

19 Jun 2020 | Affirmation

## Fitch Affirms Danske Bank at 'A' Negative Outlook

Fitch Ratings-Paris-19 June 2020:

Fitch Ratings has affirmed Danske Bank A/S's and its mortgage bank subsidiary Realkredit Danmark A/S's (Realkredit) Long-Term Issuer Default Ratings (IDRs) at 'A' and Viability Ratings (VRs) at 'a'. The banks' Short-Term IDRs have been affirmed at 'F1'. We have removed Danske's Long-Term IDR and VR from Rating Watch Negative (RWN) and we have assigned a Negative Outlook to its Long-Term IDR, while the Outlook on Realkredit has been revised to Stable from Negative.

The affirmation and removal from RWN reflect Fitch's view that Danske's ratings have sufficient headroom under our updated assessment to absorb pressure on asset quality, earnings and capitalisation, which we expect under our baseline scenario for the economies where it operates. The Negative Outlook on Danske's Long-Term IDR reflects downside risks to our baseline scenario as pressure on its ratings would increase substantially if the downturn is deeper or more prolonged than we currently expect. The Stable Outlook on Realkredit's Long-Term IDR reflects our view that the rating has sufficient headroom to absorb significant shocks under various possible downside scenarios to our baseline economic forecast, primarily because of the bank's strong asset quality.

### 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 capital buffers built to cover for potential money-laundering related fines and operational risk. However, the sharp deterioration in the bank's economic environment from the coronavirus outbreak is resulting in a material fall in internal capital generation, which could erode these buffers. This could lead to downward rating pressure, as reflected by the Negative Outlook. Revenue is challenged by expected lower business volumes, and earnings overall will be dented by elevated loan impairment charges.

Danske's franchise has been resilient to negative anti-money laundering (AML) news, despite some modest customer outflows. Management turnover has been high and it will take time for the new management team to build credibility and trust, and restoring the bank's reputation will be key. The substantial strengthening of the financial crime and compliance departments, including the hiring of international senior experts in financial crime and AML, helps alleviate management distractions from the on-going external and internal investigations.

Strategic objectives include further strengthening of compliance and control, clearer accountability, and a wide cost reduction programme. Financial targets of a return on equity of 9%-10% and a cost to income ratio below 50% by 2023 are commensurate with a 'A' rating. Although wholesale funding reliance makes the bank sensitive to a loss of investor confidence, the bank has demonstrated strong access to the funding market, and the increase in funding costs since 2018 has been manageable.

The coronavirus outbreak creates additional downside risks to the bank's operating environment, asset quality and earnings. Danske reported a loss in 1Q20, due to loan impairment charges (LICs) equivalent to 97bp (annualised) of average gross loans. About half of LICs resulted from changes in macro assumptions and post model adjustment in the context of the coronavirus crisis.

We expect further weakening in lending quality, although the extent will depend on the effectiveness of the government support measures in the Nordics and the shape of the recovery expected for 2021. Borrower quality in some higher risk sectors (particularly oil and gas) deteriorated further in 1Q20, leading to a moderate increase in Danske's impaired loans ratio to 2.9% at end-March 2020. The ratio remains above most peers.

Margin pressure in the highly competitive Nordic markets and expected lower business volumes are cyclical challenges to earnings generation. However the current crisis has created opportunities for Danske, like its peers, to strengthen its customer relationships, which combined with a stronger focus on customer satisfaction should support revenue generation. Nevertheless, higher funding costs, partly due to a sustained issuance of senior non-preferred instruments, and high AML-related expenses reduced profitability to levels below peers, and the deteriorated operating environment will make it more challenging for the bank to restore its earnings in the near term, in Fitch's opinion. Lower earnings mean there is a lower buffer to absorb potentially large fines from the investigations of the various regulators.

Risk-weighted capital ratios compare well with international peers, with a common equity Tier 1 (CET1) ratio of 17.6% at end-March 2020. Management has built buffers into its stated temporary target for the CET1 ratio of at least 16%.

Danske 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. The spread-widening on the international funding markets has increased funding costs but these remain manageable. The 'F1' Short-Term rating is the lower of the two options mapping to a 'A' Long-Term IDR in line with our assessment of funding and liquidity. Fitch expects continued strong demand for Danish mortgage bonds, given the supportive dynamics of this market, and prudent liquidity management to mitigate refinancing risk. At end-March 2020, its liquidity buffer was about 1.6 times outstanding wholesale funding, excluding Realkredit.

Pressure remains from the outcomes of the various investigations and potential impacts on the bank, in particular on capitalisation. Fitch has maintained its '4' ESG relevance score for Governance Structure for Danske given that legal risk from a large fine remains elevated and drives the Negative Outlook but only together with the economic fallout from the coronavirus outbreak.

Danske senior non-preferred debt is rated in line with the bank's Long-Term IDR to reflect average recovery prospects.

## 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 around 22% of RWA at end-March 2020. We believe that these buffers should be sustainable and sufficient. They are well above the 10% threshold in our criteria for an uplift, providing protection to more senior debt holders and depositors in a resolution scenario.

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.

## 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 their 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. The risks associated with wholesale funding reliance are mitigated by a large, deep and liquid domestic covered bond market, and access to funding from its parent if needed. The Danish mortgage bonds market remained liquid despite coronavirus disturbance supported by the strong demand for these bonds from Danish financial institutions, insurance companies and pension funds.

