

Statement on inspection at Danish Ship Finance A/S

Introduction

In September 2018, the Danish Financial Supervisory Authority (FSA) conducted an inspection at Danish Ship Finance A/S. The inspection covered the areas of management, securities, funding and liquidity, IT, group matters, outsourcing and operational risks.

Summary and risk assessment

Danish Ship Finance has a narrow business area, providing loans against ship mortgages funded by the issue of bonds, and as a ship finance institution the company is governed by special legislation in certain areas.

Danish Ship Finance has a wider scope than mortgage banks to pre-issue bonds, i.e. the institution may issue the bonds before the proceeds are to be applied. Danish Ship Finance uses this option. The proceeds from pre-issuance must be placed in particularly secure and liquid instruments. Such placement involves counterparty credit risk. Danish Ship Finance has set limits on the desired credit and counterparty risk. The FSA finds that the limits set on callable covered bonds are higher than in other institutions with comparable bond portfolios.

Danish Ship Finance has set limits to the credit spread risk related to the placement of funds in covered bonds, but had not, at the time of the inspection, made a capital add-on to the internal capital adequacy requirement on that basis. The institution was therefore ordered to assess the extent to which the credit spread risk should be covered in the determination of the internal capital adequacy requirement. Danish Ship Finance complied with the order and, at 30 September 2018, made an add-on of DKK 365 million to the internal capital adequacy requirement as a result of the institution's credit spread risk.

Danish Ship Finance has not implemented full segregation of functions in all areas, but focuses on the introduction of compensatory measures in the areas without full segregation between employees in acting, executing and controlling entities. The institution is required to maintain a strong focus on this area.

As a result of lending in USD and funding in DKK, Danish Ship Finance is exposed to foreign exchange risk, which, despite risk hedging, is of some importance to the size of the institution's capital adequacy. The reason is that the balance sheet total will fluctuate with movements in the USD, even though own funds remain unaffected due to the hedging. Danish Ship Finance uses derivative financial instruments to hedge any mismatches between lending and funding. Danish Ship Finance should consider setting limits on the use of derivatives at cover pool level.

At 30 September 2018, Danish Ship Finance's total capital ratio was 19.4% and the internal capital adequacy requirement including countercyclical capital buffer was 12.6%.

Other than the matter concerning credit spread risk, the FSA had no comments on the internal capital adequacy requirement.