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Nykredit Realkredit A/S

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Table Of Contents

Nykredit Realkredit A/S

SACP	a-	+	Support	+1	+	Additional Factors	0

Anchor	bbb+	
Business Position	Adequate	0
Capital and Earnings	Strong	+1
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Adequate	

ALAC Support	+1
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating

A/Stable/A-1

Major Rating Factors

Strengths:	Weaknesses:
• Leading mortgage bank in Denmark. • Highly collateralized nature of the loan book. • Sustainable and improving core earnings and profitability, despite low interest rate environment.	• Low-margin nature of domestic residential mortgage lending business. • High household debt in the Danish economy.

Outlook: Stable

The stable outlook reflects our view that Danish bank Nykredit Realkredit will not return to a higher reliance on short-term wholesale funding and will maintain its strong capital and additional loss absorbing capacity (ALAC) position over the next two years. In our view, lower expected annual refinancing amounts, improvements in earnings capacity, and expectations of additional capital via an IPO within the next year support a stable outlook.

We could lower the long-term rating if we saw Nykredit Realkredit materially shorten the term structure of its funding. This could lead us to revise down our assessment of Nykredit Realkredit's stand-alone credit profile (SACP) and lower the rating. In addition, a downgrade could occur if ALAC buffers were to reduce. This could happen if Nykredit Realkredit's risk adjusted capital (RAC) ratio deteriorated, or if the amount of ALAC-eligible instrument diminished, reducing the protection these instruments provide for senior unsecured creditors in a resolution scenario that we currently view as supportive of the current ratings.

We are unlikely to raise the rating at this time. We note that the completion of a successful IPO could improve Nykredit Realkredit's SACP by strengthening our assessment of capital and earnings. However, this would reduce the excess capital in the bank's ALAC buffers, likely leading us to remove the additional notch for ALAC support. However, such a scenario would likely result in higher ratings on Nykredit's hybrid capital instruments, which are notched from the SACP.

Rationale

The 'A' long-term rating on Nykredit Realkredit reflects our assessment of the Danish banking industry. It also reflects our view that the bank will maintain its dominant role in the Danish mortgage market and make meaningful improvements to its profitability, supporting its already strong capital buffers. The rating also reflects stability in Nykredit Realkredit's mortgage book and access to the well-functioning Danish covered bond market, even as the bank continues to reshape the maturity profile of its issued securities.

We equalize our ratings on Nykredit Bank A/S with those on its parent. This is based on our assessment of Nykredit Bank as a core subsidiary of the Nykredit group, as defined under our group rating methodology.

Anchor: 'bbb+' for banks operating only in Denmark

Under our bank criteria, we use our Banking Industry Country Risk Assessment's economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Denmark is 'bbb+', based on an economic risk score of '3' and an industry risk score of '4'.

Our assessment of economic risk for Denmark reflects our view that Danish banks benefit from operating in a high-income, open economy with mature political and institutional settings that promote fiscal discipline and growth-stimulating policies. The economy is competitive, diverse, and expanding modestly in line with credit growth. Although it has decreased in terms of GDP, household debt remains high and a constraint to our assessment of economic risk. In our view, problem loans from the previous credit cycle are falling, and lending in the agricultural segment is well provisioned. We expect credit losses to fall below 10 basis points (bps) per year through 2018. Consequently, we expect Denmark's economy and bank performance will remain stable, supported by a balanced fiscal policy, strong external position, and improving profitability of the banking sector.

We view the regulatory environment in Denmark as in line with that of other EU countries. We observe an overall improvement in the banking sector's profitability that, in our view, will continue through further cost efficiency measures, decreasing credit losses and higher mortgage margins. This should enable the sector, including lower-yielding mortgage banks, to report a return on equity (ROE) of at least 9% by 2017, despite a negative central bank deposit rate weighing on deposit margins.

We note the banking sector relies more heavily on functioning wholesale markets than its peers do. However, we also note the continued stability and strong track record of the Danish covered bond market, and expect continuing measures of individual banks and the regulator to reduce the share of short-term financing.

