FitchRatings

Correction: Fitch Affirms Danske Bank at 'A'; Outlook Stable

Fitch Ratings-London-22 August 2016: (The following is a correction of a release published earlier today that inaccurately excluded the Long-term IDR for Danske Corporation of 'A'. It has now been included in the ratings list below.)

Fitch Ratings has affirmed Danske Bank's (Danske) and its mortgage bank subsidiary Realkredit Danmark's (Realkredit) Long-Term Issuer Default Ratings (IDRs) at 'A', Short-term IDRs at 'F1', and Viability Ratings (VRs) at 'a'. The Outlooks on the Long-Term IDRs are Stable.

A full list of rating actions is at the end of this rating action commentary.

The rating actions are part of a periodic portfolio review of two major Danish banking groups rated by Fitch.

KEY RATING DRIVERS - DANSKE'S IDRS, VR AND SENIOR DEBT
Danske's ratings reflects the bank's strong universal Danish and, to a lesser extent, pan-Nordic franchises. These provide stable revenue generation across a wide range of products, strong capitalisation as well as healthy funding and liquidity, although wholesale funding reliance makes the bank sensitive to a loss of investor confidence. We view positively management's renewed strategic focus on relationship banking in the Nordics, whereby we believe past mistakes such as the expansion into Ireland are unlikely to be repeated.

The bank has also taken steps to strengthen its risk management framework, and we expect this to translate into further asset quality improvements. The level of impaired loans has fallen in recent years on the back of a domestic economic recovery, enhanced underwriting standards and ongoing wind-down of the non-core Irish portfolio, which is no longer a material risk to the bank. The ratio of impaired loans to gross loans was 2.9% at end-June 2016.

Profitability metrics have also improved significantly, primarily as a result of lower loan impairment charges but also thanks to tight cost control and stronger revenue generation. Fitch expects resilient income generation in 2016 and beyond, supported by modest volume growth and continued strengthening of fee and commission income. Negative interest rates in Denmark have had a manageable impact on the bank's margins, being partly offset by re-mortgaging and repricing activity. For mortgage financing (mainly through Realkredit), Danske earns a fixed margin because the market interest rate on the covered bonds is passed through to the borrower.

Danske is reliant on wholesale funding, like most Nordic banks, and has a well-diversified funding base. Its mortgage business (via Realkredit) is by law entirely wholesale-funded by mortgage bonds that match the interest term of the underlying mortgage loan. Fitch expects continued strong demand for Danish mortgage bonds in light of the need for domestic financial institutions, insurance companies and pension funds to hold highly liquid, high quality, securities in domestic currency. This is reinforced by a fairly limited outstanding volume of Danish government bonds. Nonetheless, maintaining a significant liquidity portfolio to mitigate refinancing risk is key for Danske's ratings.

Danske's risk-weighted capital ratios compare well with international peers, although they are somewhat lower than some Swedish peers due to higher risk weights. Leverage is acceptable in a European context, with a fully loaded Basel III leverage ratio of 4.0% at end-June 2016.

KEY RATING DRIVERS - REALKREDIT'S IDRS, VR AND SENIOR DEBT
Realkredit's IDRs and VR reflects Fitch's view that profitability, although moderate, will enable the mortgage bank to absorb unexpected shocks in Denmark. Realkredit's rating are based on its standalone financial strength, despite the sharing of some central functions and distribution channels with its parent bank. Fitch also expects that to a significant extent, capital is fungible between Danske and Realkredit, and thus Fitch is likely to retain the VRs within one notch of each other.

Realkredit's ratings reflect its strong domestic franchise as the second-largest mortgage lender, its strong capitalisation and its resilient asset quality. The ratings are constrained by the bank's monoline business model and wholesale funding reliance, although risks associated with the latter are mitigated by a large, deep and liquid domestic covered bond market, and access to funding from its parent if needed.

Realkredit's assets represent the majority of Danske's mortgage loan exposure. Fitch expects the quality of this portfolio to remain strong, supported by a stabilising Danish economy. We expect profitability to remain low, but stable, underpinned by resilient revenue generation (given higher administration margins), tight cost control and a continued focus on underwriting.

Realkredit is by law entirely wholesale-funded, largely through issuance of Danish mortgage bonds. Similar to its domestic peers, about 20% of Realkredit's bonds mature within a year to match the duration of the bank's underlying mortgage loans. We believe that recent mortgage price adjustments will help reduce those volumes further. The supportive dynamics of the Danish mortgage bond market and Denmark's law on mortgage bond maturity extensions will help reduce refinancing risks.

Realkredit's risk-weighted capital ratios compare strongly with those of domestic and international peers, although boosted by relatively low risk weights on mortgage loans. Leverage is good in a European context, with a tangible equity/tangible asset ratio of 5.6% at end-June 2016.

SUPPORT RATING AND SUPPORT RATING FLOOR
Danske's Support Rating (SR) of '5' and Support Rating Floor (SRF) of 'No Floor' reflect Fitch's view that senior creditors cannot rely on receiving full extraordinary support from the sovereign in the event of it becoming non-viable. The EU's Bank Recovery and Resolution Directive (BRRD) provides a framework for resolving banks that is likely to require senior creditors participating in losses, if necessary, instead of or ahead of a bank receiving sovereign support.

