RIGSREVISIONEN

Extract from the report to the Public Accounts Committee on the issue of an individual government guarantee to Amagerbanken A/S

October 2011

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I. Introduction and conclusion

1. This report is about the course of events from the time when Amagerbanken A/S submitted its application for an individual government guarantee up to the transfer of the bank to Finansiel Stabilitet A/S (publicly owned company established to ensure financial stability in Denmark) for winding up early in February 2011. Rigsrevisionen initiated the examination in February 2011 at the request of the Public Accounts Committee.

The individual government guarantee is a scheme set up under Bank Package II (the credit aid package) according to which the FS on behalf of the government for a period of up to three years guaranteed bonds and loans issued by financial institutions up to 31 December 2010. The government guarantee covered payment of interest and repayment of loans. The guarantee was issued upon application.

2. In June 2010, Finansiel Stabilitet A/S (in the following referred to as the FS) issued an individual government guarantee to Amagerbanken A/S (in the following referred to as Amagerbanken) of DKK 13.5 billion. The issue of the guarantee was made conditional upon Amagerbanken's ability to raise DKK 750 million in new capital, which the bank managed to do in September 2010. In November 2010, the new management of Amagerbanken reviewed all loan exposures exceeding DKK 15 million. On the basis of the review, the new management estimated that assets should be written down by additionally DKK 3.1 billion in the annual accounts for 2010. Eventually, however, the management realised that the severity of the difficulties facing Amagerbanken made it impossible for the bank to continue operations on its own. Amagerbanken was unable to raise new capital and on 6 February 2011 its activities were transferred to the FS for winding up.

3. Prior to the issue of the guarantee to Amagerbanken, the Danish Financial Supervisory Authority (the Danish FSA) went through a number of the bank's largest exposures in order to assess whether the bank was complying with the statutory solvency requirement.

4. The objective of Rigsrevisionen's examination is to clarify the course of events concerning the issue of the individual government guarantee to Amagerbanken and the transfer of the bank to the FS, including also the roles played by the FS and the Danish FSA in the process.

The report answers the following questions:

- Did Amagerbanken comply with the statutory solvency requirement, and did the Danish FSA's inspection in this respect uncover the financial condition of the bank?
- Was the issue of the individual government guarantee by the FS to Amagerbanken a financially sound decision?
- Did a normalized credit policy provide the basis for the assessment of the risks facing the bank that was made by the new management of Amagerbanken in January 2011?

5. Rigsrevisionen has, as part of its examination of the roles played by the FS and the Danish FSA in connection with the issue of the individual government guarantee to Amagerbanken, collected information from the FS, the Danish FSA, the Ministry of Economic and Business Affairs and the new management of Amagerbanken. The information serves as documentation for the activities pursued by the institutions during the process.

In October 2011, the Ministry of Economic and Business Affairs was re-established as the Ministry of Business and Growth. Rigsrevisionen will refer to the ministry by its current name throughout the report.

MAIN CONCLUSION

Towards the end of 2009, Amagerbanken applied for an individual government guarantee of DKK 13.5 billion. As part of the consideration of the bank's application, the FS inspected 35 of Amagerbanken's largest exposures in order to assess the financial condition of the bank. The examination showed that the business methods pursued by the bank were generally particularly risky, and the FS concluded that the financial difficulties of the bank were so severe that it might not meet the statutory solvency requirement. The FS informed the Ministry of Business and Growth of its assessment. The Ministry asked the Danish FSA to assess whether Amagerbanken was complying with the statutory solvency requirement. According to the Danish FSA's inspection, Amagerbanken did meet the statutory solvency requirement, and the Danish FSA informed the ministry and the FS in this regard. The FS then initiated negotiations with Amagerbanken on the most rigorous terms ever laid down for a Danish financial institution applying for an individual government guarantee.

The FS and the Danish FSA assessed the need for provisions to cover the bank's risk of future losses very differently. The subsequent course of events in Amagerbanken demonstrated that the total requirement for provisions exceeded the estimates made by both the FS and the Danish FSA.

When the new management of Amagerbanken took over, it identified a need for additional write-downs of the 35 exposures amounting to DKK 2.2 billion. Added to this, the new management also identified a need for additional write-downs of the remaining 134 exposures of approximately DKK 1 billion. The new management of Amagerbanken abandoned the former particularly risky business methods and based its assessment on an approach to credit that was in alignment with general market principles. The credit policy of Amagerbanken was thus brought in consistence with the bank's written policy for the area.

Total losses suffered by the government as a result of the government guarantee issued to Amagerbanken cannot be determined at this point in time, but are currently approximately DKK 2.1 billion.

The main conclusion is based on the following findings:

The Danish FSA's assessment of the financial condition of Amagerbanken

The outcome of the Danish FSA's inspection in May 2010 was that Amagerbanken, after having made additional write-downs, did comply with the statutory solvency requirement. Rigsrevisionen finds that the Danish FSA's assessment confirmed that Amagerbanken met the statutory solvency requirement at the time.

