FitchRatings

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Fitch Revises Outlook on Danske Bank to Stable; Affirms at 'A'

Fitch Ratings - Warsaw - 11 Jun 2021: Fitch Ratings has revised the Outlook on Danske Bank A/S's Long-Term Issuer Default Rating (IDR) to Stable from Negative. At the same time, Fitch has affirmed the bank's and its mortgage bank subsidiary Realkredit Danmark A/S's (Realkredit) Long-Term IDRs at 'A', Viability Ratings (VRs) at 'a' and Short-Term IDRs at 'F1'. A full list of rating actions is below.

The revision of Danske's Outlook reflects our view that its asset quality and profitability are likely to remain resilient under our updated assessment of various possible downside scenarios to our baseline expectation of a steady economic recovery. We expect 3.1% GDP growth in 2021 and 3.5% in 2022 in Denmark. We expect the four Nordic governments where Danske operates to maintain sufficient fiscal space to extend support to their economies in case of renewed adverse economic developments.

The Outlook revision also takes into consideration our opinion that Danske's solid capital ratios, which we expect to be maintained, provide a sizeable buffer to absorb potentially large fines from anti-money laundering (AML) investigations.

Key Rating Drivers

DANSKE

IDRS AND VR

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 low risk appetite, stable funding and solid capital buffers built up in the expectation of possible money-laundering related fines and operational risk.

We have revised Danske's ESG relevance score to '3' from '4' for Governance Structure because it no longer has an impact on the bank's ratings in combination with other factors. The previous score of '4' reflected elevated legal risk of a large fine, which together with the economic fallout from the pandemic, drove the Negative Outlook. We no longer expect the bank to receive an AML-related fine that could bring about a downgrade of its VR. We also believe that a potential fine would not damage Danske's franchise or funding profile to an extent that would warrant negative rating action.

Danske's operating revenue has been broadly resilient, despite the cyclical challenges of margin pressure in the highly competitive Nordic markets and the economic downturn. Higher funding costs, partly due to a sustained issuance of senior non-preferred instruments, and high AML-related expenses, reduced the bank's cost-efficiency and its profitability to levels below peers.

We expect better results in 2021 (albeit still notably lower than 2019) due to positive lending momentum, materially lower credit losses and a sizeable cost reduction, in line with the bank's restructuring plan. Danske's cost optimisation efforts started having results in 2H20 as underlying expenses have begun to shrink. We expect the bank to make further progress in 2021 and 2022 towards annual operating profit/risk-weighted assets (RWAs) of about 2% in the medium term.

Danske's impaired loan ratio (Stage 3 loans/ gross Loans) remains above most Nordic banks but is in line with similarly rated international peers. We expect a moderate increase in default rates later this year, bringing the impaired loan ratio closer to 3%, due to the wind-down of government support measures. Danske's loan book exposure is dominated by low risk residential mortgage loans, commercial real estate and housing cooperatives, with a limited share of more vulnerable agriculture and industries suffering from the pandemic.

Risk-weighted capital ratios compare well with those of international peers, with a common equity Tier 1 (CET1) ratio of 18.1% at end-March 2021. Management has built buffers into its stated target for the CET1 ratio of at least 16%. In 4Q20 Danske finalised its internal AML investigation (there were no new material issues) and the US authorities cleared it of potential sanctions breaches regarding the Estonian case. In our view, this reduces the risk that a potential capital-depleting fine will depress Danske's capital ratios to a level no longer commensurate with its 'a' VR.

The bank remains subject to criminal and regulatory investigations by the authorities in Estonia, Denmark, France and the US, relating to past AML control deficiencies in the Estonian branch. We expect that the bank will maintain sufficient loss absorption capacity to cushion a sizeable potential fine from European and US authorities.

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 remains manageable.

Danske's Short-Term IDR and short-term debt rating of 'F1' are the lower of the two options mapping to a Long-Term IDR of 'A'. This reflects our assessment of the bank's funding and liquidity factor at 'a+', compared with the minimum level of 'aa-' required for a Short-Term IDR of 'F1+' under our criteria.

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

Danske's long-term senior preferred debt and deposit ratings and DCR of 'A+(dcr)' are one notch above the bank's Long-Term IDR. This reflects the protection that could accrue to deposits and senior preferred debt from the bank's more junior bank resolution debt and equity buffers. At end-March 2021, this buffer was 23% of RWAs, adjusted for Realkredit, which is excluded from Danske's resolution strategy. We expect Danske's resolution debt buffer to remain comfortably above 10% in the long term. This also drives the equalisation of Danske's long-term senior non-preferred debt with the bank's Long-Term IDR.

Danske's short-term senior preferred debt and deposit ratings are mapped to their respective long-term ratings and also reflect our assessment of the bank's funding and liquidity at 'a+'.

REALKREDIT

IDRS AND VR

Realkredit's ratings reflect its low risk appetite and strong asset-quality metrics, which balance its monoline business model and undiversified (albeit stable) earnings. They also consider Realkredit's well-entrenched mortgage lending franchise in Denmark, strong capitalisation and well-managed reliance on wholesale funding.

Realkredit's IDRs are based on its standalone financial strength, despite sharing some central functions and distribution channels with its parent bank, which we regard as ordinary support. Currently, Realkredit's VR is rated in line with its parent's as we believe that there is a high correlation between the two VRs because of a high level of capital fungibility. Consequently, we are likely to retain the Realkredit's VR within one notch of that of its parent, unless the fungibility of capital reduces.

Realkredit is the second-largest Danish mortgage lender with about 25% market share and as a result its assets represent the majority of Danske's mortgage loan exposure. Realkredit's loan book is geographically concentrated in one country and are thus strongly linked to the performance of the Danish economy.

