FIG in Focus

Welcome to the second edition of our regular briefing on news and views in the FIG (financial institution group) world.

These are the stories and insights that have captured our attention in recent months.

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IN THIS ISSUE

Risk – Danske Bank Estonian scandal shows the maximum impact of operational risk failures

In February 2019, Danske branch was ordered to close its Estonian operations by the end of the year as a result of the money-laundering crisis which has gripped the Danish bank.

The branch in question was acquired as a result of Danske's merger with Finnish Sampobank in 2007. After the merger it continued to use a separate IT system from Danske's main platform and many of its transactional documents were written only in Estonian and Russian. Due to cost considerations, Danske deferred operational changes which would have mitigated the differences in systems and language which made central oversight of the branch difficult.

The scandal ultimately revolves around Danske's alleged role in the so-called "Laundromat" operations channeling funds from Russia and Azerbaijan from 2005-13. The transactions originated in Danske Estonia's so-called "non-resident" portfolio and is believed to be concentrated in a relatively small number of clients, who were thought to be front operations for Russian criminal organizations and politically exposed persons. Many of the suspect transactions were so-called "mirror trades" where securities are bought in Russian roubles and sold in US Dollars. The annual volume of activity originating from this portfolio exceeded the GDP of Estonia for several years and is thought to exceed €200 billion in total. In 2013 the portfolio accounted for 99% of the Estonian branch's profits and 11% of Danske's overall profits. Thomas Borgen, who was at that time head of international banking and later went on to become Danske's chief executive was keen on expansion of this lucrative business.

Given the profitability of the Estonian operation, management refused to act despite some US dollar counterparties refusing to handle mirror trades because of the perceived risk. Another warning sign was that although the non-resident customers utilized foreign exchange, bond and securities trading, the portfolio was described as having "little or no credit risk". Management was apparently unconcerned that a huge volume of business apparently had no need of credit products or facilities.

Action was only taken when an internal whistle-blower who alerted Danske's internal audit team. The whistle-blower was a senior executive at Danske's UK alleges that he was subsequently internally discredited, and attempts were made to silence his complaints. Eventually in early 2014 management made the startling admission that:

> *"It was now realized at Group level that AML [anti money laundering] procedures at the Estonian branch involving the Non-Resident Portfolio had been manifestly insufficient and inadequate. It was also realized that all control functions (or lines of defence) had failed, both within the branch and at Group level."*

A later report into the scandal by Danish lawyers Bruun & Hjejle was more scathing, describing Danske's AML in the following terms: *"(i) insufficient knowledge of customers, their beneficial owners and controlling interests, and of sources of funds; (ii) screening of customers and payments had mainly been done manually and had been insufficient; and (iii) there had been lack of response to suspicious customers and transactions."*

At the time of writing the scandal has forced the resignation and criminal charges being filed against of Danske's chief executive and finance director. Ten employees in Estonia have also been arrested and charged with money laundering offences. Danske's market capitalization has halved, and it is expected to cost Danske several billion dollars in fines from regulators in Denmark, Estonia, USA and France.

Although the scale of the Danske disaster is unprecedented many of the underlying themes are unfortunately typical of many past operational risk scandals:

