

Nykredit Capital Markets Day

11. november 2015

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Agenda

- Latest developments
 - Earnings
 - Provisioning
 - Capital
- Real estate market and best practices
- Supervisory diamond
- Regulation
 - LCR
 - Recovery plans
 - Resolution and MREL

The Danish financial sector

- Banks and mortgage credit institutions constitutes a very large share of the Danish financial system
- This reflects the fact, that capital markets are a less important source of funding in Denmark

	Total assets in bn. kr.	Total assets in percent of GDP
Banking sector	4.049	211%
Mortgage credit institutions	3.718	194%
Pensions and insurance	2.659	138%
Mutual funds	770	40%

Structure of the Danish financial system

	Banks and mortgage institutions			Non-financial corporations	
	Assets	Liabilities		Assets	Liabilities
Deposits	37%	173%		13%	0%
Bonds	68%	178%		7%	10%
Loans	301%	31%		44%	104%
Shares and other equity	15%	22%		125%	233%
Other	26%	28%		26%	21%
	General government			Households	
	Assets	Liabilities		Assets	Liabilities
Deposits	12%	1%		50%	0%
Bonds	8%	46%		4%	0%
Loans	14%	13%		0%	127%
Shares and other equity	22%	0%		65%	0%
Other	7%	7%		152%	11%
	Pensions and insurance			Danish Central Bank	
	Assets	Liabilities		Assets	Liabilities
Deposits	5%	0%		9%	27%
Bonds	70%	0%		15%	17%
Loans	2%	7%		1%	6%
Shares and other equity	83%	11%		0%	4%
Other	14%	157%		2%	1%
	Mutual funds			Rest of the world	
	Assets	Liabilities		Assets	Liabilities
Deposits	6%	0%		60%	33%
Bonds	62%	0%		80%	76%
Loans	7%	16%		24%	52%
Shares and other equity	166%	178%		80%	115%
Other	11%	9%		20%	24%



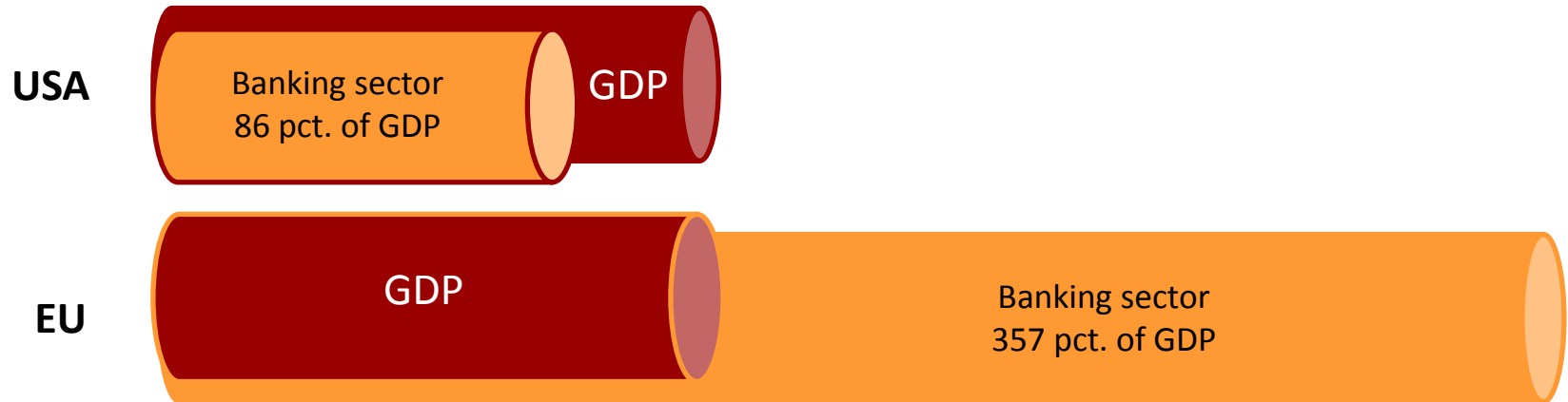
= Bonds



= Deposits and loans

Relative size of the banking sectors in the EU and the USA

- The banking sector in the EU and Denmark is much larger than in the USA
- This reflects an underlying difference in the financial structures



