the Pillar 2 requirement and doubled it to DKK 10bn. The add-on must be funded with CET1 capital.

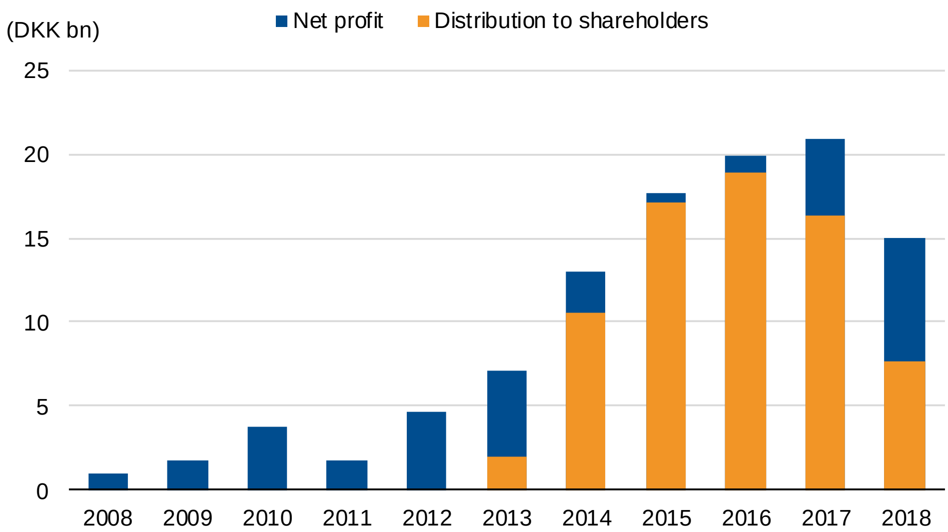
Subsequently, on 4 October 2018, Danske Bank's board announced that the bank's internal capital targets were being raised – the CET1 target to 16% from 14%-15% and total capital to 20% from 19%.

The board simultaneously decided to cease the share buyback programme amounting to DKK 10bn, which was due to end on 1 February 2019. Since it began, a total of DKK 6.9bn in shares had been repurchased under the programme.

In the past, Danske's desire not to accumulate excess capital by actively buying back shares has had no credit implications. Indeed, measured share buybacks often play a genuine part in restraining a bank's risk appetite, which could increase in an environment where 'too much' capital effectively depresses the ROE. In the present climate, the decision to build an additional CET1 capital cushion appears prudent. The decision has also been taken not to institute a new share buyback programme in 2019.

As demonstrated in Figure 3, the bank's return to shareholders (dividends plus share buybacks) is thereby reduced.

Figure 3: Danske Bank evolution of net profit versus distributions to shareholders, 2008-2018



Source: Company reports, Scope Ratings

By YE18, the CET1 ratio stood at 17% and the total capital ratio at 21.3%. Both ratios were well ahead of regulatory requirements. For YE18, Danske was subject to a solvency need of 11.3%, including 8% under Pillar 1 and 3.3% under Pillar 2. The bank also had a combined buffer requirement of 4.9%, including a countercyclical buffer (0.6%), a systemic buffer (2.4%) and a capital conservation buffer (1.9%).

Excess CET1 capital at YE18 amounted to 4.8% of the risk exposure amount or about DKK 35.9bn (YE17: 2.8%, equivalent to c. DKK 21.1bn).

In September 2018, the countercyclical buffer requirement was increased to 1%, effective 30 September 2019. Also, the Swedish FSA and the Norwegian Ministry of Finance have increased their respective national buffer requirements from 2% to 2.5%, to be phased in during 2019, which will raise the Group's capital requirement by 0.1%. Thus, the combined buffer requirement will be 6.7% when fully phased in. The fully phased-in CET1 capital requirement will be 14% and the fully phased-in total capital requirement 18.6%.

Performance expected to be on a par with 2018

Profit guidance for 2019 is in the range DKK 14-16bn, on a par with 2018. This excludes any one-off gain on the potential sale of Danica's Swedish pension business.

Although the market has focused on a decline in performance in 2018 versus 2017, with net profit lower than was estimated at the beginning of the year, Danske Bank remains profitable enough compared to most European peers. Asset quality continues to be solid with the bank still in net writeback mode overall. The bank reported net profit of DKK 15bn, down 28% from 2017, and ROAE of 9.8% (FY17: 13.6%).

The reduction in profitability was in part driven by a reduction in trading income. Danske Bank's trading business is geared towards servicing the needs of customers as opposed to proprietary trading, and the bank experienced difficult market conditions, like a number of other banks. In addition, expenses rose 10% year-on-year, mainly because of a DKK 1.5bn income contribution related to the Estonia case. The bank has agreed to donate this sum to a separate foundation to fight financial crime – provided the money is not confiscated by the authorities. The amount represents the total gross profit from the non-resident business during the period in question. It is currently held in escrow.

Aside from this, expenses rose by 3% due to increased compliance costs including the Estonia investigation, and the acquisition of SEB Pension Danmark (which increased overall operating costs and incurred integration costs of c. DKK 200m).

Stable strategy expected; key management and board appointments yet to be made

The Estonia case has put the spotlight on the bank's governance; a number of senior executives and board members most closely associated with these events (though not implying complicity) left during 2018. In addition to the CEO, Thomas Borgen, and the chairman, Ole Andersen, departures included the head of compliance and the bank's general counsel. While the new head of compliance is in place, a permanent General Counsel has yet to be appointed.

Jesper Nielsen, head of Danish banking business, was appointed as the interim CEO in September 2018. The permanent candidate subsequently proposed by the bank's board (Jacob Aarup-Andersen, the head of Danske Bank's wealth management business) was blocked by the Danish FSA in October 2018, on the basis that he did not possess the necessary experience to lead the bank.

An extraordinary general meeting took place on 7 December, called by Danske Bank's largest shareholder, A.P. Moller Holding. This is the investment firm representing the Maersk family, which also controls the shipping company A.P. Moller-Maersk. A.P. Moller Holding owns 21% of Danske Bank. The company usually acts as a passive investor, but in this case its management stated that in their view the bank had not acted fast enough to oust the previous chairman.

A.P. Moller nominated a new chairman in Karsten Dybvad, the-then head of the Confederation of Danish Industry, who was installed with the support of the board and other shareholders. Jan Nielsen, chief investment officer of A.P. Moller Holding and a LEGO board member, was approved as a Vice Chairman. The board is being cleared of all non-executives present during the money-laundering years. Two others (including Vice Chairman Carol Sergeant) will not seek re-election at the next AGM.

No firm timeline has been set for the arrival of the new CEO. While this is a top priority of the new chairman, the appointment could introduce some strategic uncertainty. That said, Scope does not believe that Danske Bank intends to aim for any major strategic shifts at present. The protection and development of its existing franchises is taking the fore.

In its Danish retail banking business, Danske Bank lost around 11,000 customers (net) as a result of the Estonia case. Although this is not a critical mass, the bank is focused on stemming further outflows and maintaining the quality of its customer relationships. Any acquisitions in the near term are most likely to be bolt-ons, as was the case with SEB's Danish pensions business during 2018.

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