Table 1

Nykredit Realkredit A/S Key Figures

	--Year ended Dec. 31--				
(Mil. DKK)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	1,379,486	1,400,362	1,383,518	1,455,049	1,414,360
Customer loans (gross)	1,206,251	1,188,757	1,175,085	1,197,647	1,192,772
Adjusted common equity	68,627	65,947	60,607	55,606	55,055

Table 1

Nykredit Realkredit A/S Key Figures (cont.)					
	--Year ended Dec. 31--				
(Mil. DKK)	**2017***	**2016**	**2015**	**2014**	**2013**
Operating revenues	8,785	12,284	12,636	8,120	10,803
Noninterest expenses	2,365	5,185	4,964	5,021	5,391
Core earnings	5,432	5,118	5,258	658	2,408

*Data as of June 30. DKK--Danish krone.

Business position: Denmark's premier mortgage provider, striving for higher returns

Our assessment of Nykredit Realkredit's business position reflects its sustained business stability, even throughout a period of extraordinary market stress in Europe, and Denmark specifically. This is partly offset by our expectation of continued limited business diversification. The group's primary focus is mortgage lending in Denmark, while commercial banking services--where Nykredit Bank has a market share of roughly 5%--and asset management are still of secondary importance to the group's performance. The Danish mortgage market is built on a business model that has proven stability and relatively low margins for more than 150 years.

Nykredit Realkredit reported total assets of Danish krone (DKK) 1.38 trillion (€185 billion) as of June 30, 2017. Nykredit Realkredit's share of the domestic mortgage lending market varies by segment, but averages about 41%, making it the market leader. Through its subsidiary Totalkredit's cooperation with partner banks, we expect Nykredit will remain the market leader in residential real estate financing. It derives about 70% of its core earnings from its mortgage lending platform, and its core subsidiary Nykredit Bank the remainder.

Nykredit Realkredit and its global peers will be subject to increased capital requirements in the coming years and will be required to comply with higher core equity tier 1 capital (CET1) and capital ratios. In order to prepare for this, in February 2016 Nykredit Realkredit announced its plan to raise equity via an IPO and eventual listing on the Copenhagen stock exchange in the following 12-24 months. We do not anticipate a significant increase in strategic risks or the risk profile as a result of new ownership. In September 2017, Nykredit chose J.P. Morgan, Morgan Stanley, and Danske Bank to act as global coordinators for its planned public listing.

In addition, Nykredit Realkredit increased its administration margins for all Totalkredit loans applicable from July 1, 2016, in an effort to improve its long-term capital situation and return on required capital metrics. We note that a similar margin increase was later registered among competitors Nordea and Danske Bank, and that this change has not materially impacted Nykredit's brand perception, despite some initial negative media coverage. In addition, in September 2017 the Danish competition authority granted Nykredit permission to increase administration margins on 60,000 of Nykredit Realkredit's adjustable rate mortgage customers, coming into effect in July 2018.

We have historically seen strength in Nykredit Realkredit's mutual organization and note that the Nykredit Association is expected to retain its controlling interest, even after the IPO. Moreover, in July 2017 Nykredit Realkredit introduced a profit-sharing model--"KundeKroner"--where the bank shares profits with customers in the form of discounts financed by future dividends paid out to the Nykredit Association. We expect this measure to support Nykredit's brand as a mutually owned institution as it begins its IPO process.

Nykredit Realkredit is Denmark's leading provider of mortgage financing and largest lender by domestic volume. It is the country's second-largest financial services group and its subsidiary Nykredit Bank A/S is the fifth-largest commercial bank in the country. In our view, Nykredit Realkredit's prominent role in the Danish mortgage market and its mutual model have contributed to low margins for all Danish mortgage banks when compared with similar international mortgage lenders. However, Nykredit Realkredit redefined its strategic objectives in 2015 and aims to achieve a pre-tax ROE of 11% by 2018, in preparation for the IPO. In 2016, the group reported a return on equity before tax of 10.0%, against 7.5% in 2015 and -0.3% in 2014. This ratio increased further to an exceptional 19.3% as of June 30, 2017, driven by positive top-line and cost developments, but also by high investment portfolio income, positive value adjustment of legacy derivatives, and reversals.

We recognize that Nykredit Realkredit's market position allows significant pricing power, as illustrated by the large margin increase registered in the Danish mortgage market after Nykredit increased its administrative fee.

Strategically, we expect Nykredit Realkredit to aim to improve market share outside of its dominant mortgage position and to compete more directly with other larger banking groups such as Nordea, Danske Bank, and Jyske Bank, by offering to provide its private individual retail clients a full-service offering via its subsidiary, Nykredit Bank. As part of its new strategy, Nykredit Realkredit envisages a gradual expansion of its banking and asset management operations to support the full-service customer concept in a market with limited credit demand. In particular, we expect Nykredit to continue expanding its wealth management business.