Differences in the financial structure

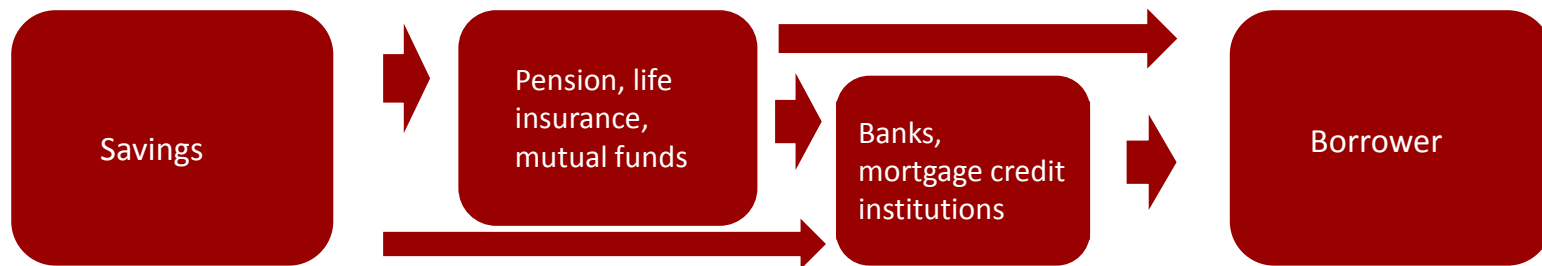
The US model



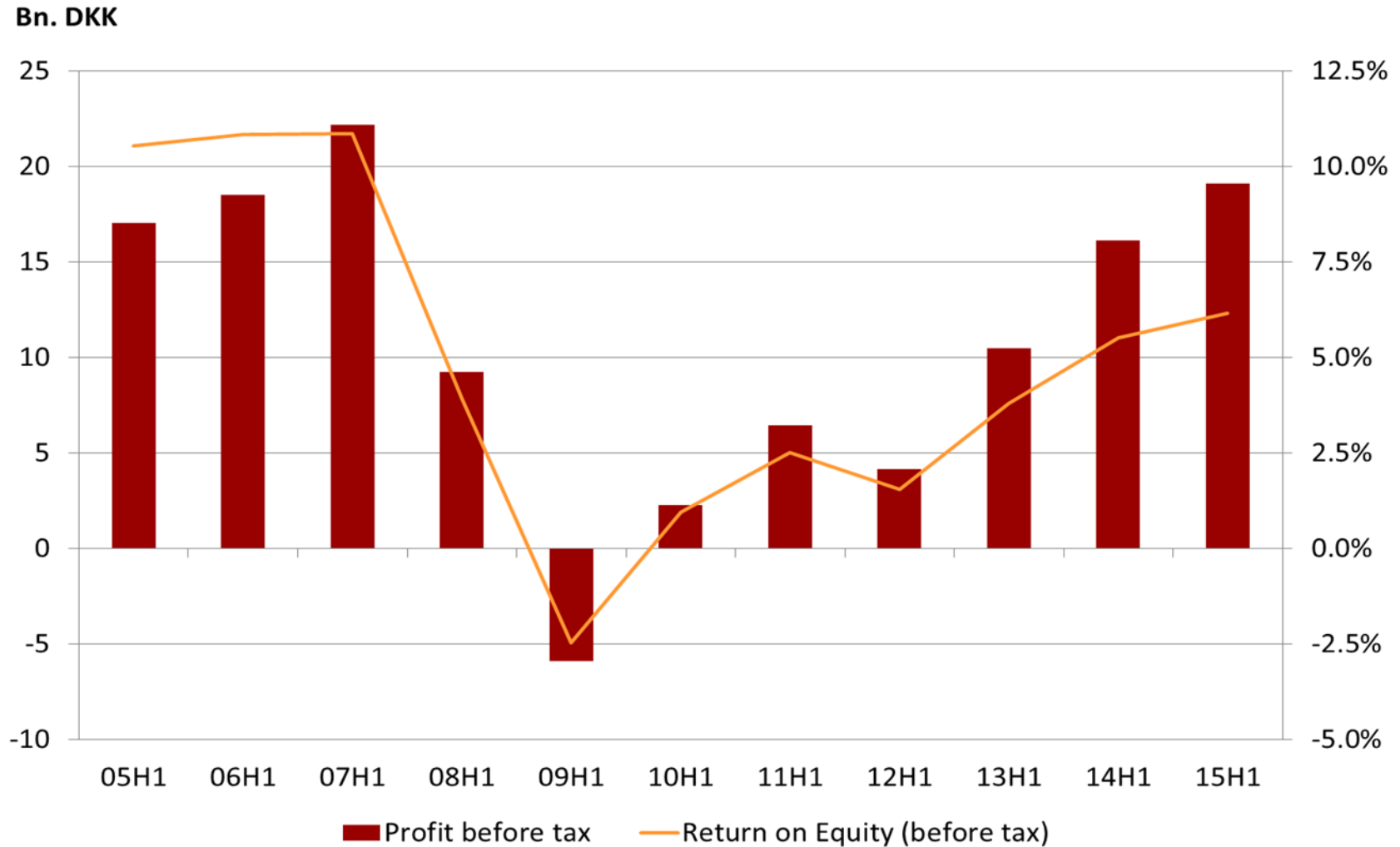
The Continental model



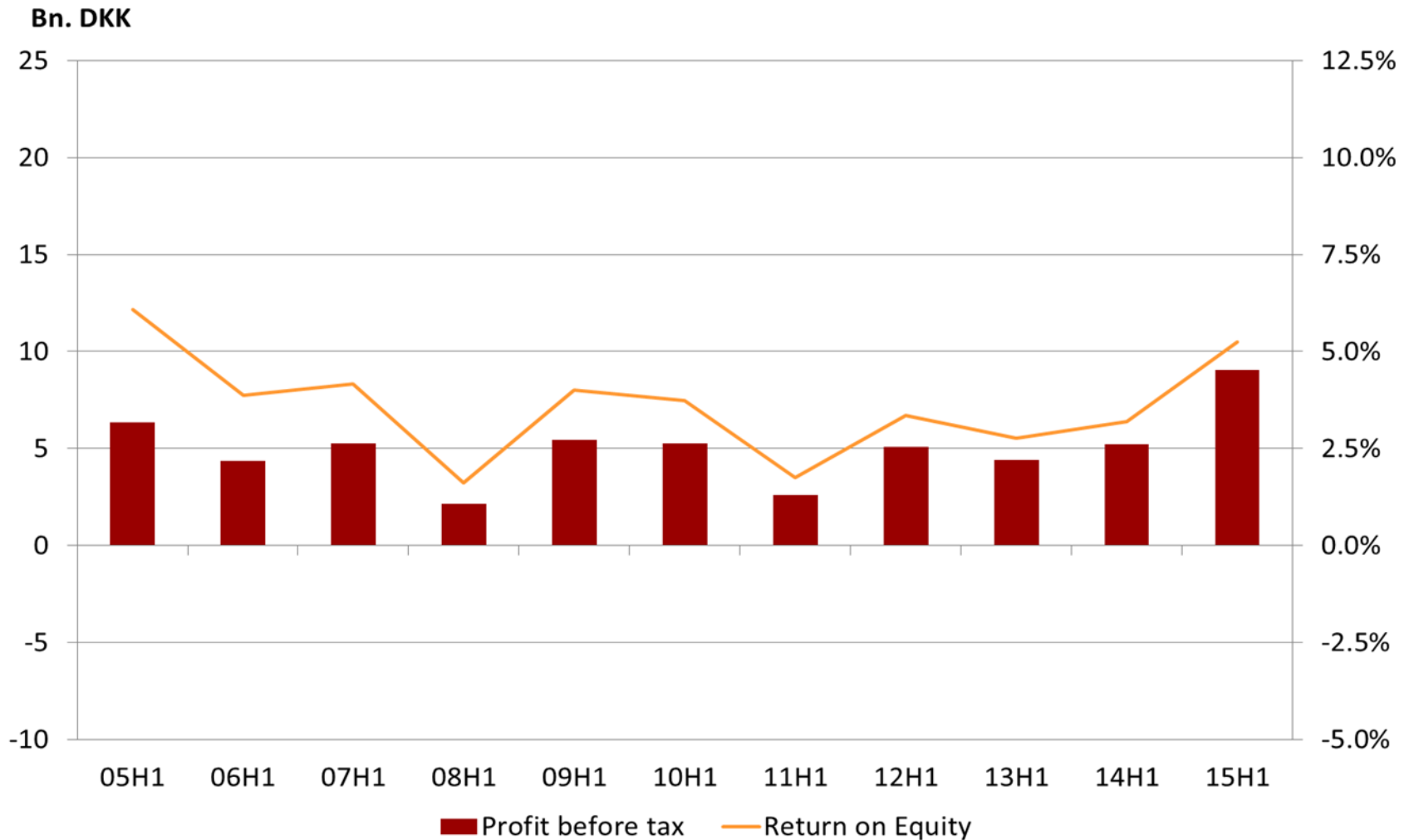
The Danish model



Positive and increasing profit for banks

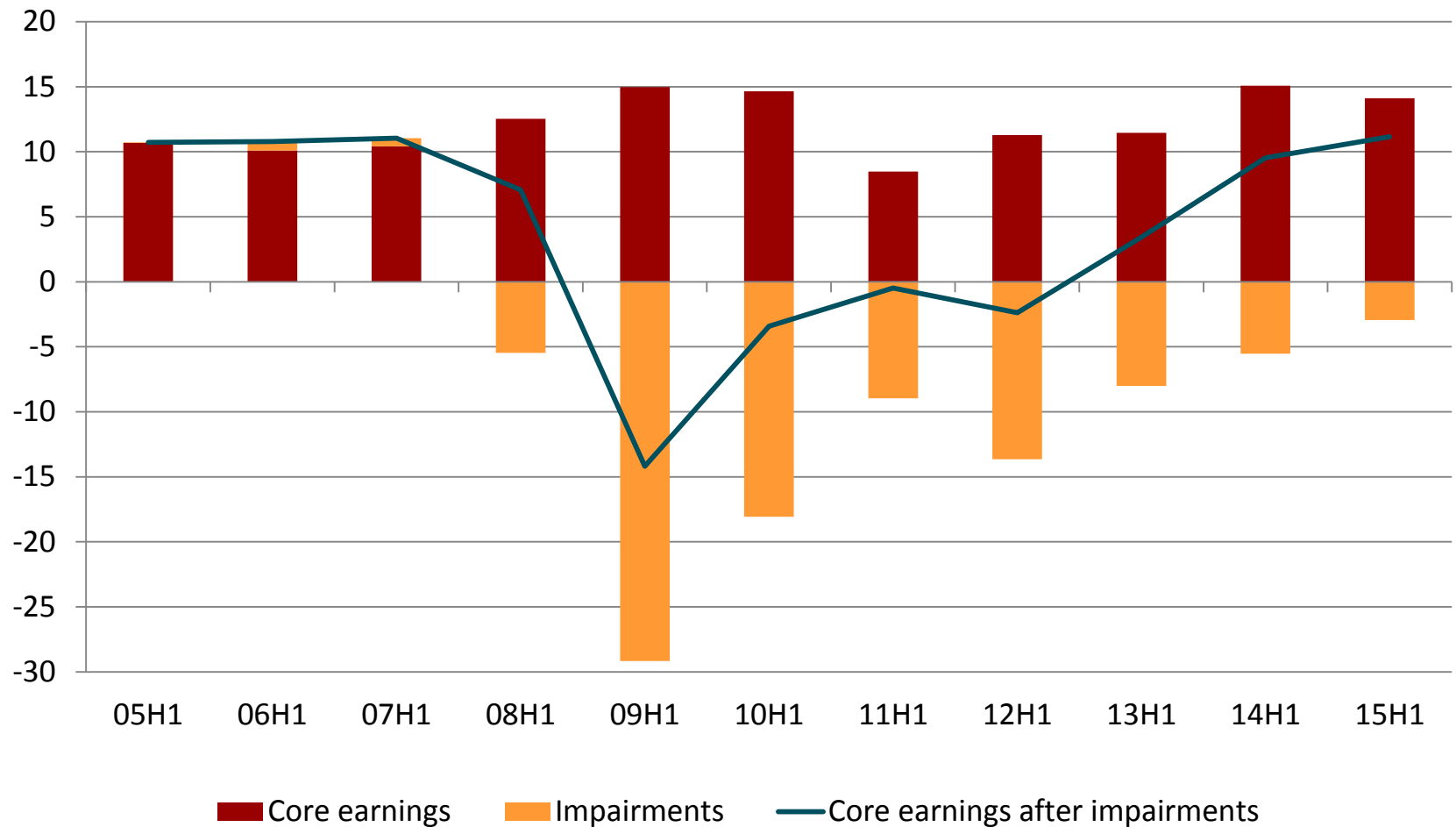


