FINANSTILSYNET

MEMORANDUM

Finanstilsynet
(The Danish Financial Supervisory Authority)

26 October 2014

Report on inspection at Jyske Bank A/S (Asset Quality Review and Stress testing)

1. Introduction

At the request of the European Banking Authority (EBA), the Danish Financial Supervisory Authority (FSA) has over the first nine months of 2014 carried out an Asset Quality Review – AQR at Jyske Bank and a stress test of the bank.

At this inspection, the FSA examined, for a number of loan exposures to corporate and personal clients, impairment charges and contributions to the bank's solvency requirements as at end-2013. The FSA focused on the question whether the bank, according to the rules, had established objective evidence of impairment (OEI), and also the FSA focused on the granting of easy loan terms for weak clients and the categorisation of defaulted exposures. In connection with the review, the FSA considered the valuation of properties against which these loans were secured.

Moreover, the inspection covered a separate review of the bank's collective impairment charges.

Considering the materiality, the review did not comprise credit valuation adjustments (CVA) and valuation of derivatives.

2. Summary and risk assessment

On the whole, the FSA assessed that the bank's Common Equity Tier 1 capital for the EU-wide stress test should be revised downwards by a pre-tax amount equalling DKK 456m before the implementation of the stress test of the bank.

For the inspection the FSA had with a risk-based focus selected 712 exposures. In addition to the bank's 50 largest exposures, the types of exposures were selected for which the FSA assessed that the impairment charges at end-2013 were most at risk of being undervalued by a larger amount.

The 712 exposures selected consisted of 442 exposures to corporate clients and 270 exposures to personal clients. A large part of these exposures had been selected through random sampling so that the FSA could establish whether or not loan impairment charges had been recognised on the entire portfolio of loans from which the exposures were selected.

The loan portfolios from which the FSA assessed the weakest and largest exposures accounted for 89% of the bank's risk-weighted assets for loans and guarantees at end-2013.

The FSA concluded that the bank's impairment charges at end-2013 for the portfolios examined should have been DKK 447m higher by DKK 206m for agricultural exposures and DKK 92m for exposures to small and medium-sized enterprises and DKK 149m for exposures to personal clients. Also, the collective impairment charges for personal clients should have been higher by DKK 9m so that, at end-2013, the bank's impairment charges were DKK 456m too low.

The bank has informed the FSA that this additional indication of impairment was recognized as an expense in the first nine months of 2014.

One of the reasons for the too low impairment charges was the bank's calculation of impairment for individually assessed exposures for which the bank had established objective evidence of impairment (OEI). On the other hand, the bank's establishment of OEI for corporate clients was satisfactory. Another reason is the level of collective impairment as the bank writes down a percentage of the part of the exposure for which collateral has not been provided (unsecured part). The effect of the bank using a more prudent calculation of the unsecured part when determining the collective impairment did therefore not suffice to ensure sufficient impairment charges.

The bank was ordered to ensure that the bank's individual and collective impairment does not underestimate the indication of impairment. Also, the bank was ordered to ensure a sufficient description of the basis of the bank's calculation of impairment.

The FSA did not find grounds for concluding that at end-2013 the bank had underestimated the contribution of the selected exposures to the solvency requirement.

As part of the assessment of the asset quality, the EBA recommended that to the extent possible, new definitions be used for reporting the granting of easy terms (forbearance) and defaulted (non-performing) exposures, to be used for reporting as from 31 December 2014. At the inspection, the FSA established that the bank was not able to provide information according to these recommendations for the inspection. This entails some uncertainty in relation to the data published in connection with the AQR, for instance, for the comparison of the results of other banks. The bank has stated that reporting according to the definitions will as required take place at the end of 2014.

In connection with the assessment of loans for the financing of real property, the FSA had selected random samples of properties provided as collateral and the bank's value assessment was checked. A total of 241 properties within the categories commercial rental properties, agricultural properties and owner-occupied homes were examined.

The FSA found that in connection with 39 properties (16%) the bank had overestimated the values. The effect of this was considered in connection with the FSA's assessment of the indication of impairment and the solvency requirement. Hence the bank's assessment was more uncertain than those of the other groups. The bank was ordered to elaborate on the business procedures for the measurement of commercial property values so they clearly describe the measurement of the value of various property categories and ensure sufficient documentation of the measurement of property values.

According to EBA guidelines, the FSA subjected the bank group to a stress test projecting the capital base for the years 2014-16 under a baseline as well as a stress scenario. The stress test was coordinated by the EBA while the FSA was in charge of ensuring the quality of the results and to incorporate the results from the preceding AQR.

As of 1 January 2014, the bank's solvency ratio was 16.3% and the Common Equity Tier 1 capital 14.9% after adjustment following the result of the FSA's asset quality review, where tax effects were considered. Under the baseline scenario the Common Equity Tier 1 capital rose to 18.6% at end-2016, while in the last year of the stress scenario the bank would maintain a Common Equity Tier 1 capital ratio of 13.6%. Both under the baseline and the stress scenarios, a considerable excess solvency was found relative to the EBA's threshold values of 8% and 5.5%, respectively.

Assuming full implementation of CRR/CRD4, the bank maintained, under the baseline and stress scenarios, a Common Equity Tier 1 capital ratio of 18.4% and 13.3, respectively, at end-2016.

The EBA stress test results were calculated before the consolidation of BRFkredit. Supplementary calculations have shown that the results relating to the Common Equity Tier 1 capital ratio did not change materially following the inclusion of BRFkredit.