We believe the group is able to retain its position in mortgage finance, building on its strong cooperation with regional banks via its Totalkredit subsidiary. Accordingly, over the short to medium term, we expect the group's strategic focus will remain on improving its financial performance to rival its strong Nordic peer group, prior to the IPO.

Table 2

Nykredit Realkredit A/S Reported Core Income Per Business Line

(Mil. DKK)						**2017Q2**	**FY2016**	**FY2015**
Core income	**Retail**	**Wholesale clients**	**Totalkredit partners**	**Wealth management**	**Group items**	**Total**	**Total**	**Total**
-Business operations	3,569	1,288	1,550	432	(19)	6,820	12,159	11,945
-Value adjustments derivatives	--	--	--	--	--	--	--	410
-Senior and subordinated debt	(49)	(4)	(54)	0	(140)	(247)	(494)	(610)
-Other					43	43	46	38
Total core income	3,520	1,284	1,496	432	(116)	6,616	11,711	11,783
Operating costs	1,533	297	294	209	32	2,365	5,260	5,066
Profit from core business before impairments	1,987	987	1,202	223	(148)	4,251	6,451	6,717
Impairments	(201)	(316)	69	0	0	(448)	680	920
Profit from core business	2,188	1,303	1,133	223	(148)	4,699	5,771	5,797

DKK--Danish krone. Source: Nykredit accounts.

Nykredit Realkredit's plan involves focusing on homeowners and increasing its market share in traditional retail products, while also continuing to develop its partnership with local Danish banks through its subsidiary, Totalkredit.

Over the short to medium term, we expect the group's strategic focus will remain on increasing revenues by acquiring more full-service clients and improving cost efficiency.

Table 3

Nykredit Realkredit A/S Business Position					
		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Loan market share in country of domicile	30.7	30.8	30.6	31.0	31.4
Deposit market share in country of domicile	4.7	5.5	5.1	5.5	5.8
Total revenues from business line (currency in millions)	8,785	12,653	12,636	8,120	10,803
Commercial banking/total revenues from business line	14.6	14.5	19.3	8.6	15.3
Retail banking/total revenues from business line	56.9	64.8	68.5	77.5	62.9
Commercial & retail banking/total revenues from business line	71.5	79.3	87.8	86.1	78.2
Asset management/total revenues from business line	6.9	8.2	6.4	9.7	7.3
Other revenues/total revenues from business line	21.6	12.6	5.8	4.3	14.5
Return on equity	15.5	8.3	5.3	(0.5)	2.9

*Data as of June 30. DKK--Danish krone.

Capital and earnings: Retained earnings support steady capital built over many years

We expect Nykredit Realkredit's capital and earnings will remain strong. This reflects our expectation that the company's RAC ratio--which stood at 12.6% on June 30, 2017, from 11.6% at year-end 2016--will remain sustainably above our 10% threshold over the next 18-24 months (excluding any proceeds from the eventual IPO). These ratios are calculated using our recently updated capital methodology (Risk-Adjusted Capital Framework Methodology, July 20, 2017). In our measure of total adjusted capital, we include the €500 million additional tier 1 instrument issued in early 2015 and the €600 million tier 2 contingent capital instruments issued in May 2014 as hybrids. This last instrument is one of the few tier 2 instruments globally that we consider as going concern contingent capital. As such, our residual life requirement for including this instrument in our calculation of capital is at 15 years. However, in line with our revised methodology, we exclude from Nykredit's total adjusted capital the equity investment it holds--which we deem significant--in non-consolidated financial institution subsidiaries (in particular DLR Kredit and Spar Nord).

We believe Nykredit Realkredit will be able to further build capital internally--and later through the proposed IPO--to satisfy higher regulatory requirements. Nykredit Realkredit targets a CET1 capital level of 17.5% in 2019 and reported a ratio of 20.9% on June 30, 2017, from 18.8% at year-end 2016. We note that this target could be reduced as a result of the IPO. Our capital assessment is supported by our expectation that the management will deliver on its plan to generate annual net profits of about DKK5 billion-DKK5.5 billion in 2017 and 2018, already achieved for 2017 in the first half of the year. We consider the quality of capital to be high, as 7% capital trigger hybrids form around 12% of total adjusted capital.

