Nordjyske Bank

Solvency Report 2016

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Introduction

The purpose of this report is to give insight into Nordjyske Bank's calculation of adequate capital base and capital adequacy requirement.
The report is prepared in accordance with information requirements in attachment 2 of the directive on risk exposure, capital base and capital adequacy requirement.

Determination of the adequate capital base and capital adequacy requirement is based on the instructions issued by the Danish Financial Supervisory Authority as most recently revised in December 2015. The instructions prescribe use of the so-called 8+ model which defines the individual capital adequacy requirement as an addition to the 8% requirement.

The report is published every quarter.

This report is a supplement to the Risk Report, which is prepared pursuant to regulation no. 575/2013 of the European Parliament and Council (EU) of 26 June 2013, articles 435 – 455. The Risk Report is prepared annually at the same time as publication of the bank's annual report.

Both reports are published on the homepage www.nordjyskebank.dk.

The information in this report is not audited.

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Solvency requirement and adequate capital base

The internal process
Pursuant to the stipulations in the CRR regulation, the board of directors and the executive board shall ensure that the bank has an adequate capital base. Furthermore, the board of directors and executive board shall calculate the bank's individual capital adequacy requirement.

The board of directors and executive board have as a minimum, quarterly discussions about determination of adequate capital base and solvency requirement. The discussions are based on a memorandum prepared by the financial manager. The executive board is responsible for the memorandum.

The memorandum contains proposals about the level of adequate capital base and solvency requirement, including risk areas for which the Danish Financial Supervisory Authority describes capital should be reserved as a minimum. Based on the discussion, the board of directors and executive board make a decision about the calculation of the bank's adequate capital base and solvency requirement, which will be sufficient to cover the bank's risks, cf. FiL S. 124 (1) and (2).

In addition, the board of directors discusses once a year the calculation method for the bank's adequate capital base and solvency requirement, including which risk areas and benchmarks should be taken into consideration for the calculation of adequate capital base and solvency requirement.

Description of method
The 8+ model is based on the fact that general risks are covered by the statutory minimum requirement of 8 pct. of total risk exposure (the minimum requirement pursuant to regulation no. 575/2013 of the European Parliament and Council (EU) of 26 June 2013, article 92). The individual solvency requirement cannot be less than 8 pct.

However, a financial institution may have increased risk in one or more areas. Typically, a higher risk will be identified in the credit area. In that case, the minimum solvency requirement cannot cover the risk, the reason why there is a need to calculate an addition to the 8 pct.

The instructions of the Danish Financial Supervisory Authority set a number of benchmarks within which each individual risk area where the Danish Financial Supervisory Authority as a starting point estimates whether the 8 % requirement is insufficient, and therefore an addition must be reserved for adequate capital base/solvency requirement. Where possible, the Danish Financial Supervisory Authority has set up methods for calculation of the size of the addition within each individual risk area.

Although the Danish Financial Supervisory Authority sets up benchmarks in a number of areas, the bank assesses in all areas whether the indicated benchmarks to a sufficient degree take the bank's risks into consideration, and individual adjustments have been made to a necessary extent. The bank's own history is used for this purpose.

In addition, it has to be determined to what extent the bank has special risks which necessitate an addition to the adequate capital base respectively solvency requirement.

Pursuant to the instructions, an assessment of the bank's risk profile shall be made in relation to the following 9 risk areas:

1. Earnings
2. Growth in lending
3. Credit risk
4. Market risk
5. Liquidity risk
6. Operational risk
7. Gearing
8. Any additions as a consequence of regulatory maturity of capital instruments
9. Any additions as a consequence of statutory requirements

Earnings
Basic earnings are the first buffer to cover loss on lending and guarantees. If basic earnings are modest compared with lending and guarantees, it cannot be expected to be loss absorbing to the same extent, and, if so, an addition shall be calculated.

If basic earnings, defined as earnings before tax, write-downs, and market price adjustments, amount to less than 1 per cent of lending and guarantees, an addition must be given when calculating the adequate capital base. The calculation is based on the budget approved by the bank's board of directors for 2017.

Nordjyske Bank expects basic earnings at the level of DKK 300-350 mill. in 2017.

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The expected earnings amount to more than 2 pct. of the bank's credit risks in the form of lending and guarantees, gross, and thus is far above the limit of 1 per cent.

In recent years, Nordjyske Bank has realised basic earnings from primary operation of more than 2 pct. gross, of the bank's in the form of lending and guarantees.

It is the opinion of the bank that the expected basic earnings are sufficient to meet the immediate risk on the portfolio of lending and guarantees. Therefore, no further capital will be reserved to cover it.

Growth in lending
During 2016, lending has increased by 0.9 pct. and 2017 the bank expects a modest growth in lending.

It is the opinion of the bank that the expected development in lending does not pose any material risk. Therefore, no capital to cover growth in lending is reserved.

Credit risk
An assessment of the cautiously estimated loss on commitments exceeding 2 per cent of the capital base has been performed. This means commitments which on group basis are larger than DKK 44 mill. Customers with financial problems include the following:

- Customers with an objective indication of value decrease (OIV), quality category 1.
- Customers with material weaknesses but no OIV, quality category 2c.

This assessment is supplemented by analyses of

- the risk of loss on the bank's commitments with agriculture, which is less than 2 pct. of the capital base
- the temporary increase of the risk of loss as a consequence of the market potential of agriculture.

Furthermore, assessment is made of the bank's credit concentration risks on the following areas:

- Individual exposures
- Industries
- Securities

Regarding individual exposures and industries, the assessment is based on the stipulations in the instructions.

