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Research Update:

Nykredit Realkredit A/S Affirmed At 'A/A-1'; Outlook Stable

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Overview

- Since 2012, Nykredit Realkredit has significantly reduced its reliance on short-term wholesale funding to a point that durably supports our adequate assessment of its funding and liquidity profile.
- At the same time, the bank has now accumulated a cushion of loss-absorbing instruments in resolution exceeding 5% of its risk-weighted assets.
- The bank continues to benefit from strong capitalization, low credit losses, and a dominant market position in Danish mortgage lending.
- We are therefore affirming our 'A' long-term and 'A-1' short-term ratings on Nykredit Realkredit and its core subsidiary, Nykredit Bank A/S.
- The stable outlook reflects our expectation that the bank's funding and liquidity profile, its capital and earnings, and its level of additional loss-absorption buffers will not materially deteriorate over our two-year rating horizon.

Rating Action

On June 20, 2017, S&P Global Ratings affirmed its 'A' long-term and 'A-1' short-term counterparty credit ratings on Denmark-based financial institution Nykredit Realkredit A/S (Nykredit Realkredit) and its core subsidiary Nykredit Bank A/S. The outlook on both banks is stable.

Rationale

The affirmation of the rating on Nykredit Realkredit 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.

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 Danish krone (DKK) 64 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.

On Dec. 31, 2016, Nykredit Realkredit's broad liquid assets accounted for 59% of its short-term funding, against 31% in 2012. Over the same period, its stable funding ratio improved to 90% from 70%. While these ratios remain weaker than those of international peers, we 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 extended 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.

For all these reasons, we consider Nykredit Realkredit's funding and liquidity as neutral rating factors, despite somewhat lower S&P Global Ratings-adjusted metrics for the bank. We will likely maintain this assessment as long as the institution does not return to a higher reliance on short-term wholesale funding. As legacy covered bond series mature, we expect a minor dip in our funding and liquidity ratios at year-end 2017, but we continue to foresee a somewhat higher long-term level for these ratios, owing to further reduction in the maturity concentrations of issued bonds.

Nykredit Realkredit has completed the issuance of €1.8 billion in senior resolution notes, thus managing to build a cushion of loss-absorbing instruments exceeding 500 basis points of S&P Global Ratings' risk-weighted assets. We expect Nykredit Realkredit to build its capital and additional loss-absorption capacity (ALAC) buffers thanks to retained earnings as it prepares for an IPO in the next year. As such, we include one notch of uplift in the long-term rating on Nykredit Realkredit based on our assessment of its additional ALAC. We note that a successful IPO could improve our assessment of the bank's capital and earnings, which could improve Nykredit's stand-alone credit profile (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 and having a neutral impact on the rating.

We view the combination of capital and risk as a strength for Nykredit Realkredit. The strong capitalization is reflected by our expectation that the bank's risk-adjusted capital (RAC) ratio, which as of Dec. 31, 2016, had increased to 11.6% from 10.9% a year earlier, will continue increasing above

12% over the next 18-24 months (excluding any proceeds from the eventual IPO) and remain sustainably above our 10% threshold. In addition, given Nykredit Realkredit's over 40% share of the Danish mortgage market, we believe that the asset quality of its loan book is well reflected in our capital analysis for its portfolio of mainly private individuals and some commercial mortgage loans.

On June 12, 2017, Nykredit participated in a voluntary offer, alongside a consortium of investors, to acquire all shares in the distressed Vestjysk Bank, including an 81% stake held by the Danish government. Nykredit Realkredit has committed to invest DKK125 million-DKK178 million, which could mean a 14.0%-19.9% ownership. At DKK125 million-DKK178 million, we view this as a relatively minor financial investment for Nykredit Realkredit, and do not expect an impact on Nykredit Realkredit's credit standing at this point.

Outlook

The stable outlook reflects our view that Nykredit Realkredit will not return to a higher reliance on short-term wholesale funding and will maintain its strong capital and 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 SACP and lower the rating. In addition, a downgrade could occur if ALAC buffers were to reduce due to a deterioration of Nykredit Realkredit's RAC ratio 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. Still, such a scenario would likely result in higher ratings on Nykredit's hybrid capital instruments, which are notched from the SACP.

Ratings Score Snapshot

Issuer Credit Rating	A/Stable/A-1
SACP	a-

Anchor	bbb+
Business Position	Adequate (0)
Capital and Earnings	Strong (+1)
Risk Position	Adequate (0)
Funding and Liquidity	Average and Adequate (0)
Support	+1
ALAC Support	+1
GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	0

Related Criteria

- 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: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- 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
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race, June 14, 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

- Banking Industry Country Risk Assessment: Denmark, Dec. 19, 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

Ratings List

Ratings Affirmed

Nykredit Realkredit A/S

Counterparty Credit Rating	A/Stable/A-1
Senior Unsecured	A
Subordinated	BBB
Subordinated	BBB+
Junior Subordinated	BB+
Junior Subordinated	BBB

Nykredit Bank A/S

Counterparty Credit Rating	A/Stable/A-1
Certificate Of Deposit	A/A-1
Senior Unsecured	A
Certificate Of Deposit	A-1

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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