And positive profits for mortgage credit-institutions



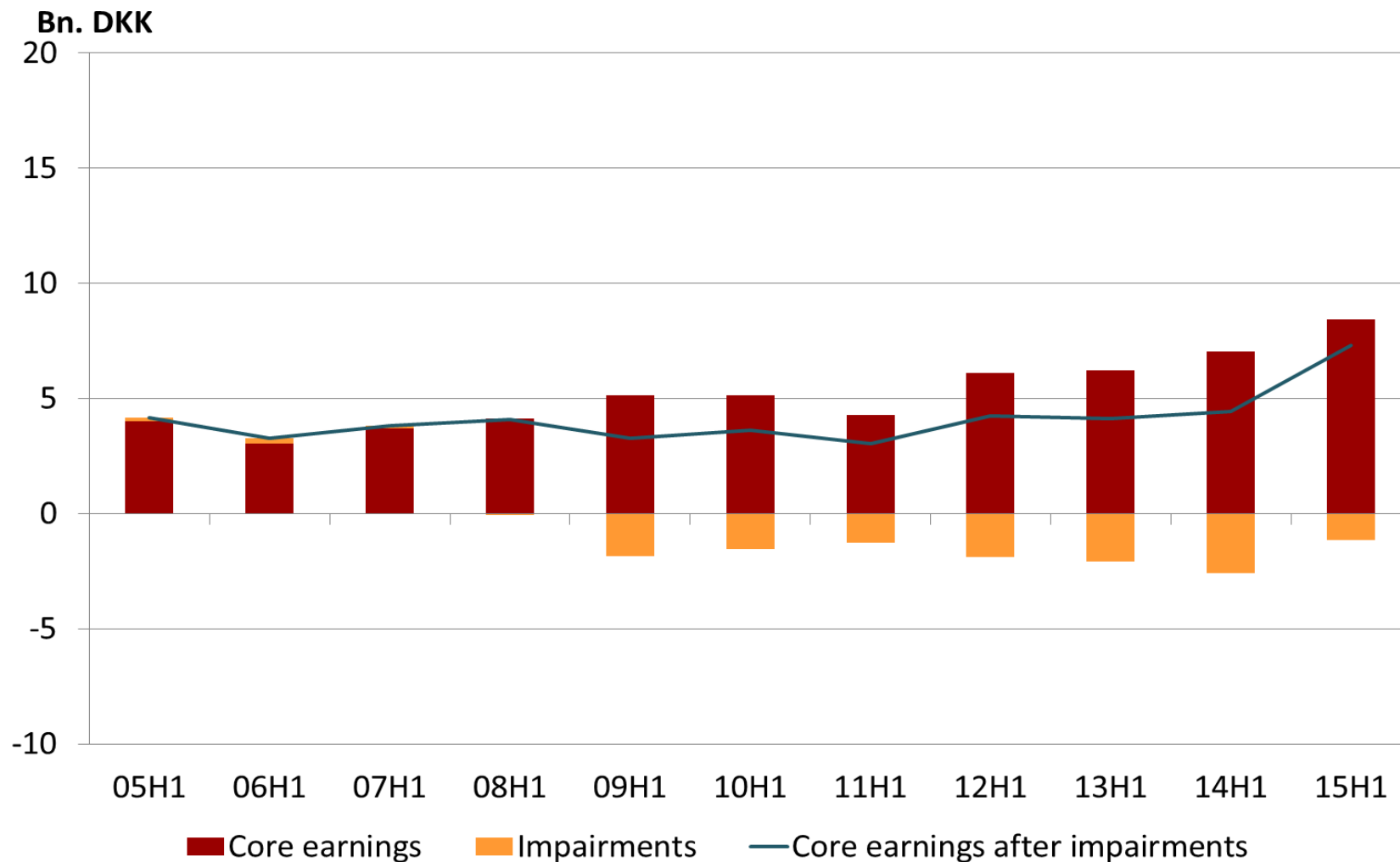
Banks core earnings trends is on the right track

Bn. DKK

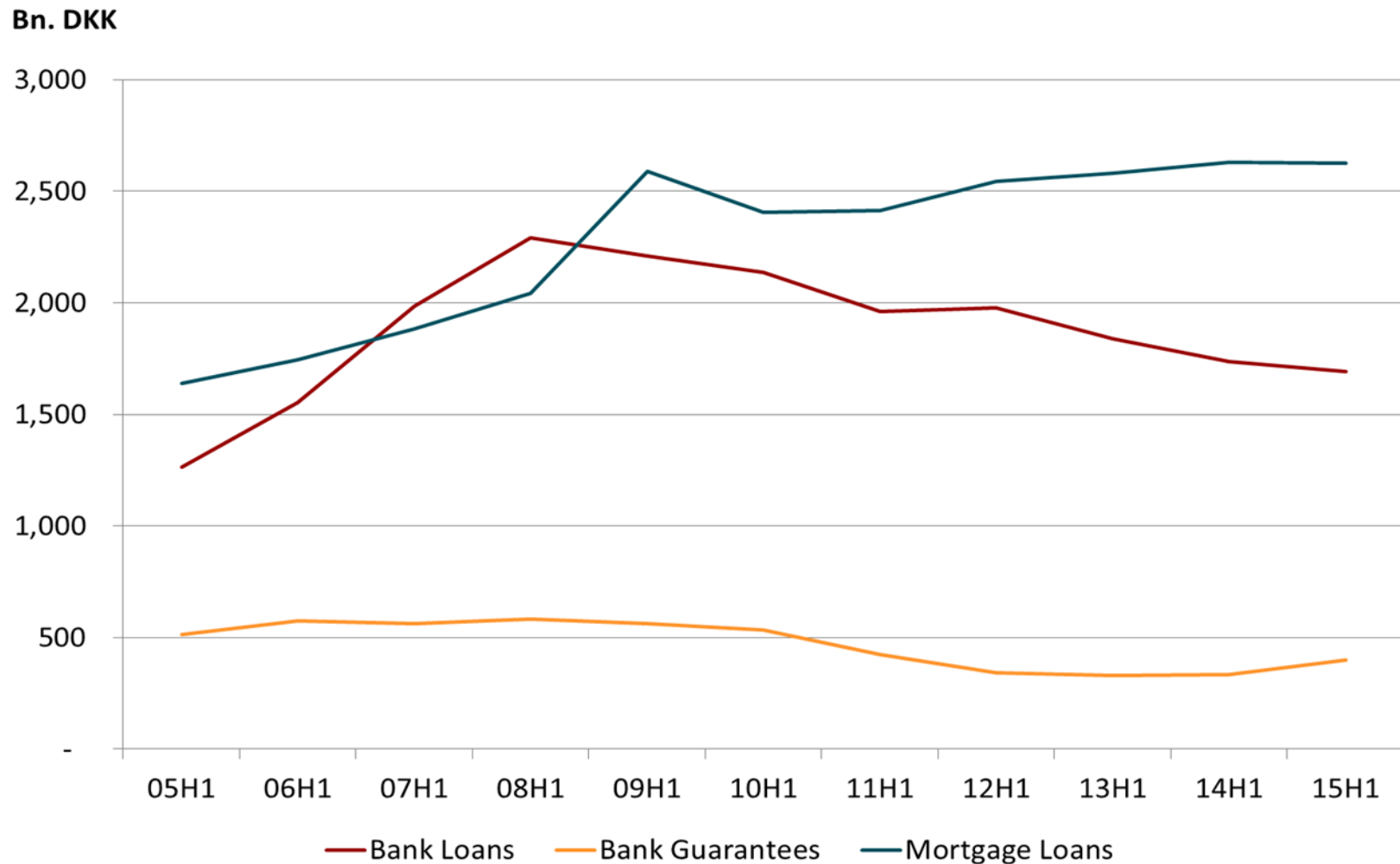


...and decreasing impairments

Mortgage credit-institutions core earnings

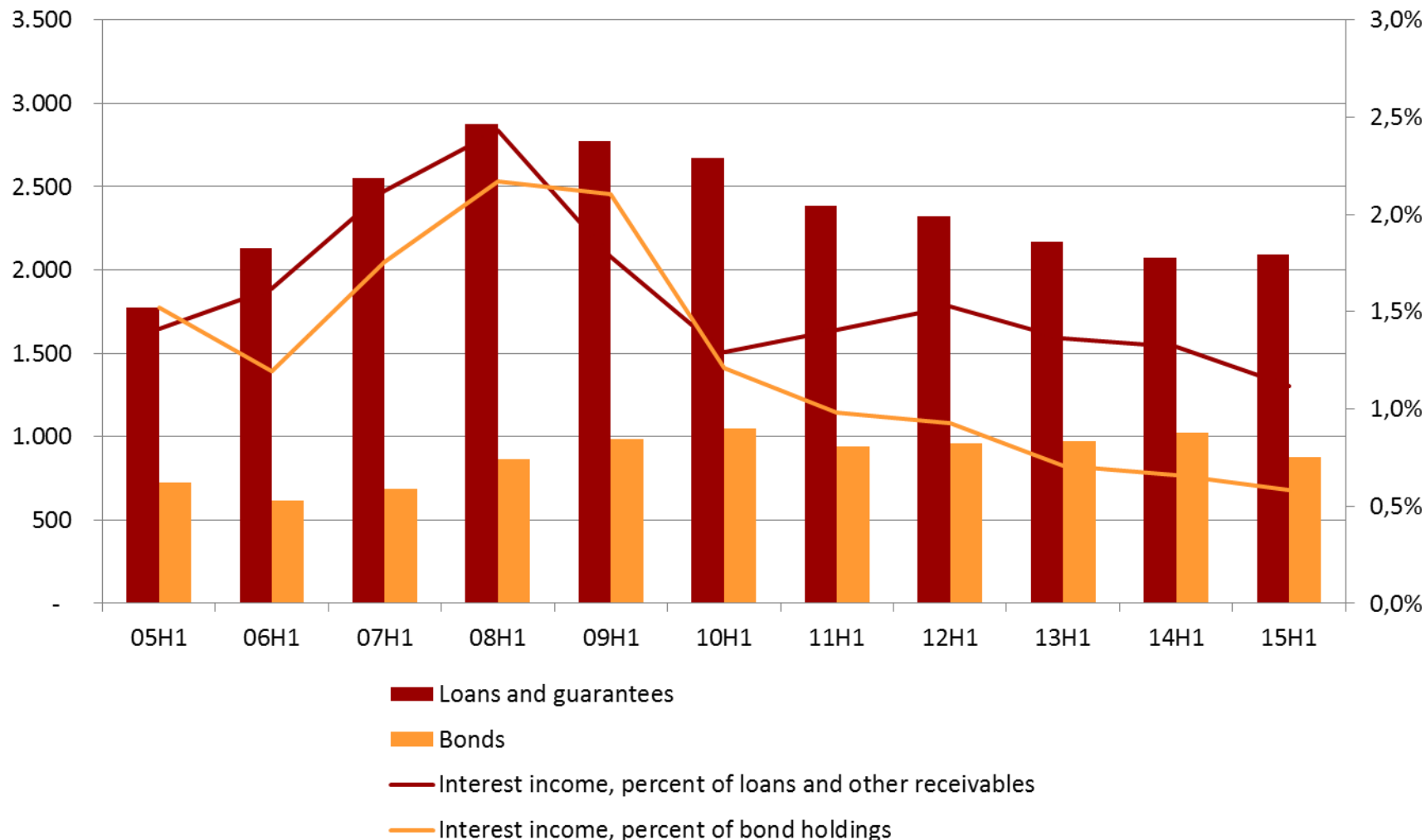


Bank loans continues to decline...



