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## Research Update:

# Danish Bank DLR Kredit Affirmed At 'BBB+/A-2'; Junior Subordinated Debt Downgraded To 'BB'; Outlook Remains Stable

### Primary Credit Analyst:

Sean Cotten, Stockholm (46) 8-440-5928; sean.cotten@standardandpoors.com

### Secondary Contact:

Alexander Ekbohm, Stockholm (46) 8-440-5911; alexander.ekbom@standardandpoors.com

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## Research Update:

# Danish Bank DLR Kredit Affirmed At 'BBB+/A-2'; Junior Subordinated Debt Downgraded To 'BB'; Outlook Remains Stable

## Overview

- We believe that Danish financial institution DLR Kredit's business position has weakened, while its earnings metrics have improved.
- We are affirming our 'BBB+/A-2' ratings on DLR Kredit A/S.
- We are also lowering our rating on DLR Kredit's junior subordinated debt to 'BB' from 'BB+' because the weakening of the business position leads to a lower stand-alone credit profile.
- The stable outlook reflects our view that the combined assessment of DLR Kredit's capital and risk position will likely improve sufficiently to offset the possible removal of government support from the ratings by year-end 2015.

## Rating Action

On July 18, 2014, Standard & Poor's Ratings Services affirmed its 'BBB+/A-2' long- and short-term counterparty credit ratings on Denmark-based DLR Kredit A/S. At the same time, we lowered our long-term rating on DLR Kredit's junior subordinated debt to 'BB' from 'BB+'. The outlook is stable.

## Rationale

The affirmation reflects our reevaluation of DLR Kredit's business position as moderate rather than adequate, and, simultaneously, our removal of the negative one-notch adjustment previously incorporated into the rating, relating to earnings metrics. The changes result in a weakening of the stand-alone credit profile (SACP) to 'bbb' from 'bbb+' and, as a result, a downgrade of DLR Kredit's junior subordinated debt instrument to 'BB' from 'BB+'.

Our assessment of DLR Kredit's business position as "moderate" reflects its comparatively narrow client base and revenues concentrated on lending to the Danish agriculture sector. In addition, Jyske Bank, which is DLR Kredit's largest owner (with nearly 10%) and also provides a substantial amount of loans, recently acquired its own mortgage company, BRFkredit. In our view, the merger creates some uncertainty for some of DLR Kredit's transferred business volumes from Jyske and places DLR Kredit in a relatively weaker business position.

While the merger may not significantly affect Jyske's transfer of agricultural loans to DLR Kredit initially, we believe that Jyske has an incentive to reduce its guarantees on loans with DLR Kredit and finance its commercial and residential real estate loans within its new group structure. We note that this could be mitigated to some degree by other owner banks prioritizing DLR Kredit ahead of BRFkredit for commercial and residential real estate financing.

We previously applied a negative one-notch adjustment to DLR Kredit's rating related to our concerns about the strength of earnings and weaknesses in the funding model. We have now removed this adjustment because DLR Kredit has further improved earnings metrics, in particular cost efficiency and profits as a share of revenues. In addition, we believe that the bank has started to address weaknesses in its funding model by introducing new products with longer maturities.

We still believe that DLR Kredit's funding and liquidity position compares negatively with that of international and domestic peers. In our view, DLR Kredit is more reliant on short-term funding and has a larger maturity mismatch of assets and liabilities than international peers. In our base case, we assume that DLR Kredit will gradually reduce this structural mismatch. An inability to do so could lead us to revise downward our assessment of funding.

Currently, we consider that DLR Kredit has "moderate" systemic importance in Denmark, which we view as "supportive" of private-sector commercial banks. As a result, and in line with our criteria, we include one notch of uplift in DLR Kredit's 'BBB+' issuer credit rating. If we perceived support as less predictable, we would likely remove this notch of uplift from the long-term rating. This would most likely arise from a reclassification of Denmark's support for private-sector commercial banks to "uncertain" under our criteria. Any decision to reclassify government support would be subject to our review of the final resolution legislation, technical standards, and other relevant information.

If, on the other hand, our view was that extraordinary government support may still be forthcoming to DLR Kredit, we could retain the notch of uplift in the long-term rating. This would be the case if the authorities publicly confirmed their supportive stance toward mortgage institutions, or if we believed that precautionary capital injections would still be likely under the new legislation to minimize the wider economic impact of the resolution of a systemically important bank. In this case, we might consider that Denmark remained "supportive" and that DLR Kredit retained "moderate" systemic importance.

## **Outlook**

The stable outlook reflects our view that DLR Kredit's strengthening SACP--from capital improving in line with its 2019 capital plan, strong loss sharing with the owner banks, and continued stable earnings--may offset the

possible removal of government support from the ratings. Specifically, we may remove the notch of uplift for extraordinary government support by year-end 2015 if we consider such support to be less predictable.

A positive rating action would require a positive trend in two factors. We could consider an upgrade if we believed that potential extraordinary government support for DLR Kredit is unchanged in practice, despite the introduction of bail-in powers and international efforts to increase banks' resolvability. In addition, if DLR Kredit continued to execute its capital plan as we expect and we became confident that its risk-adjusted capital ratio would rise to and exceed 15%, we could revise our assessment of its capital and earnings to "very strong" from "strong."

We could lower the ratings if DLR Kredit experienced a setback in its efforts to reduce the use of short-term wholesale funding, in particular the high share of loans it needs to refinance annually.

## Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB+/Stable/A-2	BBB+/Stable/A-2
SACP	bbb	bbb+
Anchor	bbb+	bbb+
Business Position	Moderate (-1)	Adequate (0)
Capital and Earnings	Strong (+1)	Strong (+1)
Risk Position	Moderate (-1)	Moderate (-1)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	+1	+1
Additional Factors	0	-1

## Related Criteria And Research

### Related Criteria

- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

## Related Research

- Denmark-Based DLR Kredit Affirmed At 'BBB+/A-2' Following Government Support Review; Outlook Remains Stable, April 30, 2014
- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
- Credit FAQ: Why Denmark's Proposed Covered Bond Law Doesn't Fully Eradicate Refinancing Risks, Feb. 4, 2014
- Banking Industry Country Risk Assessment: Denmark, Oct. 24, 2013

## Ratings List

### Downgraded

	To	From
DLR Kredit A/S Junior Subordinated	BB	BB+

### Ratings Affirmed

DLR Kredit A/S Counterparty Credit Rating	BBB+/Stable/A-2
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### Additional Contact:

Financial Institutions Ratings Europe; FIG\_Europe@standardandpoors.com

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