FITCH AFFIRMS NYKREDIT'S IDR AT 'A'; UPGRADES SENIOR PREFERRED DEBT TO 'A+'

Fitch Ratings-London-01 August 2018: Fitch Ratings has affirmed Nykredit Realkredit A/S' (Nykredit) Long- and Short-Term Issuer Default Ratings (IDRs) at 'A' and 'F1', respectively, and Viability Rating (VR) at 'a'.

At the same time, Fitch has upgraded Nykredit's senior unsecured long-term preferred debt to 'A+' from 'A'. The upgrade reflects Fitch's view that qualifying junior debt (QJD) and senior non-preferred debt within the group are sufficient to materially reduce the risk of default for senior preferred creditors in case of failure.

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

IDRS, VRS AND SENIOR NON-PREFERRED DEBT

Nykredit's ratings reflect the bank's leading Danish mortgage franchise, resilient asset quality, and robust capitalisation. The ratings also factor in Nykredit's good profitability and heavy reliance on wholesale funding, although the latter is mitigated by a large, deep and liquid domestic covered bond market.

The loan book is of good quality, with a ratio of impaired-to-gross loans of 1.5% at end-2017. The vast majority are performing mortgage loans, with a small proportion of higher-risk non-mortgage lending in Nykredit Bank (impaired loans ratio of 4.2% at end-2017). Fitch expects the quality of mortgage lending to remain resilient, supported by a continued domestic economic recovery and the group's conservative risk appetite.

Management aims to grow gradually and to diversify the bank's franchise in Denmark, although Fitch expects this to be achieved without increasing the group's risk appetite, as growth will mainly focus on cross-selling and broadening the product offering with existing clients.

The bank's capitalisation is solid and compares well with peers, both on a risk-weighted and leverage basis. Its Fitch Core Capital ratio amounted to 21.0% at end-March 2018, and its Basel III leverage ratio was 4.8%.

Nykredit benefits from resilient core revenue generation. Margins are low, reflecting its low-risk business model, and the 2016 increase in administration margin charged on mortgages is being offset to a large extent by the bank's 'Kundekroner' loyalty discount. Nykredit's cost management is solid, with a cost/income ratio of below 40%. The bank's margins have been resilient to negative interest rates in Denmark. It is not directly exposed to interest rate risk in its mortgage financing (due to the Danish covered bond funding structure), although it is sensitive to lower treasury returns, as well as movement on its legacy derivatives portfolio. The impact of the latter will reduce following the close-out in 2017 of the two largest exposures.

Nykredit's mortgage business is by law entirely wholesale-funded, by mortgage bonds that match the interest term of the underlying mortgage loan. The group has actively reduced the share of bonds maturing within one year to under 20% at end-2017 (from over one-third at end-2012), and the proportion of loans with one-year adjustable rates to 5% (over 20% at end-2014). We believe that the prolonged low rate environment will help to reduce these volumes further, albeit at a slower pace than we have seen in recent years.

Fitch believes that the risk of wholesale market dislocation is partly offset by the group's strong and sophisticated approach to wholesale funding requirement, and also partially mitigated by structural features in the Danish mortgage bond market. We expect 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 and reducing outstanding volume of Danish government bonds. Nonetheless, maintaining a significant liquidity portfolio to mitigate refinancing risks is a key factor for Nykredit's ratings.

SENIOR PREFERRED DEBT
Nykredit's long-term senior preferred debt rating is one notch above the bank's Long-Term IDR because senior unsecured preferred notes have preferential status over the bank's large buffers of QJD and senior non-preferred debt. Nykredit has a single point of entry resolution strategy, which also captures Nykredit Bank, hence the uplift also applies to its subsidiary.

The buffer of QJD and senior non-preferred debt was over 9% of risk-weighted assets (RWA) at end-March 2018, when also taking into account the EUR500 million senior non-preferred issue executed in early July 2018. We believe these buffers should be sufficient to recapitalise the bank after a resolution without causing losses to senior preferred creditors. We assume the regulator would intervene when Nykredit's CET1 capital is close to its CET1 Pillar 1 and Pillar 2 requirements (excluding the capital conservation (CCB) and systemic risk buffers), which on a forward-looking basis stand at 5.7% (point of non-viability, PONV). 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 13.7%. Overall, also taking also into account undisclosed Pillar 2 guidance, a combined QJD and senior non-preferred debt buffer of 9%-10% would most likely be sufficient to restore the bank's viability without hitting third-party preferred senior creditors.