However, the inspection carried out by the Danish FSA did not fully uncover the financial condition of Amagerbanken. As a consequence of the particularly risky business methods that were extensively pursued by the bank, the issues relating to the exposures were not addressed and resolved. The FS attached great importance to this fact in its inspection of the bank's exposures. Rigsrevisionen finds that the Danish FSA should have focused more on the particularly risky business methods that characterised Amagerbanken. Rigsrevisionen is also of the opinion that the Danish FSA should have inspected more of Amagerbanken's exposures taking into consideration that its assessment would be included in the FS' consideration of the bank's application for an individual government guarantee of DKK 13.5 billion.

Rigsrevisionen is satisfied that the Danish FSA has stated that it has now taken initiatives to tighten the regulations governing financial institutions' write-downs and assessments of the need for solvency provisions. Rigsrevisionen is of the opinion that it should be considered how the scope of action of the Danish FSA at inspections can be expanded to ensure that particularly risky business methods can be disregarded.

The FS' inspection of Amagerbanken's 35 largest exposures

- In December 2009, Amagerbanken applied for an individual government guarantee of DKK 6.5 billion, but shortly after the bank applied for an increase of the guarantee to DKK 13.5 billion. The FS therefore carried out an inspection of the bank's 35 largest exposures.

- The FS submitted the results of its inspection to the Ministry of Business and Growth and emphasized that it seriously questioned Amagerbanken's ability to meet the statutory solvency requirement. Against this background, the FS concluded that issuing a government guarantee to Amagerbanken would not be a financially sound decision.

- Subsequently, the Ministry of Business and Growth asked the FS to contact the Danish FSA. The Danish FSA then assessed the requirement to Amagerbanken's solvency. The Ministry also contacted the Danish FSA on the issue of Amagerbanken's ability to meet the statutory solvency requirement.

The Danish FSA's assessment of Amagerbanken's solvency

- The Danish FSA carried out an inspection of Amagerbanken's individual solvency need.
- The outcome of the Danish FSA's inspection was that Amagerbanken – after having made additional provisions – did meet the statutory solvency requirement. The Danish FSA also observed that the fact that Amagerbanken met the solvency requirement at the time did not imply that the bank would be able to meet the requirement in the long term.

The assessments of the financial and business risks in Amagerbanken made by the FS and the Danish FSA in the spring 2010

- The inspections of the 35 exposures carried out by the FS and the Danish FSA were all focused on financial risk. Yet, the assessments made by the FS and the Danish FSA of the need for additional provisions in relation to the 35 exposures were very different.
- To this should be added that the two institutions also identified several business risks in relation to Amagerbanken's management of the majority of the 35 exposures. The FS attached importance to these business methods in its overall assessment of the general financial condition of Amagerbanken. The Danish FSA identified the same risks during its inspections, but concluded in its assessment that it could not in all cases disregard Amagerbanken's estimated write-downs. Rigsrevisionen is, however, of the opinion that the Danish FSA should have focused even more on the particularly risky business methods that characterised Amagerbanken.
- The Danish FSA has stated that the accounting rules restrict its possibilities of disregarding management's assessments of the need for write-downs. Rigsrevisionen finds that it should be considered how assessments made on the basis of particularly risky business methods can be disregarded in connection with the inspections carried out by the Danish FSA.
- The Danish FSA should have inspected more of Amagerbanken's exposures taking into consideration that its assessment would be included in the FS' consideration of the bank's application for an individual government guarantee of DKK 13.5 billion.
- In the opinion of Rigsrevisionen, the risky business methods that were extensively pursued by Amagerbanken had the consequence that the bank neither addressed nor resolved the issues relating to the exposures.

The FS' issue of an individual government guarantee to Amagerbanken

The FS issued the individual government guarantee to Amagerbanken on a sound basis. As a consequence of the serious concerns of the FS about the financial condition of Amagerbanken, the bank was required to meet several special terms to obtain the guarantee. The FS therefore defined several special terms to ensure that the issue of the guarantee could be considered financially sound. The special terms included a capital injection of DKK 750 million. The FS could have increased the solvency requirement, but did not find sufficient grounds to do so. The FS also demanded changes in the management of Amagerbanken. Rigsrevisionen is of the opinion that with the special terms that were set at the time of the issue of the individual government guarantee, the FS had found a sound solution.