We anticipate higher capital requirements because we expect the implementation of a capital floor for institutions under Institutional Review Board regulation, as well as the introduction of floors to the parameters used in the internal models (probability of default and loss-given default), leading to higher capital requirements for mortgage loans. We acknowledge that Nykredit Realkredit is preparing to increase capital levels through its IPO to be able to meet the regulatory requirements, which further underpin our forecast of a RAC ratio comfortably higher than 12% over the next 24 months.

Nykredit Realkredit's dual objective strategy is intended to improve the group's core business result by 2018, ahead of its expected IPO process. The strategy aims to increase earnings through higher margins and increased revenues by capturing more full-service customers with additional income streams. Reported net interest margins have increased from 0.76% in 2013 to 0.87% in June 2017, an improvement accelerated by the revised fees that took effect on Nykredit Realkredit's mortgage book in July 2016. However, we now expect only limited further margins over 2018-2019, with persisting pressure on part of the bank's loan book, such as in corporate and institutional banking. We expect the group will be able to limit cost increases to achieve a stable cost-to-income ratio between 40%-45% over the next two years and maintain a low level of impairments.

Nykredit Realkredit's core earnings capacity is stable, in our view, given that the group predominantly depends on recurring interest income and that realized credit losses--apart from the acquisition of the problematic Forstaedernes Bank in 2008--were well below our normalized annual loss level of DKK3.9 billion as of 2016. With volume growth limited by low market demand, the group has focused on margins and cost efficiencies. Core earnings to adjusted assets was at an exceptional 0.89% on June 30, 2017, mostly driven by asset valuation and return in the bank investment portfolio, from 0.37% at year-end 2016 and 2015. We expect the ratio to return to those historical levels in coming years.

Table 4

Nykredit Realkredit A/S Capital And Earnings

		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Tier 1 capital ratio	22.0	19.9	20.5	17.2	18.9
S&P Global Ratings' RAC ratio before diversification	12.6	11.6	11.0	10.4	10.2
S&P Global Ratings' RAC ratio after diversification	10.4	9.5	10.0	9.4	9.3
Adjusted common equity/total adjusted capital	89.4	88.6	87.9	83.0	88.9
Double leverage	54.5	54.7	54.4	51.2	52.6
Net interest income/operating revenues	66.3	93.4	94.0	139.8	95.6
Fee income/operating revenues	(1.8)	(2.4)	(1.6)	0.6	(2.2)
Market-sensitive income/operating revenues	36.8	7.2	6.0	(42.8)	3.7
Noninterest expenses/operating revenues	25.5	42.2	39.3	61.8	49.9
Preprovision operating income/average assets	0.9	0.5	0.5	0.2	0.4
Core earnings/average managed assets	0.8	0.4	0.4	0.0	0.2

*Data as of June 30. RAC--Risk-adjusted capital.

Table 5

Nykredit Realkredit A/S Risk-Adjusted Capital Framework Data

(DKK 000s)	**Exposure (1)**	**Basel II RWA (2)**	**Average Basel II RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	56,041,799	0	0	1,109,394	2
Institutions and CCPs	50,512,774	7,365,872	15	7,621,504	15

Table 5

Nykredit Realkredit A/S Risk-Adjusted Capital Framework Data (cont.)					
Corporate	315,501,392	158,521,496	50	223,569,392	71
Retail	919,664,797	110,694,501	12	286,270,656	31
Of which mortgage	870,904,324	91,125,866	10	249,594,433	29
Securitization (3)	0	0	0	0	0
Other assets (4)	3,362,585	3,362,585	100	3,782,909	113
Total credit risk	1,345,083,348	279,944,454	21	522,353,854	39
Total credit valuation adjustment	--	649,999	--	0	--
Market risk					
Equity in the banking book	2,402,886	14,409,487	600	19,545,124	813
Trading book market risk	--	21,891,496	--	37,351,608	--
Total market risk	--	36,300,983	--	56,896,732	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	21,245,944	--	29,427,944	--
(DKK 000s)		**Basel II RWA**		**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification	--	338,141,380	--	608,678,530	100
Total Diversification/Concentration Adjustments	--	--	--	132,001,926	22
RWA after diversification	--	338,141,380	--	740,680,455	122
(DKK 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		74,715,397	22.1	76,807,260	12.6
Capital ratio after adjustments (5)		74,715,397	22.1	76,807,260	10.4

(1)EAD: Exposure at default. (2)RWA: Risk-weighted assets. (3)Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. (4)Other assets include deferred tax assets (DTAs) not deducted from ACE. (5)For Tier 1 ratio, adjustments are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RW--Risk weight. RAC--Risk-adjusted capital. DKK--Danish krone. Sources: Company data as of June 30, 2017, S&P Global Ratings.