Realkredit's assets represent the majority of Danske's mortgage loan exposure. The impaired loans/gross loan ratio was 1.6% at end-March 2020. The loan book remains well collateralised. Fitch expects the quality of this portfolio to be hurt only moderately by the economic fallout from the coronavirus outbreak given low exposure to industries vulnerable to coronavirus-related constrained business activity.

We expect pre-impairment profitability to remain low but stable, underpinned by resilient revenue generation, tight cost control and a continued focus on underwriting. However, capital generation will be affected negatively by the expected deterioration in asset quality through higher LICs.

We do not expect immediate pressure on the bank's funding profile, given Realkredit's moderate annual refinancing needs. About 20% of mortgage 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 3% 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 strong capitalisation is underpinned by its low-risk business model and solid capital surplus over regulatory minimums, giving the bank sufficient cushion to absorb losses and inflation of risk-weighted assets. Realkredit's CET1 ratio of 27.5% at end-March 2020 is boosted by relatively low risk-weights on mortgage loans, but leverage is good in a European context. As a mortgage bank, Realkredit is subject to conservative standalone capital requirements, which underpins our view on the strength of the bank's capitalisation.

## 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 probability 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.

The rating for Danske's Additional Tier 1 capital notes is four notches below its VR. The notching reflects the notes' greater expected loss severity (two notches) and incremental non-performance risk relative to senior unsecured creditors (two notches). Our assessment is based on the bank operating with a CET1 ratio that is comfortably above maximum distributable amount thresholds and our expectation that this will continue.

Fitch rates Danske's subordinated Tier 2 debt two notches below the bank's VR to reflect higher than average loss severity.

## RATING SENSITIVITIES

### DANSKE

### IDRS, VR AND SENIOR NON-PREFERRED DEBT

Factors that could, individually or collectively, lead to negative rating action/downgrade:

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 profitability and capitalisation, which could be triggered by a more severe and prolonged downturn of the economy than we currently expect.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Fitch could revise the Outlook to Stable 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 evidence that management has successfully restored stakeholders' confidence in the bank and continued to implement its current strategy, with a clear focus on the Nordic home markets. A revision of the Outlook to Stable would also depend on the bank's ability to contain the negative impact from the coronavirus outbreak.

#### PREFERRED DEBT, DCR AND DEPOSIT RATINGS

Danske's long-term senior preferred debt, DCR and long-term deposit ratings are sensitive to a change in the bank's Long-Term IDR. The ratings could be downgraded by one notch if the buffer of QJD and senior non-preferred debt falls below 10% of adjusted risk-weighted assets (excluding Realkredit) if the group includes senior preferred debt in its resolution buffer.

#### REALKREDIT

##### IDRS, VR AND SENIOR DEBT

The Stable Outlook on Realkredit reflects our view that the mortgage lender has ample headroom to withstand material shocks of various downside scenarios to our baseline economic forecast given the strength of its asset quality and capitalisation.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Realkredit's ratings would likely be downgraded if the depth and duration of the economic crisis is materially worse than our current base-case scenario, leading to permanent damage of the bank's asset quality and earnings, which would be difficult to restore within a short period of time.

In addition, a multi-notch downgrade from its parent would lead to a downgrade of Realkredit's ratings, which would not be rated more than one notch above its parent.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of Danske Bank's IDRs, which is currently 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. An upgrade of Realkredit's VR is unlikely given its monoline business model.

#### 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 a 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 primarily 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.

## Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## Public Ratings with Credit Linkage to other ratings

The Support Rating of Realkredit Danmark A/S is based on expected support from its parent Danske Bank A/S.

## ESG Considerations

Danske has an ESG Relevance Score of '4' for governance structure due to its potential involvement in money laundering, which is not a key rating driver but has an impact in combination with other factors. Realkredit's and Danske's other ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

Danske Bank A/S; Long Term Issuer Default Rating; Affirmed; A; RO:Neg  
 ; Short Term Issuer Default Rating; Affirmed; F1  
 ; Viability Rating; Affirmed; a; RW: Off  
 ; Support Rating; Affirmed; 5  
 ; Support Rating Floor; Affirmed; NF  
 ; Derivative Counterparty Rating; Affirmed; A+(dcr); RW: Off  
 ----subordinated; Long Term Rating; Affirmed; BBB+; RW: Off  
 ----subordinated; Long Term Rating; Affirmed; BBB-; RW: Off  
 ----long-term deposits; Long Term Rating; Affirmed; A+; RW: Off  
 ----Senior preferred; Long Term Rating; Affirmed; A+; RW: Off  
 ----Senior non-preferred; Long Term Rating; Affirmed; A; RW: Off  
 ----short-term deposits; Short Term Rating; Affirmed; F1  
 ----Senior preferred; Short Term Rating; Affirmed; F1  
 Realkredit Danmark A/S; Long Term Issuer Default Rating; Affirmed; A; RO:Sta  
 ; Short Term Issuer Default Rating; Affirmed; F1  
 ; Viability Rating; Affirmed; a  
 ; Support Rating; Affirmed; 1

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### **Applicable Criteria**

[Bank Rating Criteria \(pub. 28 Feb 2020\) \(including rating assumption sensitivity\)](#)

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