

Danske Markets Nordic Bank and Insurance Seminar

“Growth opportunities and challenges under a new regulatory regime”

Peter Straarup

CEO and Chairman of the Executive Board, Danske Bank

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SPEECH

Peter Straarup - Danske Bank - CEO

Growth opportunities and challenges under a new regulatory regime

Thank you for the invitation to this year's conference. And thanks to everybody here for taking the time to attend this presentation.

The theme of the seminar is the new regulation and how the proposed Basel III framework will affect the banking sector. I will take this opportunity to give you an update on Danske Bank, explain how we see the new regulations, and tell you what we have already done and what we are planning to do in the next few years. I will explain our "Four Cs" strategy and how it will change the way we run the Bank.

Executive summary

One year ago, we were all very concerned about the future. What kind of losses would we suffer? How deep would the crisis be? We don't know the final answers yet, but we do know that we are gradually recovering. Still, we do not expect it will be a quick, easy recovery. Recent turmoil in the markets is a clear indication of this.

Our expectation is that the EU and Europe in general will enter a period of low growth, possibly quite an extended period. The necessity of reducing the public deficit in many countries is a major reason for this. The demographic shift to an increasing proportion of elderly people is another. And new bank regulation will put a downward pressure on growth.

The introduction of Basel III will also put pressure on the returns in the banking sector, and if we as a sector are not willing to counteract this pressure by increasing prices, reducing expenses, or both, then the return on assets as well as on equity could decline significantly.

Let there be no doubt that Danske Bank has dedicated many resources to manoeuvring through the crisis, and that we also have been preparing the Group for the time afterwards. Our goal is to be in the strongest possible position when the crisis is over.

In the short term, our earning power will improve as the Danish Bank Package I expires. Additionally, the implementation of our Four Cs strategy will deliver value for our shareholders in the next two years.

Road to recovery – a one way street?

It is obvious that the recent turmoil in Europe has put a critical spotlight on very expansionary fiscal policies. The problems in Greece are a sobering reminder to all European countries of what happens if the market loses faith in your

ability to repay your debt. For this reason and in order to salvage the euro, many European countries will obviously have to tighten their budgets. This process has already begun. And there is no doubt that it will have a substantial effect on revised growth expectations in the coming quarter.

Fiscal stimulus will also be somewhat more restrained in the Nordic markets. Last week Denmark introduced a package that will reduce its deficit by some 24 billion kroner when fully implemented. It will probably slice up to half a percentage point off GDP growth in 2011.

Relatively speaking, however, the Nordic countries are not in a difficult situation. They are certainly much better off than what you see further south in Europe. This should give the Nordic countries the opportunity to do a bit better than average in the coming years. Still, they are open economies and would of course be very much influenced by a possible downturn in Europe as well as in the rest of the world.

When you look at our footprint, please remember that although Danske Bank has expanded outside the Nordic countries, we are still predominantly a Nordic bank. The Nordic region represents almost 90 per cent of our lending book.

In summary, even though the Nordic countries will be somewhat better off than most of Europe, we think we are entering a period of very low growth. And this obviously gives all banks quite a number of challenges.

A New Normal is emerging

Low growth will of course limit our activities and, yes, our earnings.

And then new regulation will reduce banks' gearing. This will lead to a reduction of total assets in the banking sector relative to GDP

New regulation will also require higher capitalisation, with a higher proportion of equity-based tier 1 capital.

And finally, the coming Basel III rules will result in higher liquidity buffers.

Taken together, these factors will constitute a New Normal for the banking sector.

Regulation will slash away at industry ROE and mute economic revival

Each part of the new regulations will reduce the banking sector's returns. When you look at the individual measures, most of them seem reasonable, but when they are combined, the total effect is problematic. Some might say that the combined taste could be a bit sour.

A study of the effect on a sample of large global banks shows that the return on equity in 2011 would be reduced from more than 13 per cent in the current regulatory regime to less than 6 per cent if the current proposals are fully implemented. This includes a need for more than 200 billion dollars in new capital and assumes a sharp increase in funding costs.

Such an outcome would result in value destruction in the sector. The way to limit the value destruction is through higher prices. So the burden will be shared between shareholders and customers.

But higher borrowing costs is not what the world economy needs right now and there is no way out of that.