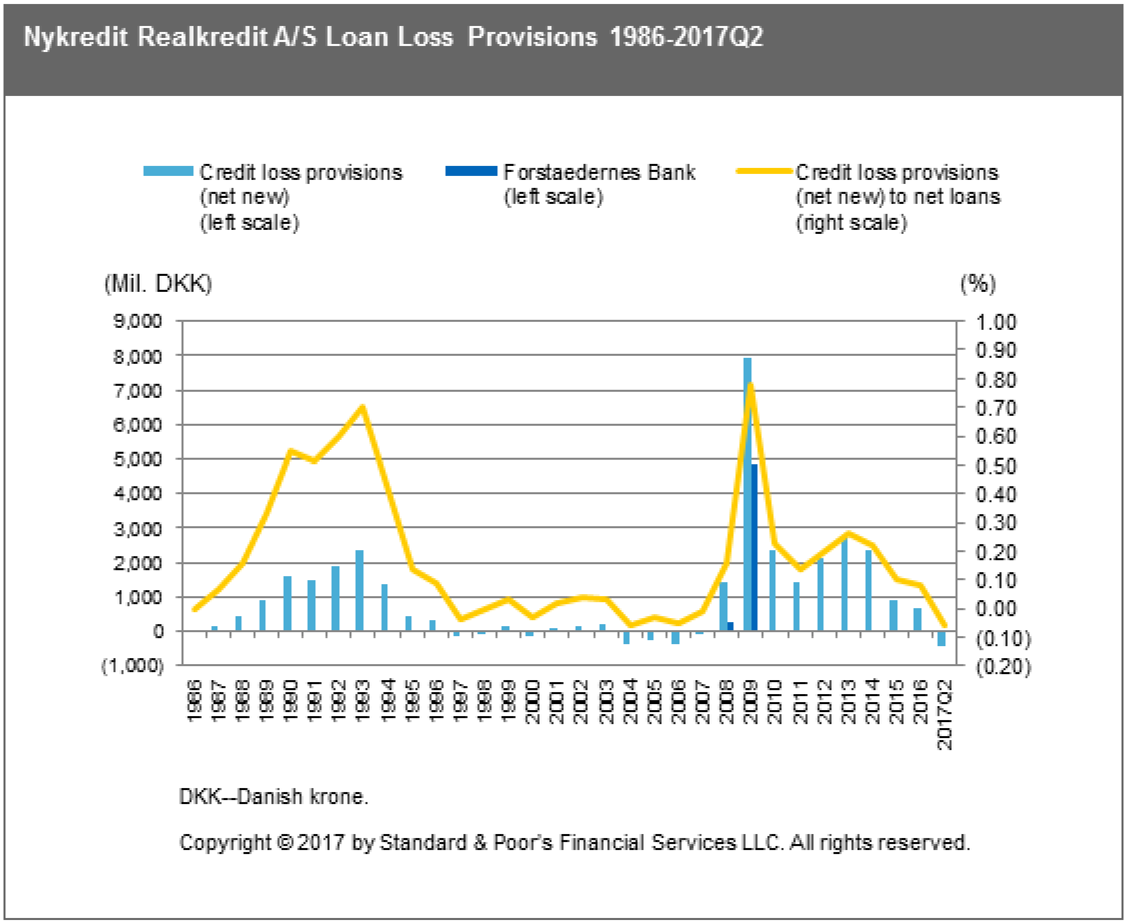
Risk position: First-priority mortgages with relatively low losses

Our analysis of a bank's risk position serves to refine the view of its actual and specific risks beyond our capital and earnings assessment. Our assessment reflects that we expect Nykredit Realkredit's asset quality to remain comparable with that of its peers--both domestically and internationally--and aligned with the capital requirements we apply as part of our analysis of capital for its portfolio of mainly retail and commercial mortgages.

As a consequence of the group's position as the country's largest mortgage lender, Nykredit Realkredit's asset quality has a strong correlation between developments in the Danish economy and the domestic property market. When the crisis began in 2008, losses mounted in line with a rise in bankruptcies and property foreclosures and continued with sizable losses in 2009, due in large part to the acquisition of Forstaedernes Bank (see chart).