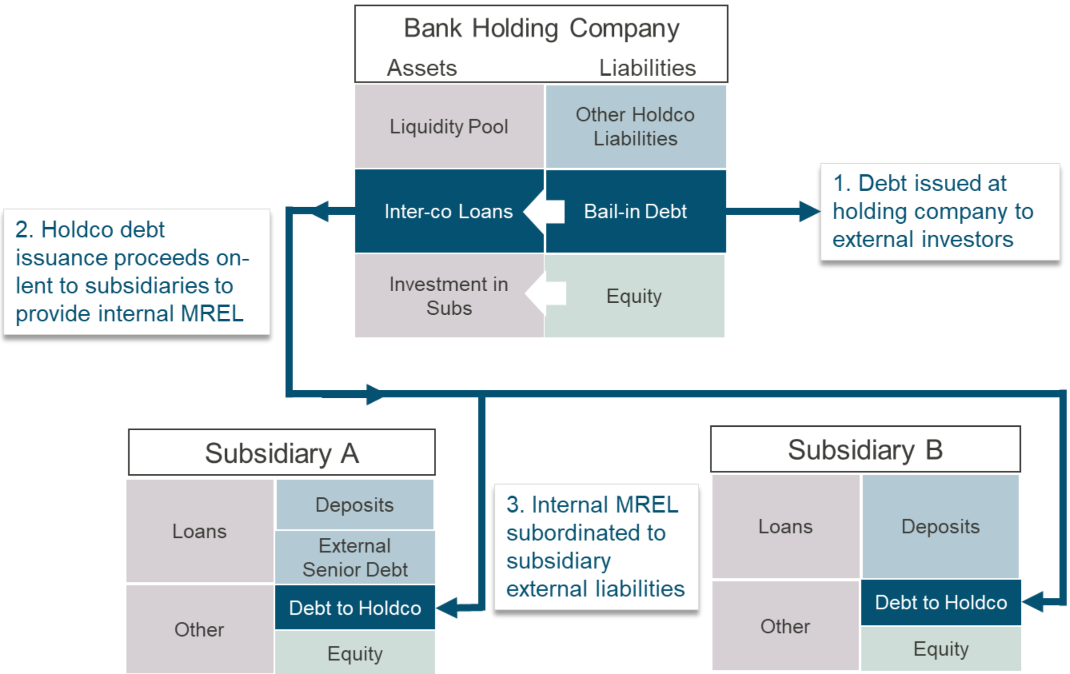
1. The theme of a geographically remote branch, suddenly contributing large amounts of profit from a previously untapped business source is reminiscent of many past scandals, most notably the 1995 collapse of Barings bank following trading losses in its Singapore office. In Danske's case the "remoteness" of the Estonian branch is compounded the fact that it was acquired by takeover and appears to have never properly integrated into the main business.
2. A source of profits which is apparently free of risks is almost certainly too good to be true. Given the competitive nature of international banking, is it realistic that peers will continue to ignore an apparently rich source of revenues for five years? In Danske's case the risks it was actually taking are obvious with hindsight, but the absence of credit risk on a large portfolio should have been a warning sign.
3. The way that Danske's management acted for much of the period is symptomatic of a corporate culture which consistently underestimated and failed to identify operational risks. At one point Danske had no appointed anti-money laundering officer (as required by Danish law), it failed to invest in proper systems and procedures in its Sampo acquisition, its money laundering procedures were not fit for purpose, and finally it sought to discredit and ignore an internal whistle-blower. This is typical of a so-called "oblivious" risk management culture, analogous to a military tank which blunders into a minefield with its hatches down, unaware of the risks ahead of it.

The Danske case is however unusual in that it demonstrates the full range of the effects of operational risk. Financial impact is likely to be significant in future fines imposed over several jurisdictions. Arguably, the halving of the share price has already imposed this loss on the owners of the business. The reputational impact upon Danske is best put in their own assessment given to a branch executive committee meeting in 2013: "here is potential reputational risk in being seen to be assisting 'capital flight' from Russia ". Franchise impacts are often limited to the loss of a group of customers, or the opportunity cost of damage repair. However, in this case the forced closure of the entire Estonian franchise demonstrates that operational risk can ultimately destroy a whole business if the risk management failures are serious enough.

Regulatory – Single Resolution Board recommends UK-style Minimum Resolution Eligible Liability (MREL) requirements

In detailed guidelines designed to set out bail-in requirements for Eurozone banks, the Single Resolution Body (SRB) has recommended that large international banking groups adopt a so-called “Single point of entry” resolution strategy, similar to guidelines already in existence for UK banks since 2018.

A single point of entry resolution strategy typically relies upon the issue of resolution eligible liabilities at the group level, with the proceeds being on-lent to operating subsidiaries (opcos). The resulting inter-company liabilities are typically subordinated to the subsidiary’s external liabilities.



The main advantage of such an approach is that by ensuring that losses are imposed on holding company creditors, an opco resolution is in theory “cleaner” to resolve as there is a specific class (or classes) of creditor(s) to absorb losses. Other advantages include the efficiency afforded by the transferability of group MREL capacity between different opcos, and the likely higher stability of their external liabilities. Against this approach is the potential for a conflict of interests between group and opco solvency, particularly where the bank operates cross-border.