Amagerbanken's application for a state-funded capital injection

- In 2009, Amagerbanken received a state-funded capital injection of DKK 1.1 billion (hybrid core capital) from the Ministry of Business and Growth following a prolonged process during which it was determined that Amagerbanken complied with the statutory solvency requirement and thereby also the application terms. In connection with the capital injection, the Danish FSA required Amagerbanken to procure more capital. Amagerbanken raised the required capital and as the application terms were thus met, the ministry fixed an interest level for the bank that was above the average interest rate charged under the scheme. The increased interest level was a reflection of the risk associated with the state-funded loan. The ministry also tightened the requirements to Amagerbanken's reporting. The ministry has stated that the objective and intention of the scheme did not warrant a demand for excess solvency cover in Amagerbanken.

- The Ministry of Business and Growth has stated that the fact that Amagerbanken had previously received a state-funded capital injection did not influence its subsequent decision to issue an individual government guarantee to the bank.

Distribution of responsibilities between the FS and the Danish FSA in the consideration of the application for an individual government guarantee

- The FS was uncertain about the weight that the company's own assessment of the financial condition of Amagerbanken would carry in the subsequent consideration of the bank's application for an individual government guarantee. With the regulations of the Act on Financial Stability as starting point, the Ministry of Business and Growth determined the division of work between the FS and the Danish FSA and concluded that the assessment of whether a financial institution is complying with the statutory solvency requirement is to be made by the Danish FSA.

- Based on the Act on Financial Stability, the Ministry of Business and Growth also established that Amagerbanken was entitled to apply for an individual government guarantee when the bank, according to the assessment made by the Danish FSA, met the statutory solvency requirement. The FS was thus instructed, and accepted, to initiate negotiations with Amagerbanken on the terms for the issue of the individual government guarantee of DKK 13.5 billion.

The special terms of the guarantee

- The FS defined special terms to be met by Amagerbanken before the individual government guarantee could be issued. The terms were the most extensive ever set by the FS for a financial institution, and included a capital adequacy requirement of DKK 750 million. The FS was in a position to tighten the capital adequacy requirement based on its own assessment of Amagerbanken's severe financial condition. However, the FS decided to take various factors into account, including the fact that the capital adequacy requirement corresponded to an excess solvency cover of 50 per cent, which was identical with the company's usual requirement to weak financial institutions.

- Rigsrevisionen is of the opinion that with the special terms that were set at the time of the issue of the individual government guarantee, a financially sound solution had been found.

The risk exposure of Amagerbanken as uncovered by the new management

In the opinion of Rigsrevisionen, the assessment of the bank's risk exposure that was carried out by the new management of Amagerbanken in January 2011 was based on a normalised credit policy and write-down practice. The new management abandoned the former particularly risky business methods and aligned Amagerbanken's credit policy with general market principles. The credit policy of Amagerbanken was thus brought in consistence with the bank's written policy for the area. Rigsrevisionen has established that the new management subsequently wrote down the value of the 35 exposures by additionally DKK 2.2 billion. In the first half of 2011, the value of the 35 exposures was written down by an additional amount of approximately DKK 1.2 billion.

- Amagerbanken's new management restructured the bank's organisation and management to achieve a more well-defined, transparent and consistent distribution of responsibilities. This exercise enabled Amagerbanken to review its largest exposures on the basis of what was considered usual practice in the industry.

- Amagerbanken's new management has stated that it wanted to perform a credit assessment of the bank's largest exposures based on principles that were consistent with general market practice to attain a complete overview of the actual condition of the bank. To this end the new management went through the former practice pursued by Amagerbanken and determined the principles for a reassessment in consistency with current market principles.

- As a result of the changed approach to the distressed exposures, in combination with deteriorations in several of the exposures, the new management's assessment of the loan portfolio showed a need for additional write-downs of DKK 3.1 billion, of which DKK 2.2 billion was related to the 35 exposures. The assessment made by the FS and the Danish FSA of Amagerbanken's risk exposure and need for additional provisions, as determined by the new management, was based on these institutions' expectations in regard to future deteriorations in the exposures. The original assessment and re-assessment of the credit risk related to the 35 exposures that was carried out by the new management in the first half of 2011, when Amagerbanken was being wound up, showed that additional write-downs of the exposures of approximately DKK 1.2 billion were needed.

- The Danish FSA is of the opinion that the credit policy established by Amagerbanken's new management reflected a normalised, yet cautious approach, whereas the write-down practice was conservative. The Danish FSA also finds that deteriorations in the loan portfolio were the main reason for the collapse of Amagerbanken. The Danish FSA's scope of action in respect to disregarding Amagerbanken's calculations of needed write-downs is, however, restricted if the estimates made by the bank fall within the framework of the accounting rules. The Danish FSA consulted the government's legal adviser on the new management's review of the bank's exposures in order to determine the responsibilities of the Danish FSA if Amagerbanken ceased to operate as a financial institution. On the basis of the response provided by the legal adviser to the government, the Danish FSA concluded that it had no grounds to disregard Amagerbanken's write-downs.

- Rigsrevisionen is of the opinion that the former risky business methods pursued by Amagerbanken had the consequence that the bank failed to address and resolve the issues relating to the exposures.