FITCH AFFIRMS NYKREDIT AT 'A'; OUTLOOK STABLE

Fitch Ratings-Warsaw/London-02 July 2019: 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'. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS, VR and SENIOR NON-PREFERRED DEBT
Nykredit's ratings reflect the bank's conservative risk appetite demonstrated in healthy and resilient through-the-cycle asset quality and robust capitalisation. Nykredit's good profitability is underpinned by the bank's leading Danish mortgage lending franchise and consistent strategy. We also take into consideration Nykredit's ample liquidity and stable funding, which is heavily reliant on a large, deep and liquid domestic covered bond market.

Nykredit's low risk appetite and business model reflects prudent underwriting standards, robust risk controls, reasonable loan growth and low market risk exposure. Nykredit's credit risk exposure is dominated by personal and business mortgage loans, which equalled respectively about two-thirds and one third of total loans at end-1Q19. Nykredit observes tight underwriting standards for mortgage loans, which are underpinned by conservative Danish covered bond legislation and regulatory constraints set by the Danish FSA.

Nykredit's healthy asset quality is demonstrated in modest levels of impaired loans and credit losses through-the cycle. At end-1Q19, impaired loans (comprising Stage 3 loans under IFRS 9) accounted for just below 1% of gross loans. We expect the ratio to remain broadly stable and somewhat stronger than regional peers' in the coming periods.

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

Capitalisation is commensurate with the bank's low-risk business model and is also underpinned by a Fitch Core Capital/ risk-weighted assets (RWA) ratio of 21% (at end-1Q19), a low stock of unreserved impaired loans and limited concentration in high-risk assets on the balance sheet. Nykredit's high capital ratios are boosted by low risk weights on mortgage loans. The regulatory leverage ratio of 4.8% at end-1Q19 was adequate and compared well with that of peers.

Nykredit's operating profit benefits from healthy and recurring revenue, tight cost control and contained credit losses. The bank's net interest margin contracted in 2018, which is likely to continue due to a growing share of lower-risk (and thus lower-yielding) loans in new disbursements (such as amortising loans or fixed-rate loans). Nykredit's cost control is sound, demonstrated by a cost/income ratio of about 40% in the past three years. The bank's ratio of operating profit/RWA stood at about 2.2% between 2016 and 1Q19.

As with most Nordic banks Nykredit relies extensively on wholesale funding, because mortgage lending is by law entirely funded by covered bonds. Fitch believes that the risk of Nykredit not being able to access the covered bond market is low. This reflects Nykredit's strong and sophisticated wholesale funding management and strong demand for Danish mortgage bonds.

In our opinion demand for Danish covered bonds will continue to remain strong, regardless of turbulences in global wholesale markets. This is because Danish financial institutions, insurance companies and pension funds invest mainly in highly liquid, high-quality securities in domestic currency, and also because of a fairly limited and declining outstanding volume of Danish government bonds. 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 qualifying junior debt (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 about 10.5% of RWAs at end-1Q19. We believe this buffer should be sufficient to recapitalise the bank in a resolution without causing losses to senior preferred creditors. We assume the regulator would intervene when Nykredit's common equity Tier 1 (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 about 5.5% (point of non-viability). 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 counter-cyclical buffer, amounts to about 14.5%.

Overall, also taking also into account undisclosed Pillar 2 guidance, a combined QJD and senior non-preferred debt buffer of about 10% would most likely be sufficient to restore the bank's viability without hitting third-party preferred senior creditors.

Nykredit plans to issue further senior non-preferred debt to meet its regulatory requirements, which should result in a further increase of the buffers. Nykredit is subject to Danish resolution requirements, including a debt buffer equal to at least 2% of mortgage lending for the mortgage institution and minimum requirements for eligible liabilities (MREL) at Nykredit Bank. In addition, from 2022, the group's own funds, liabilities eligible for bail-in and debt buffer should be at least 8% of the consolidated balance sheet.

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

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.

We rate subordinated debt 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 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. This reflects the subsidiary's core position within the Nykredit group, including full ownership, strong track record of support, and high reputational risk from a default of the subsidiary. We have not assigned a VR to the subsidiary because it does not have a meaningful standalone franchise that could exist without the ownership of the parent, due to its close integration into the larger group (including various shared services).

Nykredit Bank's long-term senior unsecured preferred debt is equalised with that of Nykredit because of the subsidiary's high integration with the parent.

Nykredit Bank's long-term deposit rating is one notch above the bank's Long-Term IDR. We believe that Nykredit's large buffers of QJD and senior non-preferred debt are sufficient to materially reduce the risk of default for deposits in case of failure. Nykredit Bank's short-term deposit rating of 'F1' mirrors that of the bank's short-term preferred debt.

RATING SENSITIVITIES
IDRS, VRS AND SENIOR NON-PREFERRED DEBT
The Stable Outlook reflects our view that we do not expect a change in ratings. 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 significantly more diversified revenue streams.

Pressure on the ratings would arise from an adverse change in investor sentiment materially affecting Nykredit's ability to access competitively priced funding or from weaker liquidity management. 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 put pressure on ratings.

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 RWAs. The notching is also sensitive to changes in our assumptions on the resolution intervention point and post-resolution capital needs, and the development of resolution planning more generally.

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. Nykredit Bank's deposit ratings are sensitive to a change in its parent's senior preferred debt 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 affirmed at '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'
Deposit ratings affirmed at 'A+/F1'
Senior unsecured debt affirmed at 'A+'/'F1'

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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)