Realkredit's SR of '1' reflects an extremely high probably that support would be provided by Danske, if required. In Fitch's view, Danske would have high propensity to support Realkredit given the latter's role as the group's main domestic mortgage provider, and the significant reputational risk Danske would face in the event of a default of Realkredit. Any required support would likely be manageable relative to Danske's ability to provide it. Realkredit's SRF of 'No Floor' has been withdrawn as we believe the Danske is the most likely source of support, and the SRF is therefore no longer relevant to our coverage.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
Subordinated debt and other hybrid capital issued by Danske are all notched down from the bank's VR and have been affirmed accordingly.

In accordance with Fitch's criteria, subordinated debt and CRD IV-compliant Tier 2 instruments are rated one notch below Danske's VR to reflect the above-average loss severity of this type of debt relative to average recoveries. The narrow notching partly reflects the absence of contractual full write-down or conversion language.

Fitch rates Danske's other Tier 2 instruments three notches below the VR to reflect loss severity (one notch) and incremental non-performance risk (two notches). Of the latter, compared to new CRD IV-compliant Tier 2 notes, Fitch has applied an additional single notch for incremental non-performance risk to legacy issues because of the issuer's ability to defer coupons. The ability to defer interest is the differentiation between the old-style Tier 2 instruments and the new CRD IV-compliant Tier 2 notes

Hybrid Tier 1 capital notes, Tier 1 instruments and Additional Tier securities are rated three, four and five notches, respectively, below Danske's VR to reflect the higher than average loss severity risk of these securities (two notches) as well as high risk of non-performance (an additional one, two and three notches, respectively).

RATING SENSITIVITIES
DANSKE'S IDRS, VR AND SENIOR DEBT
A continued sustained and material improvement in asset quality and profitability metrics could result in positive rating pressure in the medium term. This would also require management to successfully execute its current strategy, with a clear focus on Nordic home markets, while maintaining solid capital, funding and liquidity ratios.

While unexpected, a downgrade could also result from a prolonged inability to competitively access debt capital markets, if the Danish business faces a significant asset quality deterioration that materially impacts capitalisation or if the improving earnings trend reverses. At the current rating, Fitch expects Danske to maintain a large liquidity buffer and minimise maturity gaps to mitigate funding risks. The agency expects the bank to continue to have strong access to debt capital markets.

REALKREDIT'S IDRS, VR AND SENIOR DEBT
The Stable Outlook reflects Fitch's view that Realkredit will maintain its focus on asset quality and continue to generate capital internally. An upgrade is unlikely given its already high ratings for a monoline business model.

A downgrade would most likely be a result of Realkredit being unable to competitively access wholesale funding markets or if it significantly increases its reliance on international debt investors who may prove less stable during financial stress. A downgrade of Danske's ratings, or reduced focus on liquidity, would also be rating negative.

SUPPORT RATING AND SUPPORT RATING FLOOR
An upgrade of Danske's SR or upward revision of the SRF would be contingent on a positive change in Denmark's propensity to support its banks. While not impossible, this is highly unlikely, in Fitch's view.

Realkredit's SR of '1' is sensitive to any perceived change in Danske's propensity or ability to provide support.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
As subordinated debt and other hybrid securities are notched down from Danske's VR, their respective ratings are sensitive to a change in Danske's VR. They are also sensitive to Fitch changing its assessment of the probability of their non-performance risk relative to the risk captured in Danske's VR.

The rating actions are as follows:

Danske Bank
Long-Term IDR: affirmed at 'A', Outlook Stable
Short-Term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'a'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured debt: affirmed at 'A'
Short-term debt: affirmed at 'F1'
Commercial paper programme: affirmed at 'A'/'F1'
CRD IV-compliant Tier 2 instrument (ISIN: XS0974372467): affirmed at 'A-'
Subordinated debt: affirmed at 'A-'
Legacy Tier 2 debt (ISIN: XS0176929684): affirmed at 'BBB'
Tier 1 instruments: affirmed at 'BBB-'
Additional Tier 1 capital instruments (ISIN: XS1044578273 and XS1190987427): affirmed at 'BB+'

Danske Corporation
Commercial paper programme: affirmed at 'A'/'F1'
Realkredit Danmark
Long-Term IDR: affirmed at 'A', Outlook Stable
Short-Term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'a'
Support Rating: Upgraded to '1' from '5'
Support Rating Floor: affirmed at 'No Floor' and withdrawn

Contact:
Primary Analyst
Bjorn Norrman
Senior Director
+44 20 3530 1330
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Olivia Perney Guillot
Senior Director
+33 144 299 174

Committee Chairperson
Bridget Gandy
Managing Director
+44 20 3530 1095

Media Relations: Elaine Bailey, London, Tel: +44 203 530 1153, Email: elaine.bailey@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Global Bank Rating Criteria (pub. 15 Jul 2016) (https://www.fitchratings.com/site/re/884135)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1010653)
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