Concentration risk on individual exposures shall cover the risk connected with the distribution of size of exposures in the lending portfolio.

The calculation of the addition for concentration risk on individual exposures is based on the instructions of the Danish Financial Supervisory Authority where an addition shall be made, if the 20 largest exposures exceed 4% of the volume of exposure.

The calculation of the addition for concentration risk on industries is based on the instructions of the Danish Financial Supervisory Authority. Pursuant to these instructions the Herfindahl-Hirschmann index (HHI) shall be applied to calculate the rate of concentration on industries. Based on HHI the addition is calculated, where an HHI less than 20% does not give an addition in the solvency requirement, whereas HHI > 20% gives an addition depending on how much HHI exceeds 20%.

With regard to the concentration of securities, a sensitivity analysis has been performed of the bank's securities in the agriculture and fishing assets on commitments where writing downs have been made.

The assessment made results in further capital requirement of DKK 217.9 mill. to cover special risks.

Market disk
The bank's current market risks are very moderate and have been so through a number of years.

The instructions prescribe that the bank's special risks in this area should basically be assessed in relation to the maximum risk within the limits set by the board of directors for the executive board's authority to take market risks.

Regarding interest risks, the capital requirement may alternatively be calculated on the basis of the maximum framework utilisation within the last 12 months prior to the calculation. DKK 45.8 mill. Will be reserved to cover interest risks.

It is the opinion of the bank that in addition to this no further capital is necessary to cover risks in the market risk area.

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Liquidity risk
The bank's funding, which consists of deposits, subordinate capital, and the bank's equity, amounts to DKK 18.9 bn. Lending of DKK 10.8 mill. relative to funding gives a funding ratio of 0.57.

Compared with statutory requirements, cf. FIL S152, this is amounts to excess coverage of 151 pct.

Finally, the bank's LCR key figures are calculated at 273 pct. compared with statutory requirements of 70 pct.

The bank has performed a stress test of liquidity which shows that the bank can also meet the statutory requirements on a 12-month term.

The test is based on the following preconditions:

- All liquidity and credit lines from professional actors lapse when they become due
- Time deposits lapse when they become due
- Deposits that are not covered by the Deposit Guarantee Fund, are reduced by 25% at the start of the period
- Other deposits decrease by 5 pct. annually
- The customer's unused drawing rights are used by 10% at the start of the period

Based on this stress test it is the bank's opinion that liquidity does not pose any specific risk. Therefore, no capital is reserved to cover costs to procure liquidity.

Operational risk
Based on a qualitative assessment of the bank's organsiation, use of IT and the business model it shall be assessed whether there are special risks within the operational area.

In connection with assessment of adequate capital base and solvency requirement, the bank has provided an addition of DKK13.5 mill. or 0.1% of the risk exposure to uncertainty in connection with the implementation of the merger with Nørresundby Bank, including organisation and IT systems.

Gearing
The gearing ratio reflects the bank's unweighted exposure in relation to equity. The bank's gearing ratio, which can be calculated at 9.4% is estimated not to be excessive and does not give reason to reservation of further capital to cover it.

Possible additions as a consequence of regulatory maturity of capital instruments
If the bank has capital instruments that expire or in other ways can no longer be included in the capital base, it shall be assessed, in consideration of caution, whether an addition in the solvency requirement shall be performed if the bank is challenged with regard to replacement of the debt instrument in question.

At present the bank does not have this challenge and thus there is no addition for this.

Possible additions as a consequence of statutory requirements
There are no additions to the solvency requirement due to statutory requirements, as the individual solvency requirement has been calculated at more than 8% and the bank has not been ordered an individually fixed solvency requirement.

Pursuant to regulation no. 575/2013 of the European Parliament and Council (EU) of 26 June 2013, article 395, exposure should not exceed 25% of the bank's capital base. The bank has no commitments that give cause to additions to adequate capital base as a consequence of the size of the commitment.

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Adequate capital base and solvency requirement

As at 31.12.2016	Solvency requirement as a percentage	Adequate capital base
General risks	8.0	DKK 1,076.2 mill.
Special risks		
- Earnings	0.0	DKK 0,0 mill.
- Growth in lending	0.0	DKK 0.0 mill.
- Credit risk	1.6	DKK 217.9 mill.
- Market srisk	0.4	DKK 45.8 mill.
- Liquidity risk	0.0	DKK 0.0 mill.
- Operational risk	0.1	DKK 13.5 mill.
Special risks, total	2.1	DKK 277.2 mill.
Total, calculated individually	**10.1**	**DKK 1,353.4 mill.**

Excess solvency coverage

As at 31.12.2016	Solvency requirement as a percentage	Adequate capital base
Capital ratio	16.4	DKK 2,200.9 mill.
Individually calculated solvency requirement	10.1	DKK 1,353.4 mill.
Excess coverage in relation to individually calculated solvency requirement	6.3	DKK 847.5 mill.
Individually calculated solvency requirement incl. capital conservation buffer	10.7	DKK 1,437.4 mill.
Total excess capital related coverage	5.7	DKK 763.5 mill.

The bank's capital ratio has been calculated at 16.4 pct. Compared with an individual solvency requirement of 10.1 pct. there is excess coverage of 6.3 %-point.

In 2016 a capital conservation buffer of 0.625 pct. was implemented, which means that the individually calculated solvency requirement with the addition of capital conservation buffer may be calculated at 10.7 pct. and the capital related excess coverage may be calculated at 5.7 pct.

Objective

The bank's board of directors has determined an objective for core capital ratio of min. 15.5 pct. at the end of 2018. Pursuant to the bank's business model there shall be an excess solvency coverage of 25 pct. relative to the solvency requirement.