However, the economy in Denmark is recovering and both foreclosures and bankruptcies are on a clear positive trend toward recovery. Nykredit Realkredit had net reversal of 6 bps of average customer loans in the first half of 2017, part of which was driven by the positive settlement of two large cooperative exposures. We expect Nykredit Realkredit to return to its 2015-2016 provision level in the next two years, remaining between 8 bps-11 bps of loans, given the low interest rate environment and the slow but steady recovery of the rural housing markets in Denmark.

Chart 1



Nykredit Realkredit A/S Loan Loss Provisions 1986-2017Q2

DKK--Danish krone.

The bank's mortgage portfolio includes personal customers, which form 61% of the mortgage loans; commercial loans form 31% and agriculture loans the remaining 8%. Overall, the loan-to-value (LTV) ratio for the entire mortgage loan book was around 63% at June 2017, from 65% a year earlier. We consider the risk management practices as adequate and believe the management is prudent in its lending and underwriting standards.

The agricultural sector in Denmark continues to trail the broader economy despite being on an improving trend. Combined with high initial leverage, the sector has seen an elevated number of defaults over the past five years. In particular, we note a positive price trend for milk farmers since 2016, but these sectors remain volatile. Arrears over 75 days have been increasing from about 0.5% in December 2013 to slightly above 1% in December 2016, mostly driven by cattle and pork producers, but 15 and 45 days past dues are on the decrease since the second half of 2016. We continue to expect Nykredit Realkredit, which is the first-lien mortgage lender, to be in a relatively good position and its portfolio of DKK95 billion to be well-provisioned for any future bankruptcies in the sector. In addition, the bank has a lower LTV limit of 60% for agriculture mortgage loans and the average LTV was 58% at June 2017.

In October 2013, Denmark's financial supervisory authority Finanstilsynet adjusted provisioning requirements for swap contracts with weak counterparties within the "Andelsboligforeninger" sector (cooperative housing associations). As of June 31, 2017, the total accumulated impairment provisions for valuation changes in interest rate swaps amounted to DKK3.3 billion. The reason for the provisions derives mainly from the increasing market values of 30-year swap contracts as interest rates have come down, leading to a less favorable position for borrowers. We believe that the current swap provisions more than cover the outstanding value of swaps for the small number of cooperatives where a default would be likely. Furthermore, in the second quarter of 2017, DKK1,005 million of profit was attributable to the settlement of two large housing cooperative exposures, where the property sale generated one-off income in the form of reversed loan impairment of DKK266 million and recovery of losses on swap transactions of DKK739 million. We also note no significant rise in the number of failing housing cooperative, and that the Danish Ministry for Industry, Business and Financial Affairs has set up a working group for the purpose of creating a solid foundation for a sound and stable cooperative housing sector.

We consider Nykredit Realkredit's concentration and diversity as adequate. Since Nykredit Realkredit is the largest mortgage lender in Denmark, mortgage loans form 83% of the total asset size of Nykredit Realkredit as of June 30, 2017, with 95% of exposures within Denmark and the remaining 5% in Sweden, Germany, and other European countries. Within Denmark, the loans are well diversified.

Table 6

Nykredit Realkredit A/S Risk Position

		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	2.9	1.2	(1.9)	0.4	(0.1)
Total diversification adjustment / S&P Global Ratings' RWA before diversification	N.M.	9.9	9.7	10.6	9.4
Total managed assets/adjusted common equity (x)	19.3	21.2	22.8	26.2	25.7
New loan loss provisions/average customer loans	(0.1)	0.1	0.1	0.2	0.3
Net charge-offs/average customer loans	0.0	0.0	0.0	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	2.2	2.4	2.6	2.4	2.4
Loan loss reserves/gross nonperforming assets	27.4	28.7	28.6	31.4	29.8

*Data as of June 30. RWA--Risk-weighted assets. N.M. Not meaningful.

Funding and liquidity: Price initiatives having a substantial positive impact on funding imbalances

Since 2012, Nykredit Realkredit has materially extended the term structure of its funding, primarily in the form of covered bonds, as it prepares for tightened regulations with respect to the share of short-term loan refinancing. Through pricing incentives and a flat yield curve, Nykredit Realkredit has reduced the share of one-year adjustable-rate mortgages (and corresponding one-year covered bonds, thanks to the match principle) to DKK64 billion (6% of portfolio; approximately €8.6 billion) on March 31, 2017, from DKK300 billion (27% of portfolio) at the end of 2012. With this reduction, Nykredit Realkredit has positioned itself well to abide by the supervisory diamond for mortgage banks, requiring a mortgage bank to have only 25% of its issued bonds maturing within a year.