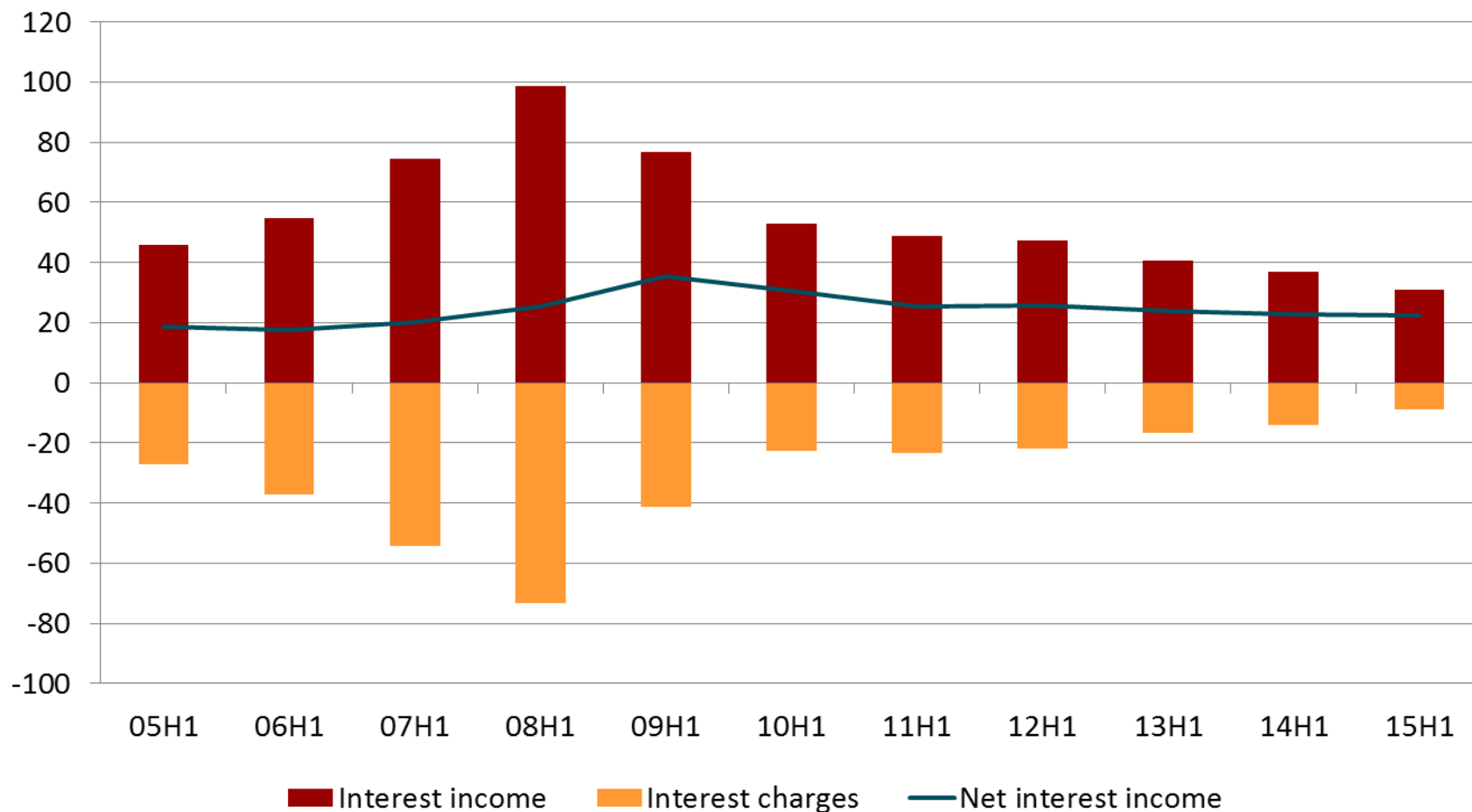
...while mortgage loans and bank guarantees grows