Realkredit's asset quality is a rating strength underpinned by prudent underwriting standards and robust collateralisation, which limits credit losses. Asset quality in 2020 suffered only modestly due to limited direct exposure to industries that are vulnerable to the coronavirus outbreak. We expect a modest increase in the bank's impaired loan ratio to about 1.5% at end-2021 and elevated credit losses at about 5bp of gross loans as delinquencies materialise after the wind down of government support. Loan impairment charges should materially shrink in 2022, due to economic recovery and the limited risk of property prices correction.

Realkredit's profitability is weaker than similarly rated peers, as its income is almost solely reliant on its lending activity, but it has been stable and its cost efficiency is robust. We expect Realkredit's operating profit/RWAs to remain in line with a 'a' category rating, but most likely to remain below 3% due to administrative margin pressure and regulatory-driven inflation of RWAs.

Realkredit relies extensively on wholesale funding because mortgage lending is by law entirely funded by covered bonds in Denmark. We believe that the risk of Realkredit not being able to access the covered bond market is low, due to strong demand for these bonds from Danish financial institutions, insurance companies and pension funds. Refinancing risk is also mitigated by the bank's good liquidity buffer and potential ordinary support from Danske if needed.

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 potential credit losses and inflation of RWAs. Realkredit's CET1 ratio of 27.9% at end-March 2021 is boosted by relatively low risk-weights on mortgage loans, but leverage is adequate in a European context. As a mortgage bank, Realkredit is subject to standalone capital requirements, which underpins our view of the bank's capitalisation.

Realkredit's Short-Term IDR and short-term debt rating of 'F1' are the lower of the two options mapping to a Long-Term IDR of 'A'. This reflects our assessment of the bank's funding and liquidity factor at 'a', compared with the minimum level of 'aa-' required for a Short-Term IDR of 'F1+' under our criteria.

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 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. Any required support would likely be manageable relative to Danske's ability to provide it.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

Danske's Tier 2 debt is rated two notches below its VR to reflect the above-average loss severity of this type of debt. Additional and legacy Tier 1 securities are rated four notches below Danske's VR to reflect higher-than-average loss severity risk of these securities (two notches) as well as the high risk of non-performance (an additional two notches). Our assessment is based on the bank operating with a CET1 ratio comfortably above maximum distributable amount thresholds and our expectation that this will continue.

RATING SENSITIVITIES

DANSKE

IDRS, VR, NON-PREFERRED DEBT

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

An upgrade of Danske would require i) a completion of AML investigations and clarification of potential fines; ii) an expected CET1 ratio of at least 15% net of AML settlements; iii) a sustainable reduction of impaired loans ratio below 2%; and iv) a successful implementation of the bank's transformation plan demonstrated by a durable recovery of the operating profit/RWAs ratio to at least 2.5%.

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

The bank has sufficient rating headroom to withstand a downward revision of our assessment of asset quality and profitability by one notch that could be triggered by the severe delays to economic recovery expected by Fitch. A substantial and durable CET1 ratio erosion below 14% would lead to a downgrade, which could be driven by an AML fine considerably larger than the bank's current loss absorption capacity.

We could also revise the Outlook to Negative if we reassess that the bank's AML fine absorption capacity may be insufficient. This could be triggered if we expect Danske's CET1 ratio surplus over its requirement to shrink materially below 250bp.

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 senior non-preferred and more junior 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

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

Realkredit's IDR could be upgraded if Danske's IDRs are upgraded, assuming it retains its important role within the group. An upgrade of Realkredit's VR is unlikely in the near term given its monoline business model. In the longer term, an upgrade would be contingent on Realkredit's broadening its product offering, providing it with significantly more diversified revenue streams.

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

We would downgrade Realkredit's ratings if we expect that it will not be able to maintain its CET1 ratio above 14% or restore it to that level within a short period of time. This could be due to significantly higher-than-expected loan impairment charges driven by a prolonged recession, high unemployment and material property price correction.

In addition, a downgrade of its parent's VR by more than one notch could lead to a downgrade of Realkredit's ratings, given the high correlation we believe exist between the two ratings.

An adverse change in investor sentiment that requires extraordinary support from the parent due to materially weakening Realkredit's ability to access competitively priced covered bond funding would be rating negative. An increased reliance on international debt investors who may prove less stable during financial stress would also put pressure on ratings.

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 and Covered Bond 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

Realkredit's IDRs are aligned with Danske's. Realkredit's Support Rating is based on expected support from its parent Danske.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or 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

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Danske Bank A/S	LT IDR	A	Affirmed		A
	ST IDR	F1	Affirmed		F1

ENTITY/DEBT	RATING			RECOVERY	PRIOR
	Viability	a	Affirmed		a
	Support	5	Affirmed		5
	Support Floor	NF	Affirmed		NF
	DCR	A+(dcr)	Affirmed		A+(dcr)
• subordinated	LT	BBB+	Affirmed		BBB+
• subordinated	LT	BBB-	Affirmed		BBB-
• long-term deposits	LT	A+	Affirmed		A+
• Senior preferred	LT	A+	Affirmed		A+
• Senior non-preferred	LT	A	Affirmed		A
• short-term deposits	ST	F1	Affirmed		F1
• Senior preferred	ST	F1	Affirmed		F1
Realkredit Danmark A/S	LT IDR	A	Affirmed		A

ENTITY/DEBT	RATING			RECOVERY	PRIOR
	ST IDR	F1	Affirmed		F1
	Viability	a	Affirmed		a
	Support	1	Affirmed		1

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Bank Rating Criteria (pub.28 Feb 2020) (including rating assumption sensitivity)

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