# FITCH AFFIRMS DANSKE BANK AT 'A', NEGATIVE OUTLOOK

Fitch Ratings-Stockholm/London-02 July 2019: Fitch Ratings has affirmed Danske Bank's 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 Danske and Realkredit's Long-Term IDRs are Negative and Stable, respectively. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
DANSKE BANK
IDRS, VR AND SENIOR NON-PREFERRED DEBT
Danske's ratings reflect the bank's strong universal banking franchise in Denmark and to a growing extent, across the Nordic region, providing stable revenue generation across a wide range of products. The ratings also consider Danske's strong capitalisation and funding access, although wholesale reliance makes the bank sensitive to a loss of investor confidence.

The Negative Outlook on Danske's Long-Term IDR reflects uncertainty relating to the ultimate impact on the bank's capitalisation, franchise and funding profile from the various investigations by regulators on the bank's serious deficiencies of its anti-money laundering controls, in particular in its Estonian non-resident portfolio. Around EUR200 billion of payments from non-resident clients were allowed to flow through the Estonian branch between 2007 and 2015, a large part of which are expected to be deemed suspicious.

Danske has suffered significant reputational damage. This has led to some customers in Denmark leaving the bank, but so far these have appeared manageable. The bank has decided to close its Baltic operations, following the order in February 2019 by the Estonian FSA to cease its operations in the country. The pressure on the strong domestic franchise should ease if customer outflows reduce in a notable and prolonged way, but expansion into other Nordic countries could be slowed down.

The Estonia case reflected badly on management. The executive board has seen significantly turnover over the past 24 months. Following the appointment of a new CEO in May 2019, and the dismissal in June 2019 of the Head of Banking Denmark for his responsibilities in the miss-selling of a savings product, we expect more stability and a reduction in strategic and managerial uncertainty. The largely new management team needs time to fully restore trust from the various stakeholders.

The substantial strengthening of the financial crime and compliance departments, including the recent hiring of international senior experts in financial crime and anti-money laundering (AML), should help alleviate management distractions from on-going authority and internal investigations.

Danske has maintained healthy access to wholesale funding since September 2018, and more particularly the beginning of 2019, but at higher prices than in the past and compared with its regional peers. As it is reliant on wholesale funding, like most Nordic banks, its well-diversified funding base has proven resilient to the negative news from the AML investigations, enabling the bank to execute its funding plan for the year without delays. The spread-widening on the international funding markets has increased funding costs but these remain manageable. Over the past 12 months, Danske has successfully issued senior non-preferred bonds to meet its minimum requirement for own funds and eligible liabilities (MREL) on 1 July 2019, and spreads have been generally improving in 2019 to date.

Pressure remains from the outcomes of the various investigations and potential impacts on the bank, including on capitalisation, and hence on investor confidence. In this context, Fitch has maintained its '5' ESG relevance score for Governance Structure for Danske given that legal risk from a large fine remains elevated and drives the Negative Outlook.

Asset quality has been improving. Danske's stage three loans had decreased to about 2.5% of gross loans at end-March 2019, but the gross impaired loans ratio remains above most peers. We expect it to continue to improve. The bank has strengthened its risk management framework in recent years, in particular making better use of stress testing and portfolio analysis to more proactively capture emerging risks. We believe that this will translate into a loan portfolio that is more resilient to stress scenarios.

Danske enjoys strong and stable revenue generation as well as good cost control. Margins are low but have proven resilient to negative interest rates. Profit generation has been affected by higher expenses and investments and higher funding costs, related to the AML issue. We believe that earnings should remain sound despite the current headwinds. Danske will gradually benefit from the continued expansion in Norway and Sweden.

Risk-weighted capital ratios compare well with international peers, with a Fitch Core Capital (FCC)/risk-weighted assets (RWA) ratio of 15.3% and a common equity Tier 1 (CET1) ratio of 16.7%, at end-March 2019. Leverage is somewhat high compared with peers, although still acceptable and decreasing, with a reported fully loaded regulatory leverage ratio of 4.5% at end-March 2019.

The 'F1' Short-Term rating is the lowest to the two options mapping with a 'A' Long-Term IDR in line with our assessment of funding and liquidity. Liquidity is healthy, as it is important for Danske to maintain a significant liquidity portfolio to mitigate refinancing risk. At end-March 2019, this totalled 14% of total assets.

The long-term rating of senior non-preferred debt is in line with the bank's Long-Term IDR.

PREFERRED DEBT, DERIVATIVE COUNTERPARTY RATING (DCR) AND DEPOSIT RATING

Danske's DCR, long-term senior preferred debt and deposit ratings are one notch above the bank's Long-Term IDR because derivatives, deposits and senior unsecured preferred notes have preferential status over the bank's large buffers of qualifying junior debt (QJD) and senior non-preferred debt.

Danske's resolution strategy excludes Realkredit. On this basis, Fitch calculates that the buffer of QJD and senior non-preferred debt was over 16% of RWA at end-March 2019. We believe that these buffers should be sufficient to recapitalise the bank after a resolution without causing losses to senior preferred creditors.

