

Fitch Affirms Danske Bank and Realkredit Danmark at 'A'/Stable

Fitch Ratings-Paris/London-08 September 2015: 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' with Stable Outlooks, and their Viability Ratings (VRs) at 'a'. A full list of rating actions is provided at the end of this commentary.

KEY RATING DRIVERS - DANSKE'S IDRS, VR AND SENIOR DEBT

Danske's ratings reflects the bank's strong Danish and, to a lesser extent, Nordic franchise, which provide stable revenue generation across a wide range of products, sound capitalisation as well as healthy funding and liquidity. However, wholesale funding reliance makes the bank sensitive to a loss of investor confidence. The ratings also incorporate a continuous improvement in asset quality and profitability metrics.

Since 2008 Danske's asset quality ratios have been significantly affected by the bank's exposure to Irish real estate, as well as a prolonged downturn in the Danish economy. While the level of impaired loans remains higher than at peers, asset quality has improved in recent years. This should continue, driven by the ongoing wind-down of the Irish portfolio, now classified as non-core, and a recovering Danish economy.

Earnings have also improved, driven primarily by declining loan impairment charges. These used to consume between one-third and three-quarters of pre-impairments profits but are now down to more normalised levels. Negative interest rates in Denmark have had a manageable impact on earnings, being partly offset by mortgage lending re-pricing and volume growth. Fitch expects the bank's risk appetite to remain moderate and that management will remain focused on driving profitability via lower costs and without increasing the bank's risk appetite. Danske has a strong management team, in Fitch's opinion, but senior management turnover has been fairly high in recent years.

Danske has a well-diversified funding base. Similar to most Nordic peers, it has significant reliance on wholesale funding, in particular through its mortgage loan business which by law is exclusively funded through Danish mortgage bonds. Demand for Danish mortgage bonds should remain strong in light of the need from predominantly domestic financial institutions, insurance companies and pension funds to hold highly liquid, high-quality, securities in domestic currency. This is reinforced by the fairly limited outstanding volume of Danish government bonds. Nonetheless, maintaining a significant liquidity portfolio to mitigate refinancing risk is key to Danske's current ratings.

Danske's risk-weighted capital adequacy ratios compare well with those of international peers, but lag behind those of some Nordic peers. Leverage is acceptable in a European context, with tangible common equity/tangible assets at around 4%.

KEY RATING DRIVERS - REALKREDIT'S IDRS, VR AND SENIOR DEBT

Realkredit Danmark's IDRs and VR reflects Fitch's view that profitability, although moderate, will enable the mortgage bank to absorb unexpected shocks in Denmark until economic growth is firmly back on track in the country. Despite the sharing of some services with its parent bank, the ratings of Realkredit Danmark are based on its standalone financial strength. Fitch also expects that capital is, to an extent, fungible between Danske and Realkredit Danmark, and thus the VRs are, to a certain degree, inter-connected.

The ratings reflect the bank's strong Danish franchise as the second-largest mortgage lender, its solid capitalisation and its strong asset quality. Its monoline business model and reliance on wholesale funding constrain the ratings, although risks associated with the latter are mitigated by a large, deep and liquid domestic funding market.

Realkredit Danmark's assets represent the majority of Danske's mortgage loan exposure and Fitch expects the quality of the mortgage lending to remain strong, supported by a stabilising Danish economy. However, profitability should remain modest, driven by its low-margin mortgage loan business.

Realkredit Danmark is by law entirely wholesale-funded, largely through issuance of Danish mortgage bonds. Similar to its domestic peers, about one-third of Realkredit Danmark's bonds mature within a year to match the duration of the bank's underlying mortgage loan. Generally such dependence on short-term wholesale funding would suggest a lower rating. However, the supportive dynamics of the Danish mortgage bond market are an important mitigating factor for this risk. Realkredit Danmark's move to extend bond maturities and Denmark's law on mortgage bond maturity extensions will help reduce refinancing risks (see: 'Nordic Banks' Significant Wholesale Funding Reliance', dated 29 April 2015)

Realkredit Danmark's capital adequacy ratios compare well with those of domestic and international peers. Low risk weights on mortgage loans boost reported capital ratio while leverage is acceptable in a European context.