Table 7

Nykredit Realkredit A/S Funding And Liquidity Metrics

Outstanding One-Year ARM Loans

	2017Q2	2016	2015	2014	2013
Stable funding ratio (%)	89	90	86	77	76
Broad liquid assets/short-term wholesale funding (x)	0.5	0.59	0.49	0.41	0.36
Stock of outstanding 1-year ARM loans (DKK billion)	62	69	120	242	299

ARM Loans--Adjustable resetting mortgage loans. DKK--Danish krone.

On Dec. 31, 2016, Nykredit Realkredit's ratio of broad liquid assets as a share of short-term funding (BLAST) was 59%, against 31% in 2012. Over the same period, its stable funding ratio improved to 90% from 70%. In our base case, we think Nykredit Realkredit will continue to reduce the structural mismatch of asset and liability maturities over time. However, important legacy refinancing in late 2017 is momentarily causing a halt to this improvement of the BLAST and stable funding ratios at mid-year 2017, at 50% and 89% respectively. The trend is to become positive again in 2018, but we expect this long-term improvement to happen only gradually.

While these ratios remain weaker than those of Nykredit Realkredit's international peers, we compare the ratios to the bank's local mortgage bank peers and consider the importance of supporting characteristics of the Danish covered bond market. In particular, we note that the balance principle results in a high degree of duration and cash flow matching (in addition to interest rate and currency matching) and that the industry and the regulator have worked to reduce the volume of one-year bond refinancing significantly, resulting in longer and more balanced debt maturity profiles. In our view, this improvement in stability is complemented by the 2014 Danish covered bond legislation that extends bond maturities by 12 months in the event of a failed auction, thus effectively passing refinancing risks to investors and repricing risks onto borrowers. In addition, we note that the Danish covered bond market--a key investment target for Danish pension funds--has, over its long history, continued to perform well in several crisis situations, not least during 2008. We expect pension funds' demand for low-risk domestic assets to continue to support stable demand for Danish covered bonds.

Moreover, our ratio calculation does not currently give credit to the fact that some covered bonds maturing within a year--and are therefore considered short-term funding--could already be pre-auctioned with a forward settlement, or could be linked to a planned installment on the borrower side. We estimate that giving credit to these Denmark-specific features in our ratio calculation would currently improve our BLAST ratio between 5 bps and 10 bps, and our stable funding ratio by around 2 bps.

For all these reasons, we consider Nykredit Realkredit's funding and liquidity as neutral rating factors, despite somewhat lower S&P Global Ratings metrics. We will likely maintain this assessment as long as the institution does not return to a higher reliance on short-term wholesale funding.

Table 8

Nykredit Realkredit A/S Funding And Liquidity

		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	5.5	5.1	4.9	4.9	5.0

Table 8

Nykredit Realkredit A/S Funding And Liquidity (cont.)					
		--Year ended Dec. 31--			
(%)	2017*	2016	2015	2014	2013
Customer loans (net)/customer deposits	1,726.4	1,804.5	1,863.4	1,822.0	1,817.3
Long term funding ratio	80.7	80.1	77.8	68.3	69.2
Stable funding ratio	88.7	89.8	86.4	77.3	76.3
Short-term wholesale funding/funding base	20.5	21.1	23.4	33.3	32.3
Broad liquid assets/short-term wholesale funding (x)	0.5	0.6	0.5	0.4	0.4
Net broad liquid assets/short-term customer deposits	(198.8)	(180.2)	(256.2)	(428.1)	(453.6)
Short-term wholesale funding/total wholesale funding	21.5	22.1	24.5	34.7	33.8
Narrow liquid assets/3-month wholesale funding (x)	1.4	1.5	1.3	1.1	0.8

*Data as of June 30.