Low interest rates puts pressure on banks earnings

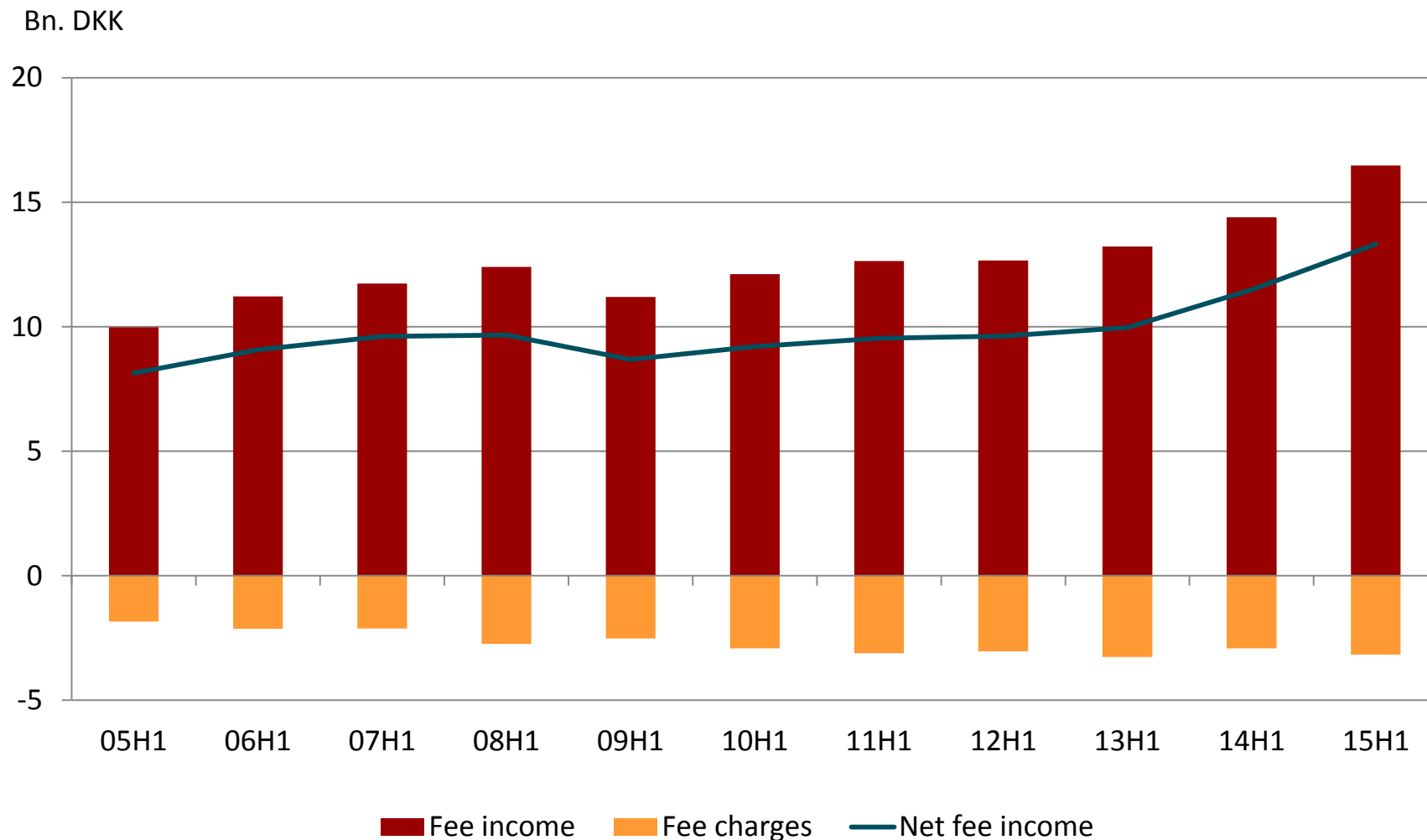


Slightly declining net interest income - banks

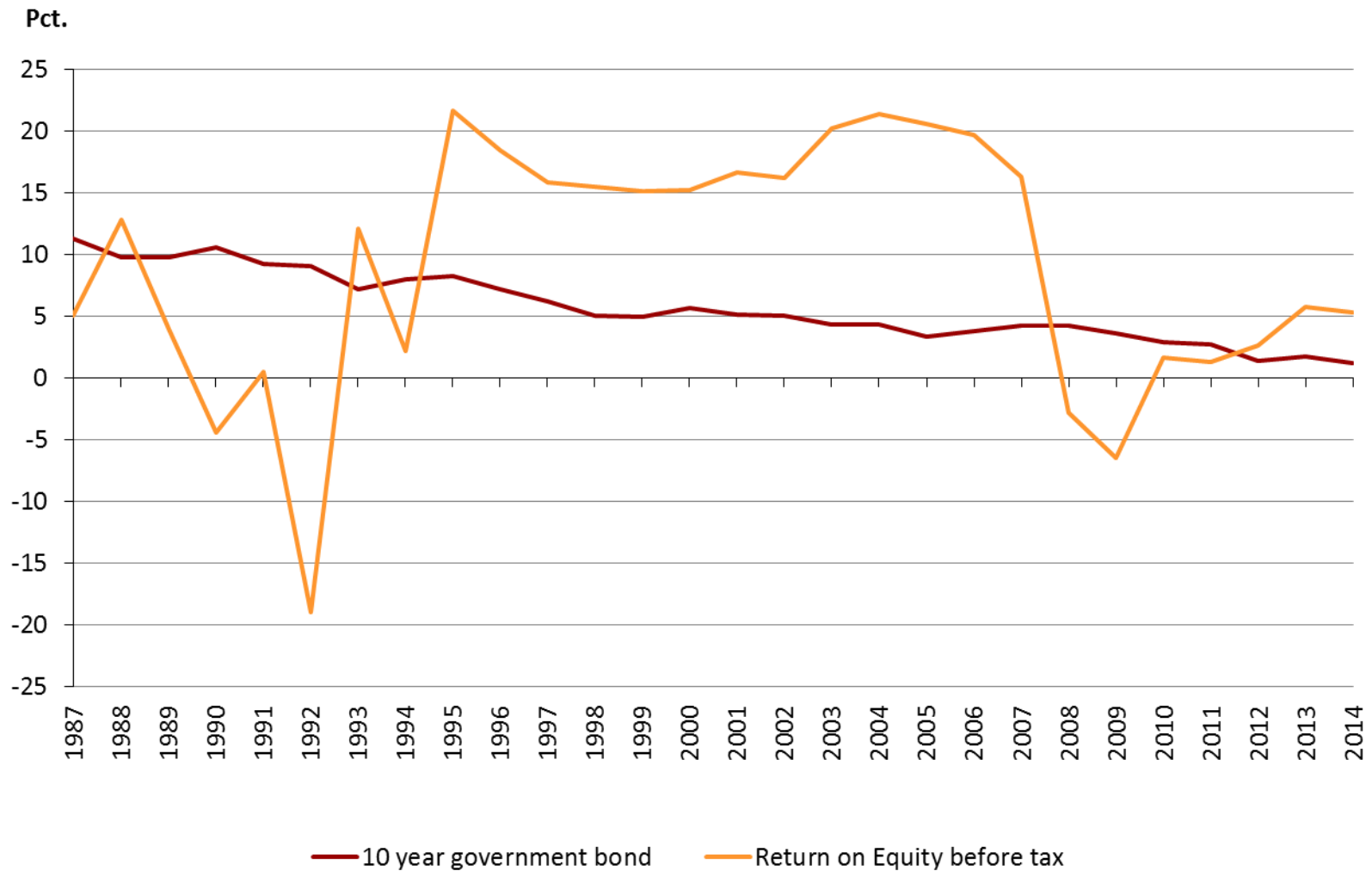
Bn. DKK



...but increasing net fee income - banks



Banks Return on Equity vs. Risk-free interest rate

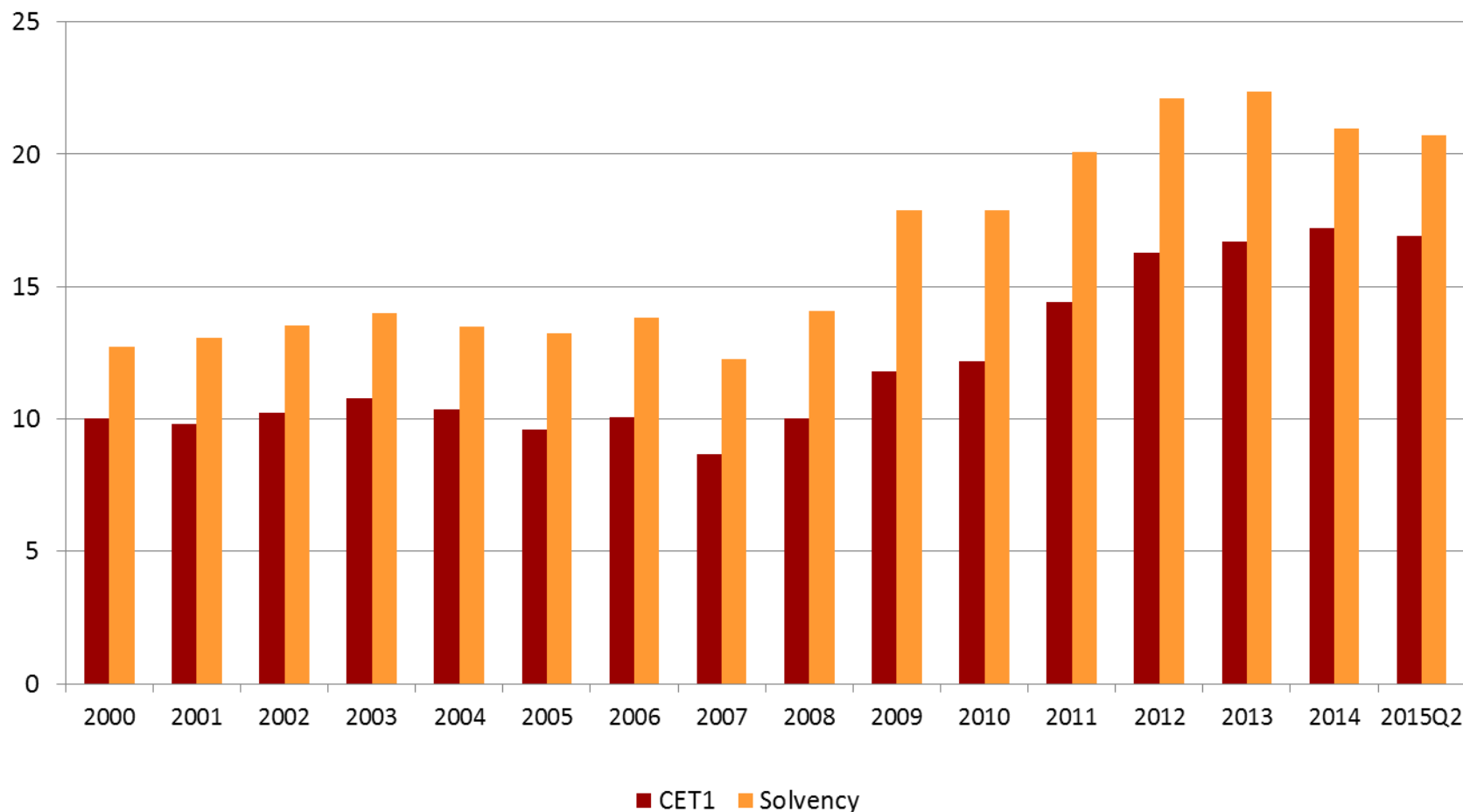


Realistic ROE and sustainable dividends

- Market pressure for higher dividends to increase ROE. But:
- Low interest rate reduces short term ROE for financials
 - and for banks funded by deposits it reduces profits and ROE even more
- Higher capital level reduces risks of shareholders
 - Reduces long term ROE
- In the long run with normal growth and ROE it is not sustainable with paying out 75 per cent of profits.
- Important to build up capital reserves during good times

Banks CET1 and solvency

Percent of REA



Banks CET1 capital positions have strengthened

Strong capital position

- Robust banking sector – large loss absorption capacity

Excess capital 1H - 2015:

<i>Fractiles</i>					<i>Average (weighted)</i>
<i>10%</i>	<i>25%</i>	<i>Median</i>	<i>75%</i>	<i>90%</i>	
2,8%	4,8%	6,8%	9,9%	19,5%	7,3%

Note: Solvency ratio subtracted by individual solvency need

- ...a few institutions still face a challenge, though

Challenged banks

- In general, the Danish banking sector is robust
- Still a small group of banks on intensified supervision due to potential solvency problems during the next 12-18 months