Liquidity rules (NSFR) seem unrealistic...

And capital requirements are not the only measures that would cause problems.

The new set of rules on liquidity appears to be extremely challenging. One new rule is the Net Stable Funding Ratio. According to Morgan Stanley, the proposal from the Basel Committee in its current form would result in a need for 1.5 trillion euros in new long-term funding if the European banking sector were to reach a Net Stable Funding Ratio of 100 per cent. That is a huge amount that would certainly put pressure on funding costs. And one may well ask who would buy all these bonds?

Still, Nordic banks appear to be relatively well positioned, and Danske Bank is one of the stronger players. But all the Nordic banks need to increase their long-term funding.

If Morgan Stanley's calculation is right, or even close, there are grounds for expecting some changes in the proposed ratio, especially because this will be an extra funding need on top of the banks' ongoing re-funding.

Danske Bank has very low funding need in 2010-11

When we look at funding needs from a short-term perspective, Danske Bank is in a very favourable position. In 2009, we were very active, issuing medium- and long-term funding of around 180 billion kroner, twice the normal volume. We also reduced our funding need by improving our loan-to-deposit ratio.

This means that our funding need for the remainder of 2010 and for 2011 is as low as 5.5 billion euros, or 40 billion kroner. This is less than 2 per cent of our funded balance sheet.

This amount we can finance solely by the issuance of covered bonds, as we have a pool of unutilised mortgage loans of at least 50 billion. This does not mean, however, that we will use

only this funding source. Our issues depend on the attractiveness of the various markets, and the issued funding this year comes from a range of sources, such as both US and euro medium-term notes as well as covered bonds.

As the slide shows, in comparison with other Nordic banks, our funding need is very low, and given the recent market conditions, we are glad to be in a very comfortable position regarding our long-term funding.

Nordic Banks have strong capital ratios and Danske Bank are among the bests

Many banks have strengthened their capital ratios in recent years, this also include Danske Bank. We have done this through retained earnings, reduced risk-weighted assets and raised capital in form of a convertible hybrid capital loan from the Danish state.

With a total solvency ratio of almost 18 per cent and a tier one ratio of 14.2 per cent, we are in the top among our Nordic peers, and Nordic Banks in general are among the best placed in Europe.

The new proposal from the Basel committee suggest some tightening of the criteria for core capital and the final rules will also include an increase in the minimum tier 1 ratio. It will also include a higher proportion of equity based capital and the main part of the total tier 1 capital should be loss-absorbing in a going concern.

I think that Danske Bank will stand in a relative good position on this, because of a total tier 1 ratio of 14.2 per cent and because 12.4 per cent is currently loss absorbing.

The Four Cs: Strategic focus areas

Now I will turn to our strategy. We have defined four focus areas for the coming year, called "the Four Cs": Customers, Credit, Costs and Capital.

I have just covered the focus area on capital. That and liquidity issues are obviously of prime importance. At Danske Bank we are doing our part in the process of formulating the new set of rules. We participate by contributing both input to the QIS studies and comments on them. It is important that the outcome fulfils as many of the objectives as possible while at the same time maintaining the business model of banking.

We also see a need to look at ourselves internally and prepare the Bank for the New Normal. We began this process more than a year ago, with the aim of improving our services and products at the same time as we operate at a considerably lower cost.

Customer focus: Differentiated organic strategy

Our platform strategy, which enables us to deliver products and services at a lower cost, are very focused on the creation of the optimal strategy for our various business units.

We can broadly divide our brand activities into three groups: major players, focused attackers and specialist players.

These distinctions are important because we must shape the units so that they fit the needs of our customers in the various markets. This goes for products and services as well as for accessibility and distribution channels. This way we will also be able to maximize the benefit to the bank of the individual franchise.

Customer service strategy takes advantage...

The channel strategy is a cornerstone of our Four Cs strategy, and the goal is simple: We want to use our resources where our customers are, and we want to allocate the most resources to our best customers. So the C for customers is a cornerstone in our ambition.

Our customers use online banking services more and more and our brick-and-mortar branches less and less. That is in line with the general trend in society and the intention of our pricing structure, which makes online banking more attractive. This process has been underway for a number of years, and our Four Cs strategy will be a strong driver that shifts an increasing number of customer segments towards online banking and telephone services at our contact centres.