Support: One notch of ALAC support on ALAC over 5% in June 2017

We include one notch of uplift in the long-term rating on Nykredit Realkredit based on our assessment of its ALAC. Based on Nykredit's outstanding ALAC-eligible instrument--namely additional tier 1, tier 2 and tier 3 senior resolution notes--we calculate that the bank's ALAC buffers exceed 500 bps of S&P Global Ratings' risk weighted assets, and we expect the bank to durably remain above this threshold. This includes the bank's four issuances of a total €1,800 million in tier 3 senior resolution notes (Nykredit Realkredit's Proposed Senior Subordinated Tier 3 Notes Rated 'BBB+', May 26, 2016). In addition to the tier 3 instruments, we include all of Nykredit Realkredit's junior subordinated and non-deferrable subordinated debt instruments (excluding those required for a strong capital and earnings assessment) in our ALAC assessment. We do this because, over our projection period, we believe these instruments have the capacity to absorb losses without triggering a default on Nykredit Realkredit's senior obligations. Nykredit Realkredit issued three ALAC-eligible instruments in 2015: additional tier 1 capital of €500 million, and two tier 2 instruments of €800 million and €50 million. We expect the ALAC will continue to grow to above 5% in 2018 as the bank retains additional earnings, thus improving ALAC further as Nykredit Realkredit prepares for its IPO. Also, we expect the bank to satisfy the debt buffer of 2% of unweighted loans imposed by Danish authorities on the mortgage banks. Given that Danish mortgage banks are exempt from the bail-in powers under the bank recovery and resolution directive (BRRD), the Danish authorities have established a 2% buffer of unweighted loans for mortgage banks--to be gradually phased in over five years from 2016 until 2020--in addition to their capital requirements. We expect this buffer will be used in a resolution scenario.

Although we currently include one-notch positive adjustment for ALAC support from the 'a-' SACP, we note that a successful IPO could improve our assessment of the bank's capital and earnings, which would bolster Nykredit Realkredit's SACP. However, this would reduce the excess capital in Nykredit Realkredit's ALAC buffers, likely prompting us to remove the additional notch for ALAC support.

We view Denmark's resolution regime as effective under our ALAC criteria because, among other factors, we believe it contains a well-defined bail-in process. Under this process, authorities would permit non-viable systemically important banks to continue critical functions as going concerns following a bail-in of eligible liabilities.

Additional rating factors: None

No additional factors affect this rating.

Core subsidiaries: Nykredit Bank A/S and Totalkredit A/S

We equalize the rating on core subsidiary Nykredit Bank A/S, Nykredit Realkredit's banking subsidiary, with the ratings on Nykredit Realkredit, according to our group methodology. Nykredit Bank, the group's banking arm, is integral to the group for its payment services and market activities in relation to its funding operations. It also provides all the banking services that are not performed by the parent company.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- The Danish Mortgage Sector Solved The Immediate Problem Of Interest-Only Mortgages, But Remains Vulnerable To Housing Slumps, Sept. 12, 2017
- Nordic Banks Continue To Outperform European Peers On Capital Thanks To Steady Retained Earnings And Hybrid Issuance, July 12, 2017
- Nordic Banking Regulation Compared, July 10, 2017
- Banking Industry Country Risk Assessment: Denmark, Dec. 19, 2016
- Nykredit Realkredit's Proposed Senior Subordinated Tier 3 Notes Rated 'BBB+', May 26, 2016
- Bulletin: Nykredit Realkredit's Planned Capital Strengthening Initiatives Have No Immediate Rating Impact, Feb. 4, 2016
- Various Rating Actions On Four Danish Banks After Review Of Government Support And Additional Loss-Absorbing Capacity, July 13, 2015
- Various Rating Actions On Danish Banks On EU Bank Recovery And Resolution Directive To Be Implemented In Denmark, May 12, 2015
- Credit FAQ: The Danish Covered Bond Market Explained, July 15, 2014
- Credit FAQ: Why Denmark's Proposed Covered Bond Law Doesn't Fully Eradicate Refinancing Risks, Feb. 4, 2014

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	**3**	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	**bbb+**	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of November 1, 2017)

Nykredit Realkredit A/S	
Counterparty Credit Rating	A/Stable/A-1
Junior Subordinated	BB+
Junior Subordinated	BBB
Senior Secured	AA-/Stable
Senior Secured	AAA/Stable
Senior Unsecured	A
Short-Term Debt	A-1
Subordinated	BBB
Counterparty Credit Ratings History	
08-Jul-2016	A/Stable/A-1
13-Jul-2015	A/Negative/A-1
12-May-2015	A+/Watch Neg/A-1
19-Jul-2013	A+/Negative/A-1
Sovereign Rating	
Denmark (Kingdom of)	AAA/Stable/A-1+
Related Entities	
Nykredit Bank A/S	
Issuer Credit Rating	A/Stable/A-1
Certificate Of Deposit	
Local Currency	A-1
Senior Unsecured	A
Short-Term Debt	A-1
Subordinated	BBB
Totalkredit A/S	
Senior Secured	AAA/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and

Ratings Detail (As Of November 1, 2017) (cont.)

debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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