We assume that the regulator would intervene when Danske's CET1 capital is close to the bank's CET1 Pillar 1 and Pillar 2 requirements (excluding the capital conservation (CCB) and systemic risk buffers), which on a forward-looking basis stand at 7.2%. We assume the regulator would then likely require the group to be recapitalised to meet its total minimum capital requirements, which including the CCB and systemic risk buffers, but excluding the countercyclical buffer, amounts to 17.3%. This results in an estimated recapitalisation amount of about 10%. Therefore, a combined buffer of 10%-11% should be sufficient to recapitalise the bank after a resolution without causing losses to senior preferred creditors. We view the buffers as sustainable since the bank will have to meet MREL from 1 July 2019.

We have affirmed Danske's short-term preferred senior debt and short-term deposit ratings at 'F1'. This is the lower of the two options mapping to a long-term debt rating of 'A+', and reflects our assessment of Danske's funding and liquidity.

The ratings for commercial paper issued by Danske Corporation, a fully-owned subsidiary solely used to issue commercial paper in the US, are in line with the parent's and reflect Fitch's expectation that the parent would honour its guarantee for the programme.

REALKREDIT

IDRS AND VR

Realkredit's IDRs are based on its standalone financial strength, despite sharing some central functions and distribution channels with its parent bank. Fitch believes that Realkredit's risk profile has been relatively unaffected by the Estonian AML issues affecting its parent. However, given that we believe that capital is to some extent fungible between Danske and Realkredit, we are likely to retain the VRs within one notch of each other.

Realkredit's IDRs and VR 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. The stage three loans/gross loan ratio improved to 1.2% at end-March 2019. The loan book remains well collateralised and performed very well in the wake of the financial crisis. Fitch expects the quality of this portfolio to remain strong, supported by a strong and stable Danish economy. We expect profitability to remain low but stable, underpinned by resilient revenue generation, tight cost control and a continued focus on underwriting.

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. The reliance on short-term bonds has fallen in recent years and they now represent less than 5% of Realkredit's total stock of mortgage bonds. The supportive dynamics of the Danish mortgage bond market and Denmark's law on mortgage bond maturity extensions reduces refinancing risks.

Realkredit's risk-weighted capital ratios compare strongly with those of domestic and international peers, with an FCC ratio of 30.5% end-March 2019, although boosted by relatively low risk-weights on mortgage loans. Leverage is good in a European context.

SUPPORT RATINGS 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 the bank 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 a 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.

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. 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). Fitch has applied two notches for incremental non-performance risk because of the issuer's ability to defer coupons.

Additional Tier 1 securities are rated five notches 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 three notches).

RATING SENSITIVITIES
DANSKE
IDRS, VR AND SENIOR NON-PREFERRED DEBT
Fitch could downgrade Danske's ratings if it becomes likely that the bank will incur fines that would materially deplete its capital base, especially if we believe that this would also translate into a material loss of franchise strength or a weaker funding profile. Negative rating pressure could also arise from significant asset quality deterioration that materially impacts capitalisation, although this is not expected.

Fitch could revise the Outlook to Stable and affirm the ratings if the risk of a capital-depleting fine diminishes, and if the bank can put the Estonian case behind it without materially damaging its franchise or funding profile. In addition, this would require management has successfully restored stakeholders' confidence in the bank and continued to implement its current strategy, with a clear focus on Nordic home markets.

Longer term, a sustained and material improvement in asset quality and profitability, while maintaining solid capital, funding and liquidity ratios, could result in positive rating pressure.,

PREFERRED DEBT, DCR AND DEPOSIT RATINGS
Danske's long-term senior preferred debt, DCR and long-term deposit ratings are notched up from and are sensitive to a change in the bank's Long-Term IDR. The DCR and senior preferred debt ratings could be downgraded by one notch, and the deposit ratings withdrawn, if the buffer of QJD and senior non-preferred debt falls below 10%-11% of adjusted risk-weighted assets (excluding Realkredit), or if Fitch reassesses its estimate of the required recapitalisation amount due to a change in Danske's capital requirements.

REALKREDIT
IDRS, VR AND SENIOR DEBT
The Stable Outlook reflects both Fitch's view that Realkredit will maintain its focus on asset quality and continue to generate capital internally, and that its franchise is less affected by the Estonian case than its parent. An upgrade of Realkredit's VR is unlikely given its already high ratings for a monoline business model. Given the links with Danske, Realkredit's VR is unlikely to be rated more than one notch above Danske's.

A downgrade of Realkredit's VR would most likely be a result of it 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 reduced focus on liquidity would also be negative for the VR. A downgrade of Realkredit's VR, combined with a downgrade of Danske's ratings, would result in a downgrade of Realkredit's Long-Term IDR.

An upgrade of Danske Bank's IDRs, which is unlikely given the Negative Outlook, would likely result in an upgrade of Realkredit's IDRs, at which point Realkredit's IDRs would be driven by parent support.

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 Negative
Short-Term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'a'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Derivative Counterparty Rating: affirmed at 'A+(dcr)'
Senior preferred debt: affirmed at 'A+/'F1''
Senior non-preferred debt: affirmed at 'A'
Long-term deposit rating: affirmed at 'A+'
Short-term deposit rating: affirmed at 'F1'
Subordinated debt: affirmed at 'A-'
Additional Tier 1 capital instruments: affirmed at 'BB+'

Danske Corporation
Commercial paper programme: affirmed '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: affirmed at '1'

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Additional information is available on www.fitchratings.com

Applicable Criteria
Bank Rating Criteria (pub. 12 Oct 2018)
https://www.fitchratings.com/site/re/10044408
Short-Term Ratings Criteria (pub. 02 May 2019)
https://www.fitchratings.com/site/re/10073011