We have recently extended our contact centre channel to cover small business customers. At the new business contact centres, called Business Direct, small companies are served by expert corporate advisers.

Obviously, it is important that we do not forget certain groups of customers when we streamline our processes. That is why we are also busy improving the expertise of our staff so that when customers move to the contact centres, they get at least the same quality of service as they did before.

Loan impairment: Downward trend will support earnings

Let us look at credits. We have all learned that credit management is key during a downturn, especially when the downturn is as serious as this one. It is also extraordinarily important that credit policies and risk appetite are aligned with the environment we can expect in the future. So at the same time as we are managing a substantial number of troubled credits, we are establishing the framework for tomorrow's cautious - but intelligent - credit underwriting, the third C in our strategy.

We have seen high impairment charges at Danske Bank. But it is worth noting that in most regions, our losses are in line

with those of other banks operating in the region. That is the case in Ireland and the Baltic countries. And also in Denmark, where corporate customers in many sectors are undergoing difficulties.

We base our impairment charges on the assumption that the recovery and economic growth will be only modest in the next couple of years. We can hope that we are mistaken in our caution, but thus far there is nothing to indicate that.

In the first quarter of 2010, loan impairment charges declined to 4.3 billion kroner, a reduction of 14 per cent from the preceding quarter. We have thus reduced impairments for the fifth consecutive quarter.

The positive elements included a sharp reduction in the Baltics, no further impairments at Danske Markets, and low charges in Northern Ireland and the Nordic countries, except for Denmark. Less positive elements are the continuation of high impairments in Ireland and an increase in Denmark.

The charges included 636 million in collective impairments, mainly against the agriculture and hotel segments and retail customers.

Will the trend continue downwards quarter by quarter? Again, we can only hope so, but I cannot give you any guarantees.

Cost management: Leaving no stone unturned

The fourth C stands for Costs. We have been focusing on costs for more than a year now, and we proceed along two tracks: One is a thorough review of our total cost base; the other is a strong focus on how best to use our resources to serve our customers, as I described earlier.

The first track is very straightforward. We are cutting away everything unnecessary and changing processes, purchasing habits and the like to make our operations more efficient.

In order to support the customer channel strategy and increase the efficiency of the organisation, we will invest 1 billion in IT development over a three-year period from 2009 to 2011. Despite these investments, the first results of our intensified cost management are already coming through, and we will see more in the remainder of the year and in 2011.

Tangible results of intensified cost focus...

Let me give you some numbers to illustrate what I mean. Since the summer of 2008, we have cut our staff by 8 per cent and the number of branches by 14 per cent. This process will continue this year and next.

Bank Package I expires at end-Q3 2010 ...

We are also getting closer to the termination of the Danish Bank Package I at the end of September this year.

After that date, we will no longer have to pay approximately 1 billion in quarterly expenses for the fee for the State guarantee and for our part of the bill that Danish banks must pay for other banks that go under.

That will make a big contribution towards our goal of restoring the Bank's profitability.

The Four Cs strategy is the key to creating long-term value

Our Four Cs strategy will lead to a stronger Danske Bank with a greater capacity to create long-term value for our shareholders:

- The strategy will give our customers better service and better product offerings
- We can provide these improvements at a lower cost
- We will maintain our strong support for current and new customers and will expand our business with targeted customer groups
- Although new regulation will lower returns, the expiry of Bank Package I will reduce our expenses and impairments
- And the gradually improving macroeconomic environment will support new growth opportunities

Executive summary

Let me conclude by reminding you of the challenges we as a bank are facing at the moment:

We expect a slow recovery with low growth for an extended period, and we will probably experience periods with headwinds such as the recent turmoil in southern Europe.

There is no doubt that the new regulatory environment will put renewed pressure on the sector, even though the current proposals will probably be revised and eased somewhat.

Danske Bank's near-term goal is to restore profitability. The Four Cs strategy is a key initiative in this effort.

Q&A session

I hope I have shown you that Danske Bank is shedding the burden of the crisis and emerging as a stronger bank than we were a year ago. We are now focusing increasingly on the time after the crisis rather than on crisis management - as important as that effort has been.

Thank you for your attention.

I will be happy to answer any questions you may have.