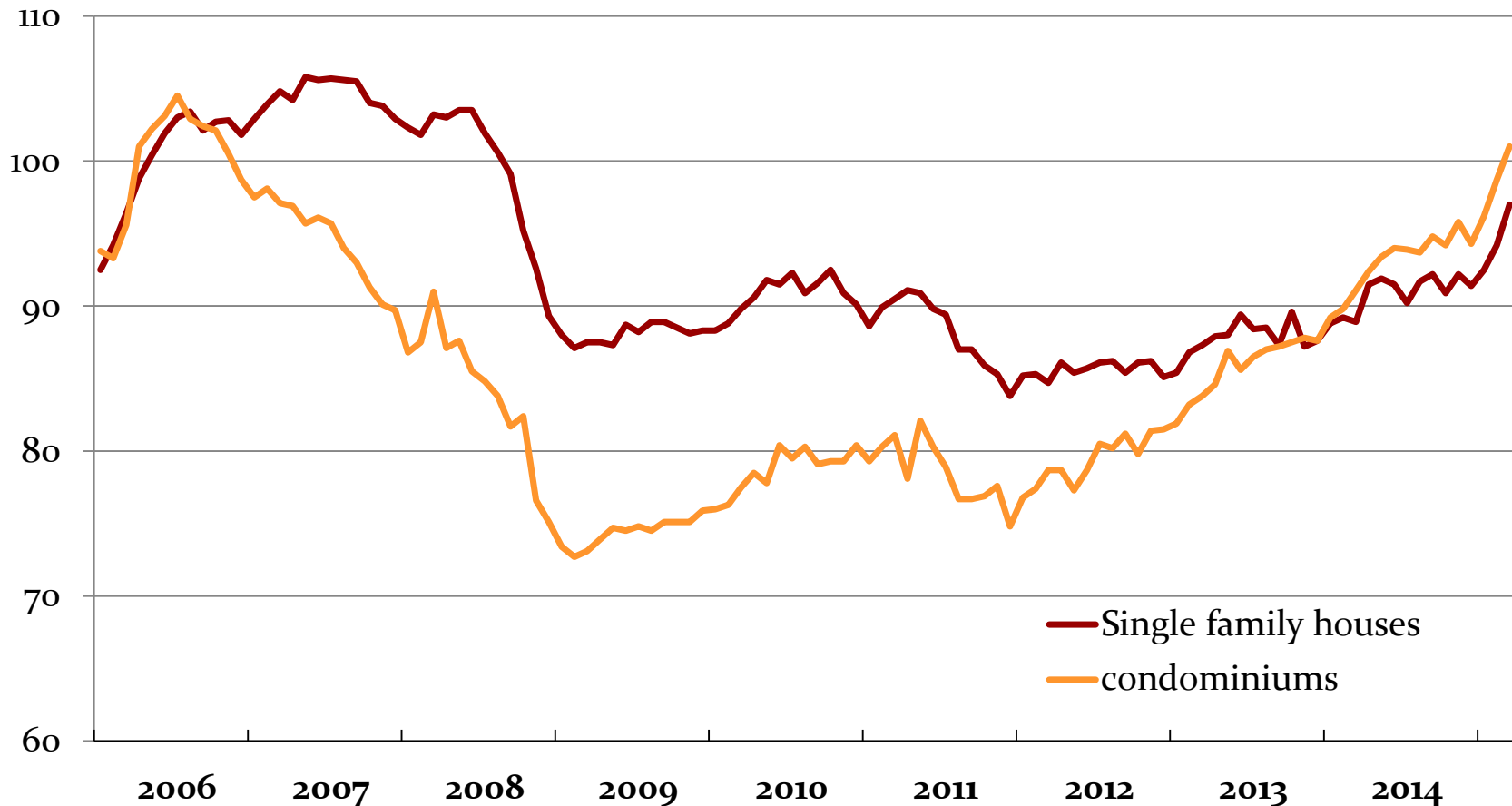
	Market share of challenged banks	
	30.06.2014	30.09.2015
Loans	3.6 per cent	3.2 per cent
Total assets	2.6 per cent	2.4 per cent

Supervision during good times

- Potential risks in banks counter acting on low interest rate and lack of growth:
 1. Key risks from core business: Compromise lending standards to achieve growth
 2. Key risks on other activities: eg stock investments
 3. New risks: Alternative investments such as high-yield bonds with risk that are severe to assess.
- Particular no. 1 has been observed in DK. Supervisory action:
 - Housing loans
 - Liquidity in commercial real estate
 - Supervisory Diamond



Property prices increasing rapidly



Average 2006: index=100

In the major cities this is reflected in lending

7 best-practices - Background

- After its meeting in marts, the Danish Systemic Risk Council warned against the risks stemming from a prolonged period of low interest rates, especially in combination with an economic upswing. Therefore, the council urged credit institutions to exercise suitable caution when granting loans on the basis of real property.
- Against this background, the Danish FSA asked major banks to explain how they in their granting processes took into account potential price corrections or decreasing sale activities in the housing market, especially in metropolitan areas as for example Copenhagen and Aarhus.
- Based on the outcome of this analysis, the Danish FSA decided to introduce a guideline on good credit management to ensure sufficiently caution when granting loans on the basis of real estate property in areas with significant price increases. The guideline is a supplement to existing practices. Currently, the guideline undergoes a public consultation.

7 best-practices – For areas with significant price increases

1. best-practice:

Institutions must assess the customer's affordability under the scenario of interest rate hikes, when granting adjustable rate loans for housing. The aim is mainly to ensure that borrowers with a limited disposable income do not run a higher risk if the interest payment should increase.

2. best-practice:

Institutions, when granting loans for buying shares in cooperative housing associations, must "stress" the relevant association's debt under the scenario of interest rate hikes. Institutions must then take the results from such stress into account, when calculating the borrower's disposable income.

3. best practice:

Borrowers with negative equity must amortize sufficiently.

4. best practice:

Borrowers with high debt-to-income ratios must have a robust and positive net wealth even in a scenario of falling house prices or high job security and fixed interest rate and amortization.

5. best practice:

When a borrower buys a new home before the old one is sold, the borrower must pay interest and principal payments on both homes until the institution expects the old home to be sold (though a minimum of 6 months). If a borrower has more than two residences, the borrower must pay interest and principal payment on all the homes during the period the borrower is likely to own them (though a minimum of 12 months).

7 best-practices – For all geographical areas

6. best practice:

A borrower's disposable income must always be assessed individually. It is not sufficient that the disposable income lies above a pre-defined minimum threshold.

7. best practice:

When financing the purchase of shares in cooperative housing associations, institutions must review the association's underlying financial status (annual reports and budget) to ensure that the borrower is buying in a healthy association.

Credit standards in property financing

- When lending to property rental there shall be positive liquidity in the property. Applies only to credit institutions. Special rules for real estate development will apply.
- Consistent with present standards in the banking sector, but will secure that standards are not being lowered in the future.

Supervisory diamond for mortgage-credit institutions

Large exposures: The sum of the 20 largest exposures < CET 1

Lending growth: Lending growth to each lending segment < 15 % pr. year

The lending segments are the following: private homeowners, property rental, agriculture and other corporate

Short term funding: The share of lending that is refinanced within a 6 month period < 15 % of total lending



Interest rate risk of the borrower: Lending where the LTV exceeds 75 % of the lending limit for MCIs and an interest rate fixed less than 2 years < 30 %

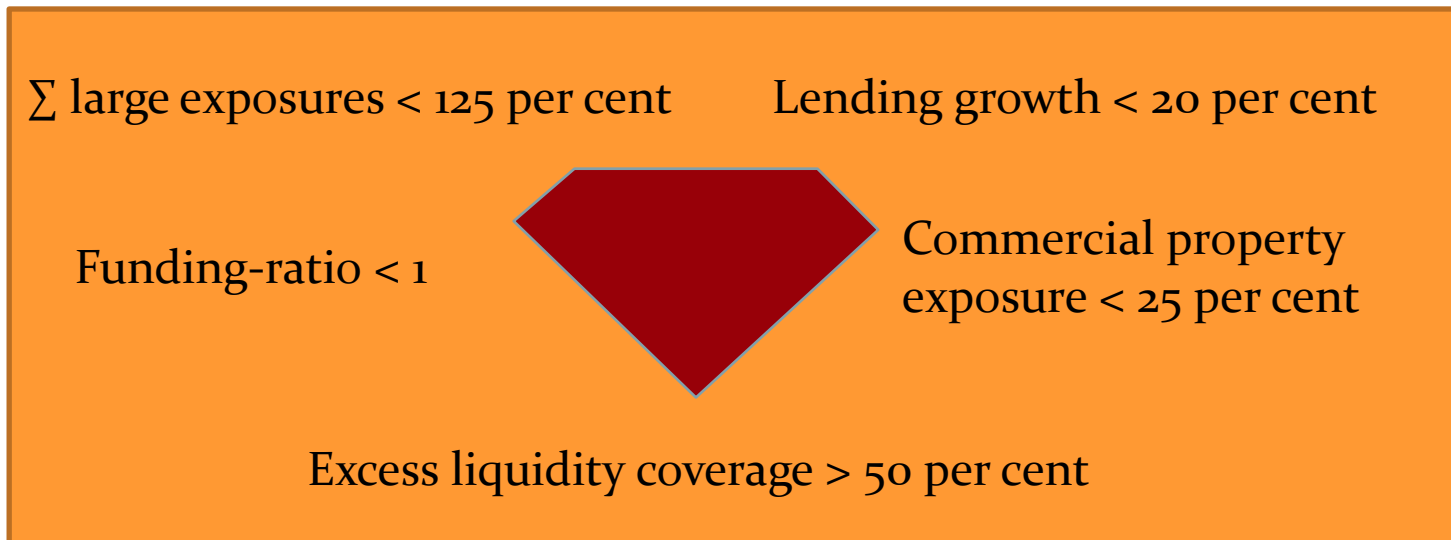
Applies only to lending to private homeowners and property rental

Interest only lending: The share of interest-only lending (no amortization) < 55 % of total lending in the LTV band above 75 % of the lending limit for MCIs
Applies only to private homeowners

Application: The initiatives concerning short term funding and interest only lending will apply from 2020. The remaining 3 initiatives will apply from 2018.

