M E M O R A N D U M

The Danish FSA

26 October 2014

Statement on inspection at Sydbank (Asset quality review and stress test)

1. Introduction

In Q1-Q3 2014 the Danish FSA conducted a review of Sydbank's asset quality (AQR) as well as a stress test of the bank on the recommendation of the European Banking Authority (EBA).

During this inspection the Danish FSA reviewed impairment charges and add-ons to the bank's solvency need at year-end 2013 as regards a number of credit exposures to corporate and retail clients. The Danish FSA focused on whether the bank identified objective evidence of impairment (OEI) in compliance with the rules and focused on the granting of easy loan terms to weak exposures and the categorisation of exposures in default. In connection with its assessments the Danish FSA considered the valuation of property mortgaged as security for these credit exposures.

Moreover the inspection included a separate assessment of the bank's collective impairment charges.

In view of materiality considerations the assessment did not include credit value adjustments (CVA) or the valuation of derivatives.

2. Summary and risk assessment

Overall the Danish FSA assessed that the bank's CET1 capital, which is covered by the pan-European stress test, should be reduced by an amount corresponding to DKK 75m before tax before the stress test of the bank was conducted.

For its inspection with a risk-based focus the Danish FSA had selected 480 exposures. In addition to the bank's 50 largest exposures, the Danish FSA selected the types of exposures where it believed there was the greatest risk that the impairment charges at year-end 2013 might be under-valued by a substantial amount.

The selection of exposures must be regarded in connection with the inspection conducted by the Danish FSA in November-December 2013 of 142 of the bank's corporate exposures exceeding DKK 10m as well as the exposures to the bank's board of directors and group executive management, etc, cf the separate statement concerning this inspection by the Danish FSA.

The selected 480 exposures for the inspection in 2014 consisted of 280 corporate exposures and 200 retail client exposures. A large number of these exposures were randomly selected test samples allowing the Danish FSA to determine whether the impairment charges recorded were adequate as regards the entire portfolio of loans from which the exposures had been drawn.

The loan portfolios from which the Danish FSA assessed the weakest and largest exposures represented 86% of the bank's risk-weighted assets as regards loans and advances and guarantees at year-end 2013.

The Danish FSA concluded that the bank's impairment charges at year-end 2013 as regards the portfolios reviewed should have been DKK 51m higher: DKK 17m on property exposures and DKK 34m on exposures to small and medium-sized enterprises. In addition collective impairment charges should have been DKK 24m higher, ie the total shortfall in the bank's impairment charges at year-end 2013 represented DKK 75m.

According to the bank these additional impairment charges were charged to the income statement in Q1-Q3 2014.

The Danish FSA did not find that there was a need to increase impairment charges as regards retail clients. However this reflected the fact that in terms of many retail clients the bank had failed to identify objective evidence of impairment (OEI) and calculate impairment charges whereas as regards other retail clients the impairment charges recorded were more than adequate. Consequently the bank was ordered to ensure that the bank identifies OEI in compliance with the rules.

The Danish FSA did not find grounds to conclude that the bank at year-end 2013 had underestimated the add-ons to the solvency need of the selected exposures.

As part of the asset quality review, the EBA has recommended that the new definitions are used to the greatest extent possible for reporting purposes as regards forbearance and non-performing exposures that are to be used in connection with reporting as from 31 December 2014. During its inspection the Danish FSA ascertained that the bank was unable to provide information in accordance with this for the inspection. As a result there is some uncertainty as regards the data released in connection with the AQR, including in connection with the comparison of results with other banks. The bank has stated that reporting in compliance with the definitions as required will take place at year-end 2014.

In connection with the assessment of loans to finance real property, the Danish FSA had randomly selected properties provided as security to examine the bank's valuation. The review included a total of 135 properties in the categories: commercial rental properties, agriculture and owner-occupied properties.

The Danish FSA assessed that 18 properties (13%) had been overvalued by the bank. The effect thereof is included in the Danish FSA's assessment of impairment charges and the solvency need.

The Danish FSA has conducted, according to the guidelines of the EBA, a stress test of the banking group in which the capital base was projected for the years 2014 to 2016 under a baseline scenario and an adverse scenario, respectively. The stress test was coordinated by the EBA and the Danish FSA was responsible for the quality assurance of the results as well as for incorporating the results of the previous AQR.

At 1 January 2014 the bank's total capital ratio stood at 16.2% and the CET1 ratio accounted for 13.7% after the adjustment due to the result of the Danish FSA's asset quality review which takes tax effects into account. Under the baseline scenario the CET1 ratio rose to 15.5% at year-end 2016 whereas the bank's CET1 ratio stood at 12.9% in the last year of the adverse scenario. Under the baseline scenario as well as the adverse scenario there was significant excess cover relative to the EBA's threshold values of 8% and 5.5%, respectively.

Assuming full implementation of CRR/CRD IV the bank maintained a CET1 ratio of 15.5% and 12.9%, respectively, under the baseline scenario and the adverse scenario at year-end 2016.