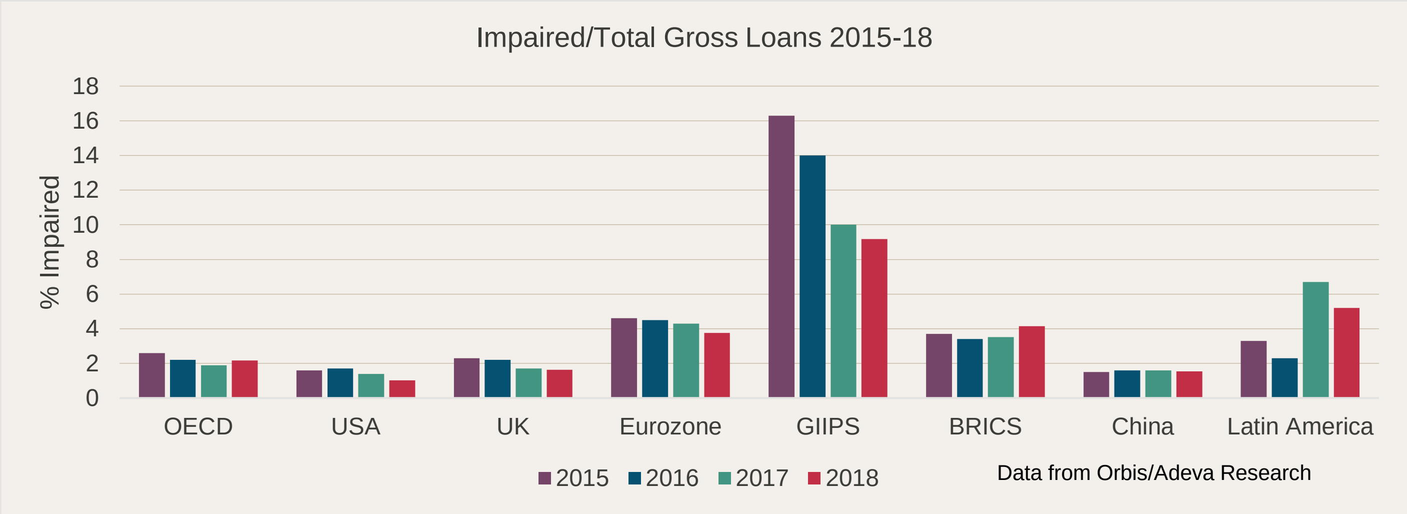
The SRB is also to set MREL targets for banks’ largest operating subsidiaries, having previously only set targets at group level. Similar to the existing UK rules, MREL will be based upon regulatory capital requirements plus a recapitalisation amount. However, the SRB methodology for the recapitalisation amount will be based upon a “market confidence amount” to differentiate between the systemic importance of firms and may be reduced by 20% where a resolution strategy credibly includes the disposal of assets and liabilities. MREL requirements will ultimately rise to 18% + combined buffers for globally systemically important banks and 16% + combined buffers for other firms. Most of this requirement must be met by subordinated instruments, including the structural subordination of internal MREL shown above.

According to Moodys Investors Services, the clarified requirements are expected to result in around half of Eurozone banks issuing MREL eligible liabilities before the phased in requirements become fully effective in 2023.

Performance – Are Bank NPL's in 2018 as Good As it Gets?

Impaired loans continue to fall at 2018 year-end whilst IFRS 9 expected loss provisioning has a mixed effect.

Bank impaired loans in almost all jurisdictions continued to fall in 2018, which considering the clouds on the macro-economic and political horizon may represent a cyclical low. Developed economies in particular, performed especially strongly with USA and Eurozone rates falling by 0.4% and 0.5% respectively. The latter was partially due to significant improvements in the NPL ratios of large Italian banks, which was partially effected through the securitisation of non-performing loans.