Supervisory Diamond, banks - upcoming changes

Supervisory Diamond today:



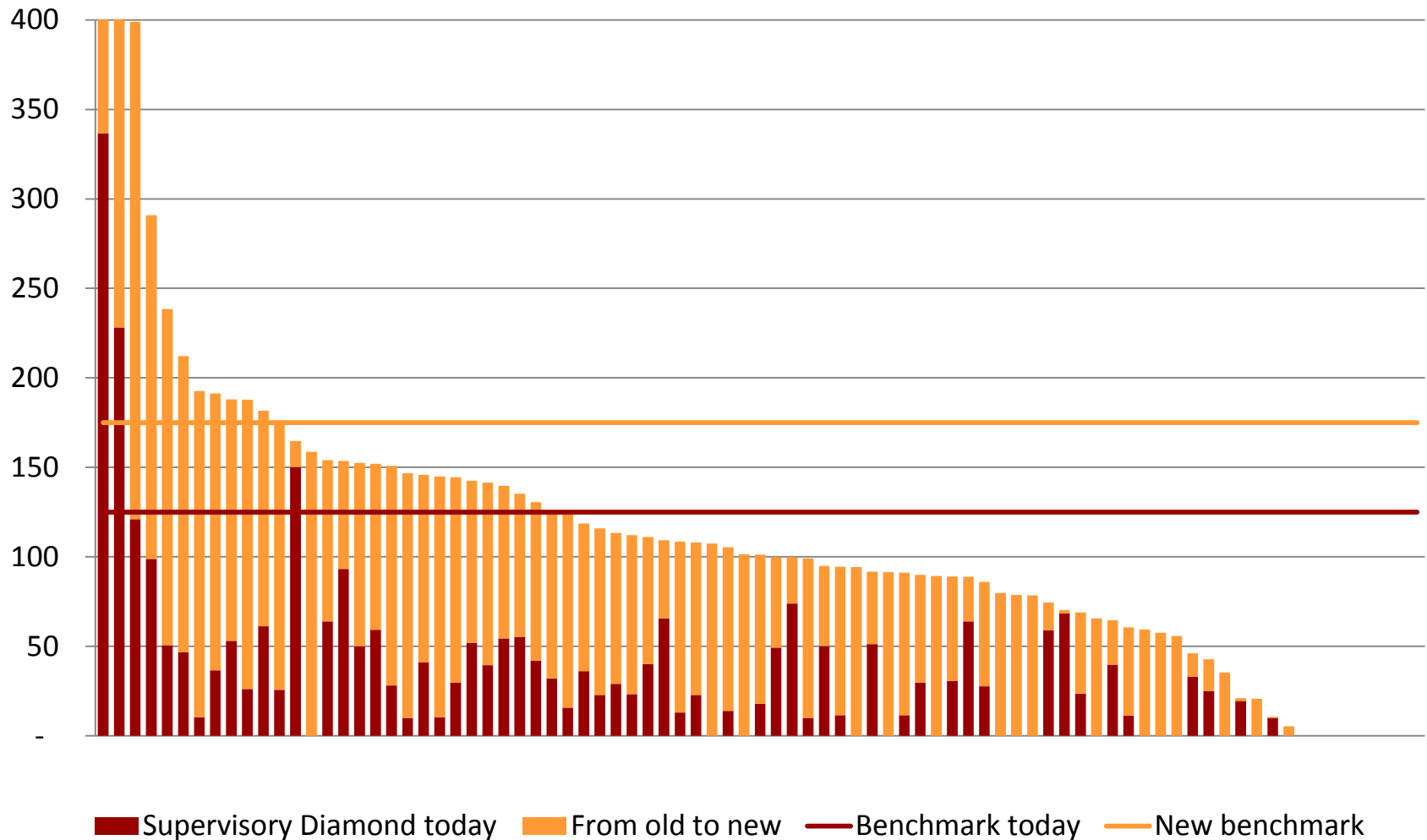
- New benchmark for large exposures change per. January 1, 2018
- New benchmark for excess liquidity coverage will be based on LCR when the section 152 requirement phases out
- New benchmark for funding await greater clarity on upcoming EU requirements

Supervisory Diamond, banks – new benchmark for large exposures

$$\text{Sum (SE}_{20})/\text{CET}_1 < \text{limit value}$$

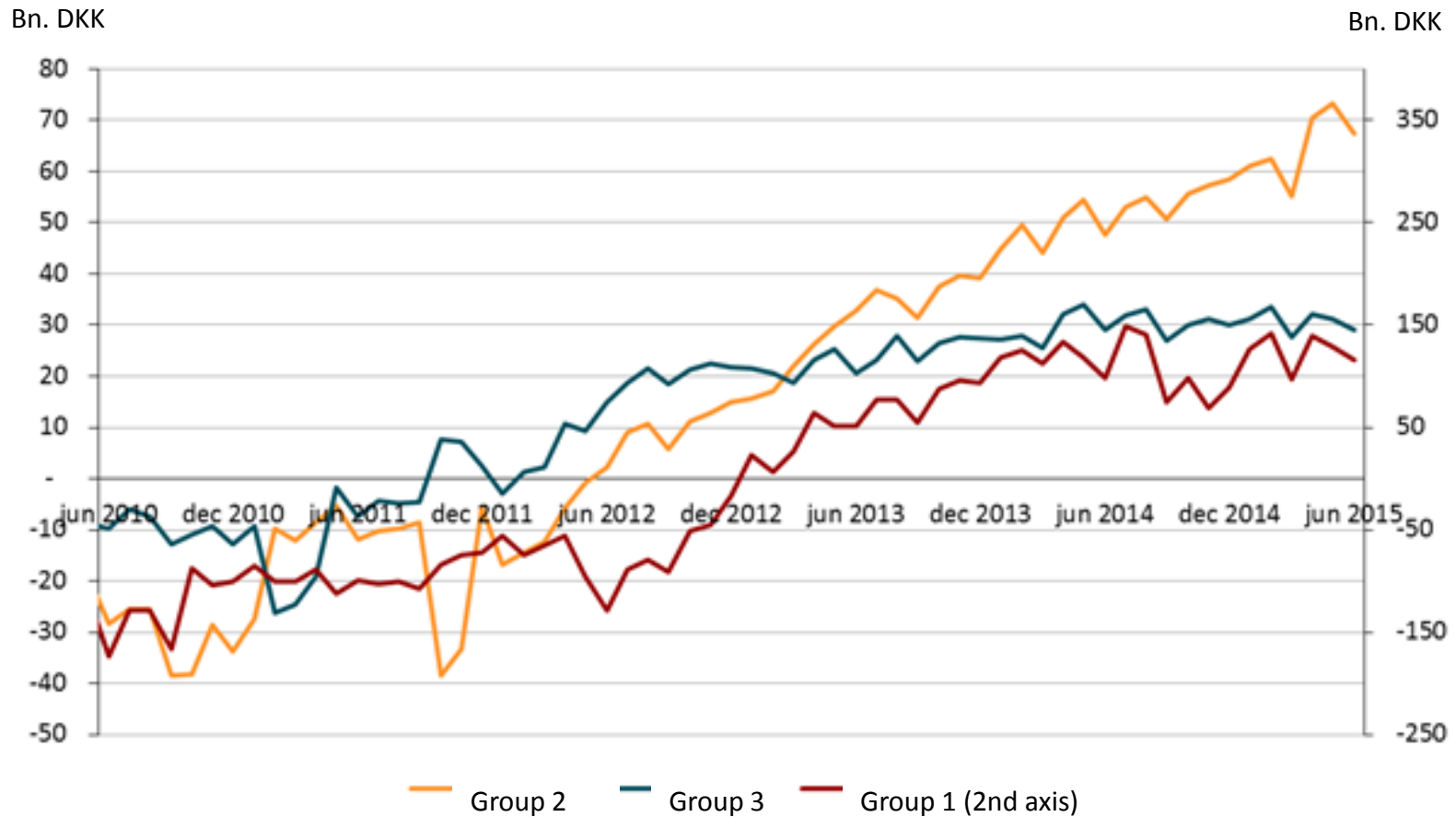
- 20 largest Exposures - regardless of the size relative to own funds
- Calculation in relation to CET1
- Are to be based on the CRR assessment of exposures
- - However, with the following adjustments:
 - Exposures to institutions under the supervision of the European supervisory authority are not included
 - Exposures to common-owned data centrals are not included
 - Continuation of 3 million DKK de minimis limit