SUPPORT RATING AND SUPPORT RATING FLOOR

Danske's and Realkredit's '5' Support Ratings and 'No Floor' Support Rating Floors reflect Fitch's view that senior creditors can no longer rely on receiving full extraordinary support from the sovereign in case of need. In Fitch's view, the EU's Bank Recovery and Resolution Directive (BRRD) is now sufficiently progressed to provide 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.

In the EU, BRRD has been effective in member states since 1 January 2015, including minimum loss absorption requirements before resolution financing or alternative financing (eg, government stabilisation funds) can be used. Full application of BRRD, including the bail-in tool, is required from 1 January 2016.

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. The ratings reflect each instrument's respective non-performance and relative loss severity risk profiles, which vary considerably.

Danske's CRD IV-compliant Tier 2 instruments are notched down once below the bank's VR to reflect the notes' higher expected loss severity relative to senior unsecured creditors. The notching also takes into consideration a lack 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, Fitch has applied a 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 securities are rated four notches below Danske's VR to reflect the higher-than-average loss severity risk of these securities (two notches) as well as their high risk of non-performance (an additional two notches).

Danske's Additional Tier 1 instruments are rated five notches below Danske's VR, reflecting the notes' higher expected loss severity relative to senior unsecured creditors (two notches) and higher non-performance risk (three notches), given their fully discretionary coupon payments. Fitch believes Danske's capital buffer being above the 7% CET1 trigger and the minimal capital ratio taking into account the additional buffer on Danish systemically important financial institutions is sufficient to limit the notching for non-performance risk to three (which could otherwise result in wider notching).

RATING SENSITIVITIES

DANSKE'S IDRS, VR AND SENIOR DEBT

The Stable Outlook incorporates Fitch's expectation that Danske will continue to improve profitability while gradually reducing its volume of impaired loans both in Denmark as well as in its non-core business.

An upgrade is currently unlikely given the current earnings and asset quality pressures. Over the medium- to long-term, an upgrade is contingent on the bank successfully executing its current strategy, with a clear focus on home markets. This is provided that asset quality metrics also continue to improve, combined with sustainable and solid internal capital generation.

The ratings could be downgraded if Danske is unable to competitively access wholesale funding markets, if its Danish business faces a significant deterioration in asset quality that materially affects its capitalisation or if its improving earnings trend reverses, reducing its ability to absorb shocks.

REALKREDIT'S IDRS, VR AND SENIOR DEBT

The Stable Outlook reflects Fitch's view that Realkredit Danmark will maintain its focus on asset quality, will continue to generate capital internally and that its adequate earnings will be able to absorb unexpected shocks.

A rating downgrade would most likely be a result of Realkredit Danmark 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.

An upgrade is currently unlikely given the bank's already high ratings and monoline business model.

SUPPORT RATING AND SUPPORT RATING FLOOR

An upgrade to the Support Ratings and upward revision to the Support Rating Floors 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.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The ratings of the subordinated debt and other hybrid capital issued by Danske are sensitive to a change 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'

Commercial paper programme: affirmed at 'A'/F1'

Long-term senior debt: affirmed at 'A'

Short-term senior debt: affirmed at 'F1'

CRD IV-compliant Tier 2 instrument (ISIN: XS0974372467): affirmed at 'A-'

Subordinated notes: affirmed at 'BBB'

Tier 1 instruments: affirmed at 'BBB-'

Additional Tier 1 capital instruments (ISIN: XS1044578273): affirmed at 'BB+'


Danske Corporation


Commercial paper programme: affirmed at 'A'/F1'

Realkredit Danmark


Long-term IDR: affirmed at 'A', Stable Outlook
Short-term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'a'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'

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Applicable Criteria

Global Bank Rating Criteria (pub. 20 Mar 2015)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=863501)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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