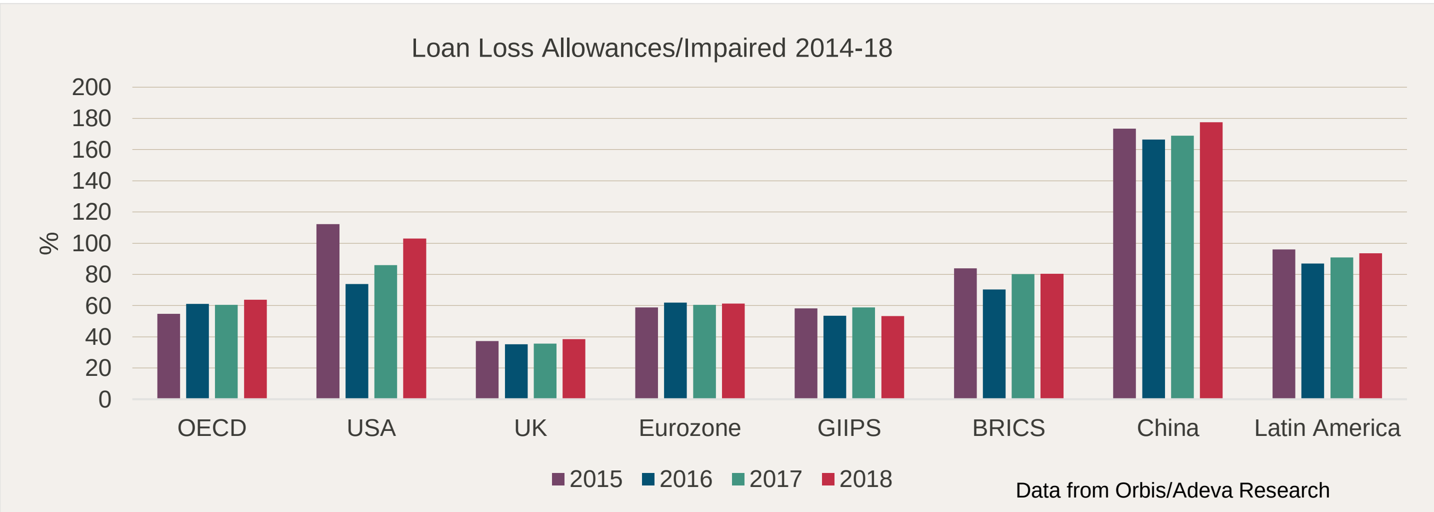


GIIPS: Greece, Ireland, Italy, Portugal and Spain

For emerging economies there was more of a mixed picture. BRIC's showed an average increase of 0.6% driven by rising impairments in Russian and South African banks, partially offset by improving performance in Brazil. China showed little change overall, although the performance at an individual bank level is mixed.

The improvement in Brazil was also responsible for a general improvement in Latin America, although the picture across other countries was a little more variable.

In terms of the allowances made for impaired loans, the adoption of IFRS 9 seems to have had a mixed effect. In general, provisioning for expected loss seems to have slightly increased allowances, particularly in the UK, Eurozone and Latin America. In jurisdictions where provisioning models are highly developed, the increase may be attributed to the inclusion of Stage 2 (increased credit risk but not impaired) allowances. In China, provisioning against often considerable levels of special mention loans has increased allowances from 169% to 177% under IFRS 9.



In peripheral Europe however, IFRS9 adoption appears to have reduced provisions in certain banks. This may be due to banks carrying historically large allowances, which are too great on an expected loss basis due to recovering property values. In Italy NPL securitisations may have also assisted this trend.

In the USA, where IFRS9 has not been adapted, allowances have increased from 85% to 100% of impaired. As IFRS 9 has not been adopted, (USGAAP will adopt its own expected loss model from 2020), this appears to be caused by holding absolute USD allowance levels relatively flat whilst, as previously discussed, impairment levels have fallen by almost a third. However, as expected loss provisioning for US banks is expected to have a significant impact, the retention of existing allowances appears prudent.

Interesting links

Missed the last edition of FIG in Focus? Download it here: https://www.adevapartners.com/view/4723/FIG-in-Focus-1.pdf

Regulation

BCBS & IOSCO Finalise Margin Requirements for Non-cleared Derivatives

https://www.bis.org/bcbs/publ/d475.pdf

BIS provided guidance on frequently asked questions for the new operational risk standardised approach

https://bis.us7.list-manage.com/track/click?u=287c540f49d1d58db1f6fa773&id=cb097a8d10&e=f96297b9ad

EBA proposes changes to EU deposit guarantee schemes to improve depositor protection

https://eba.europa.eu/-/eba-publishes-the-first-of-three-opinions-on-the-implementation-of-the-deposit-guarantee-schemes-directive

EBA publishes quantitative impact study on the impacts of Basel III finalisation

https://eba.europa.eu/-/eba-advises-the-european-commission-on-the-implementation-of-the-final-basel-iii-framework

UK PRA requires public disclosure of large firms resolution plans from 2021

https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss419.pdf?la=en&hash=62C832F99F89F88F2BAACB81E280227B6396E54A

Market Commentary

Jyske Bank imposes negative interest margins on customers. (FT)

https://www.ft.com/content/ebabea22-c31b-11e9-a8e9-296ca66511c9

US Dollar Inverted Yield Curve (NY Times)

https://static.nytimes.com/email-content/PK_16122.html?campaign_id=116&instance_id=11614&segment_id=16122&user_id=e505b00c7db2ec473b69b130faf63033&regi_id=68796369&nl=paul-krugman&emc=edit_pk_20190813

Global cross border banking claims grow at their fastest rate since 2007 (BIS)

https://www.bis.org/statistics/rppb1907.pdf

UK high LTV mortgages reach post banking crisis peak (FT)

https://www.ft.com/content/afa0e9d4-a6d2-11e9-984c-fac8325aaa04

Drop in Euro yields renders Greek government debt cheaper than US Treasuries

https://www.ft.com/content/adf7e9ac-a18c-11e9-a282-2df48f366f7d

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