12 banks exceeded the benchmark



Some of them also have other challenges

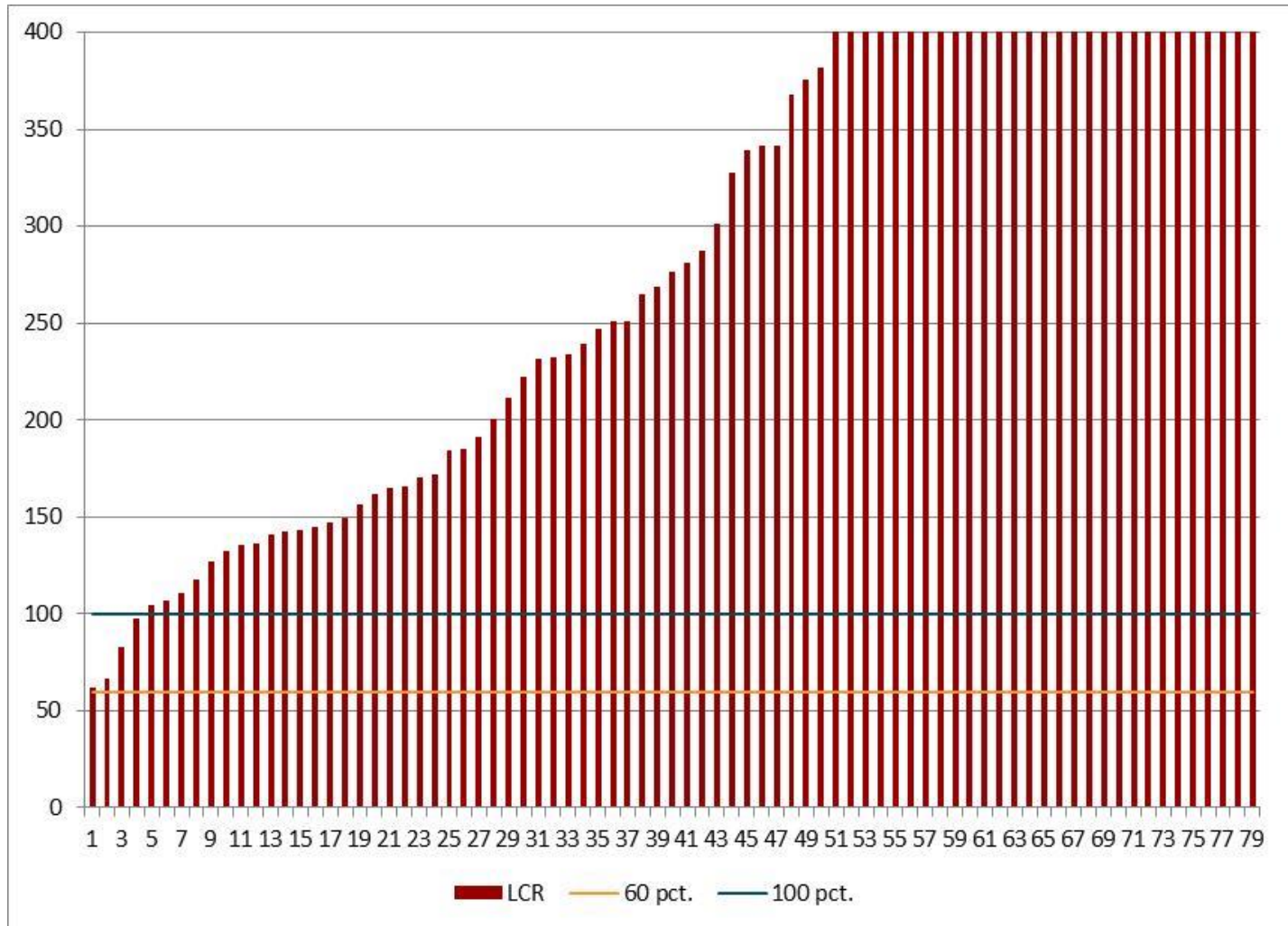
Deposit surplus



LCR is now applicable

- All institutions comply with the LCR requirement based on the assessment made at end September 2015.
- The requirement is phased in gradually for non-SIFI institutions by 60 per cent on the 1st October 2015, 70 per cent on the 1st January 2016, 80 per cent on the 1st January 2017 and 100 per cent on the 1st January 2018
- SIFI institutions are required to meet the LCR requirement by 100 per cent by 1st October 2015
- Next step: adjustment of risk management for LCR
 - Policies, business practices, internal reporting, etc..
 - Revised guidance on risk management in the liquidity area is now published. The description of the LCR has been elaborated in this guide.

LCR-level end of September 2015



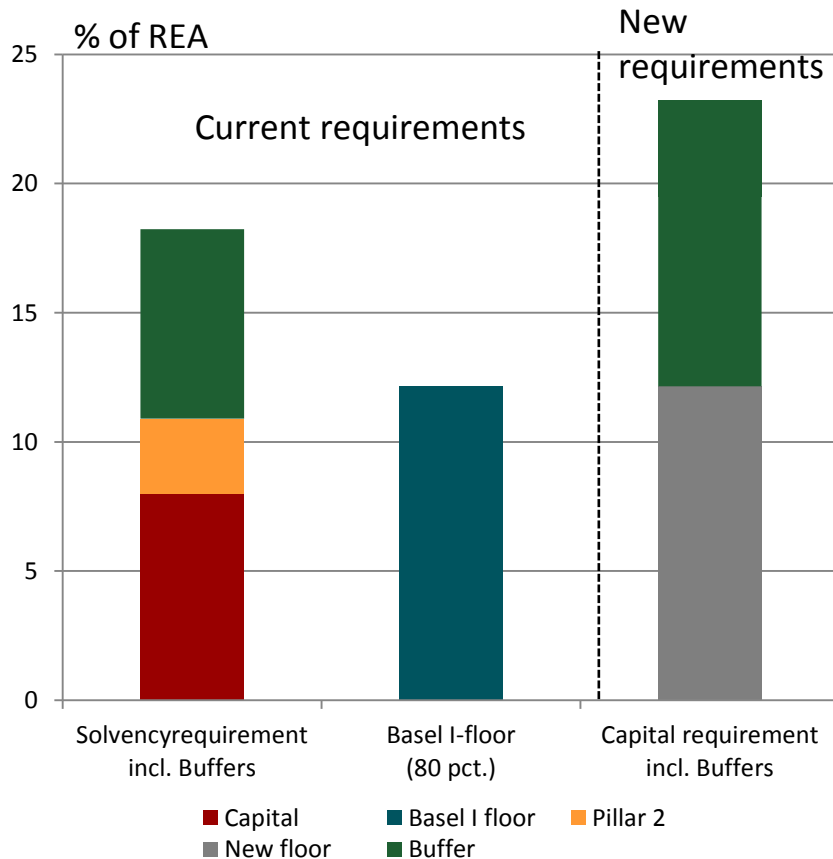
4 banks with LCR below 100 percent, 29 banks with LCR above 400 per cent

BCBS consultative documents – credit risk and IRB floor

- The standardized approach is revised – the risk weight is determined on the basis of risk factors for a range of exposure types
- The IRB floor will be based on the revised standardized approach
 - Separate floors for credit-, market- and operational risk as well as exposure classes are under consideration
 - The floor might be determined as a floor for the risk weighted exposures
- The consequences will depend on the final calibration of the standardized method for credit risk and the floor (today 80 per cent of the Basel I capital requirement)
- QIS-exercise in progress – revised proposal expected in 2016
- If the floor is implemented in the EU as a floor for the risk weighted exposures, this could mean that the combined buffer requirement has to be determined on the basis of the floor of the risk weighted exposures and put on top of the IRB-floor.

Possible effect of implementation of a new IRB floor

Example on the effect of a floor under the risk weighted exposures



- A change to a floor for the risk weighted exposures may have an impact for some of the Danish IRB-institutions, as
 - The buffer requirement is calculated on the basis of the floor
 - The buffers are added to the capital requirement calculated on the basis of the floor
- This is easily demonstrated by a simple example where
 - The buffer requirement, calculated on the basis of the current floor, is added to the current Basel I-floor
- For three out of the five large IRB-institutions, the capital requirement will increase
 - By an average of approx. 5 per cent of RWE

For simplicity pillar 2 is assumed fully covered by pillar 1 34

How about the Denominator – and IRB modelling

- High capital requirements → incentive to REA optimization
- REA differences to be addressed
 - Should be based on the actual differences in risk
- The Danish FSA:
 - Believe in IRB modelling
 - ... but will continue to take a skeptical view on changes of the IRB framework which can lead to significant reductions in REA

Recovery plans – regulation and purpose

- New regulatory framework in place
 - Executive order on recovery plans for banks, mortgage credit institutions and investment companies I
 - Guidance for the drafting of recovery plans has been issued
 - EBA-RTS specifies the requirements for the content
- Focus by the FSA:
 - Operational plans rather than compliance
 - Management tool and part of the undertaking's risk management
 - The recovery plan reflects the undertaking's risks and describes possible recovery initiative
 - Indicators has to be set so that the undertaking itself has the opportunity

Background – new areas of focus in resolution planning

New areas of focus:

- resolution plans and the continuation of critical functions
- MREL-requirement
- Difficulties with resolution



Principles for resolution

Principles for the preferred resolution strategy

- No banks should fail - the critical functions to be continued
- Depositors should have access to their banking transactions Monday morning
- Loss on resolution or restructuring will primarily be carried by the institutions themselves (i.e, owners and holders of impairment suited liabilities) – not by the state

Non-SIFI institutions:

- Control over institutions that are viable after restructuring should as soon as possible be transferred to the creditors, who have become owners
- Other institutions should to the extent possible be sold to other institutions

SIFI institutions:

- To be restructured and returned into the market

Determination of MREL requirement

- The MREL requirement should be determined based on the resolution strategy and from the upcoming level 2 regulation from the European Commission
- The MREL requirement is determined by the principles for resolution - there must be adequate capital in each institution and in the financial system to withstand losses
- The MREL requirement is determined by the situation of the institution i.e. business model - the MREL requirement by similar institutions will be set by uniform principles

Time changes – supervisory task is the same

- The role by the Danish FSA is to be a watchdog - we have to be critical
- By the presence of seven years of fat cows the Danish FSA will call for prudence
- In the coming 7 lean years there must also be something to draw on

Forthcoming supervision - strategic considerations

- The political/regulatory scenario is more diffuse than previously
- Uncertainty concerning the economic developments
- The business models are challenged by the technological development
- Globalization
- The velocity of changes requires an more agile supervision
- An adjusted strategy is expected to be presented in the first half of 2016