We expect that Nykredit will issue further senior non-preferred debt, which should result in a further increase of the buffers, and which we view as sustainable since the bank will have to meet Danish resolution requirements, a combination of a 2% debt buffer for mortgage lending and MREL requirements for Nykredit Bank.

We have affirmed Nykredit's short-term debt rating at 'F1'. This is the lower of the two options available at a long-term debt rating of 'A+', and reflects our view that Nykredit's funding and liquidity is not exceptionally strong for this rating.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
Subordinated debt and other hybrid capital issued by Nykredit are all notched down from its VR and have been affirmed accordingly.

In accordance with Fitch's criteria, subordinated debt is rated one notch below Nykredit's VR to reflect the higher-than-average loss severity of this type of debt.

Tier 2 contingent capital instruments and Additional Tier 1 securities are rated three and five notches below Nykredit's VR, respectively, to reflect the higher-than average loss severity risk of these securities (two notches) as well as the high risk of non-performance (an additional one notch and three notches, respectively).

SUPPORT RATING AND SUPPORT RATING FLOOR

Nykredit's '5' Support Rating (SR) 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 will require senior creditors to participate in losses, if necessary, instead of or ahead of a bank receiving sovereign support.

SUBSIDIARY AND AFFILIATED COMPANY
Nykredit Bank's IDRs and debt ratings are aligned with Nykredit's given the subsidiary's core position within the Nykredit group, including full ownership, strong track record of support, and high reputational risk from allowing the subsidiary to default. Given its close integration into the larger group, including various shared services, we have not assigned a VR to the subsidiary.

In line with the parent bank's rating actions and in view of the high integration of Nykredit Bank into the parent, Fitch has upgraded Nykredit Bank's senior unsecured long-term preferred debt to 'A+' from 'A'. Fitch has also assigned Nykredit Bank deposit ratings of 'A+'/'F1'.

RATING SENSITIVITIES
IDRS, VRS AND SENIOR NON-PREFERRED DEBT
The Stable Outlook reflects Fitch's view that Nykredit will continue to maintain strong asset quality while sustaining the recent improvement in its earnings to internally generate capital.

Although not expected by Fitch, pressure on the ratings could come from an adverse change in investor sentiment materially affecting Nykredit's ability to access competitively priced funding or from reduced emphasis on liquidity. An increased reliance on international debt investors who may prove less stable during financial stress, or increasing risk appetite - particularly at Nykredit Bank - would also be rating-negative.

An upgrade is currently unlikely given the group's already high ratings and limited product breadth. In the longer term, an upgrade would be contingent on Nykredit broadening its product offering, providing it with more diversified revenue streams.

SENIOR PREFERRED DEBT
Nykredit's long-term senior preferred debt ratings are notched up from and are sensitive to 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 9%-10% of RWA, or if due to a change in the bank's capital requirements Fitch reassessed its estimate of the required recapitalisation amount.

SUPPORT RATING AND SUPPORT RATING FLOOR
An upgrade of the SR and upward revision of the SRF would be contingent on a positive change in the sovereign'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 subordinated debt and hybrid securities issued by Nykredit are sensitive to a change in its VR.

Tier 2 contingent capital instruments and Additional Tier 1 securities are also sensitive to Fitch changing its assessment of the probability of their non-performance risk relative to the risk captured in Nykredit's VR.

SUBSIDIARY AND AFFILIATED COMPANIES
Nykredit Bank's ratings are sensitive to a change in Nykredit's ratings.

The rating actions are as follows:

Nykredit Realkredit A/S
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'
Long-term senior unsecured debt upgraded to 'A+' from 'A'
Short-term senior unsecured debt affirmed at 'F1'
Senior non-preferred debt affirmed at 'A'
Subordinated debt affirmed at 'A-'
Tier 2 contingent capital notes affirmed at 'BBB'
Additional Tier 1 notes affirmed at 'BB+'

Nykredit Bank A/S
Long-Term IDR affirmed at 'A'; Outlook Stable
Short-Term IDR affirmed at 'F1'
Support Rating affirmed at '1'
Long-term deposit rating assigned at 'A+'
Short-term deposit rating assigned at 'F1'
Long-term senior unsecured debt upgraded to 'A+' from 'A'
Short-term senior unsecured debt affirmed at 'F1'

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Applicable Criteria
Bank Rating Criteria (pub. 22 Jun 2018)
https://www.fitchratings.com/site/re/10034713