Research

Research Update:

Denmark-Based DLR Kredit Affirmed At 'BBB+/A-2' Following Government Support Review; Outlook Remains Stable

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Overview

- We consider that potential extraordinary government support for European banks will likely decrease as resolution frameworks are put in place.
- We are affirming our 'BBB+/A-2' counterparty credit ratings on Danish financial institution DLR Kredit A/S.
- The stable outlook reflects our view that DLR Kredit's stand-alone creditworthiness will likely improve sufficiently to offset the possible removal of government support from the ratings by year-end 2015.

Rating Action

As previously announced on April 29, 2014, Standard & Poor's Ratings Services affirmed its 'BBB+/A-2' counterparty credit ratings on Denmark-based DLR Kredit A/S. The outlook is stable.

Rationale

The affirmation follows the completion of our review of potential extraordinary government support for European banks (see "Standard & Poor's To Review Government Support In European Bank Ratings," published March 4, 2014, on RatingsDirect). We observe that European authorities are taking steps to increase the resolvability of banks and require creditors rather than taxpayers to bear the burden of the costs of failure (see "Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review," published on April 29, 2014). In the near term, we expect that governments will remain supportive of systemically important banks' senior unsecured creditors while resolution frameworks take shape. From January 2016, however, the EU Bank Recovery and Resolution Directive (BRRD) is set to introduce the mandatory bail-in of a minimum amount of eligible liabilities, potentially including certain senior unsecured obligations, before governments could provide solvency support. However, we understand that for mortgage banks in Denmark, bail-in mechanisms would not be applicable because most of the banks' debt issuance is in the form of senior mortgage-covered bonds. Instead, we expect that, if necessary, mortgage banks will be wound down using national laws based on the principles of other articles in the BRRD.

On March 19, 2014, the Danish authorities passed a law that stipulates the mandatory extension of short-term covered bonds should there be problems with refinancing activities (see "Credit FAQ: Why Denmark's Proposed Covered Bond Law Doesn't Fully Eradicate Refinancing Risks," published on Feb. 4, 2014). The same law also addresses the winding down of mortgage banks by aligning maturities of liabilities with underlying assets. However, we believe that certain instruments, for example, Section 15 bonds (junior covered bonds), might be susceptible to deferred payments or write-downs in certain circumstance.

All considered, we believe that the potential extraordinary government support available to DLR Kredit could be less predictable and potentially diminish within our two-year rating horizon.

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 our long-term rating on DLR Kredit. If we perceived support as less predictable, we would likely remove this notch from the 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 may consider that Denmark remained "supportive" and that DLR Kredit retained "moderate" systemic importance.

An additional factor is our view that DLR Kredit's funding and liquidity profile compares negatively with that of international and domestic peers. We have therefore made a downward adjustment of one notch, bringing the long-term rating to 'BBB+'. 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, and its inability to do so may lead us to revise our assessment of funding downward. However, we also see that the stability of DLR Kredit's revenues and low cost base continues to improve. We believe, therefore, that DLR Kredit's capital could approach or enter our "very strong" category over the next two years, which would support the current ratings.

In addition to our view of the stand-alone credit profile (SACP) and potential extraordinary government support, future rating actions on DLR Kredit may result from other factors.

The potential reduction of extraordinary government support would not affect our ratings on DLR Kredit's subordinated debt. We have long believed that subordinated creditors would not receive extraordinary government support in a stress scenario, and for that reason we already notch these instruments down from the SACP.

Outlook

The stable outlook reflects our view that DLR Kredit's strengthening SACP, from improved capital 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.

We could consider an upgrade if we believe 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 continues to execute its capital plan as we expect and we become more confident that it's risk-adjusted capital ratio will 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 experiences 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

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

Related Criteria And Research

Related Criteria

- Group Rating Methodology, Nov. 19, 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
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
- Credit FAQ: The Rating Impact Of Resolution Regimes For European Banks, April 29, 2014
- Standard & Poor's To Review Government Support In European Bank Ratings, March 4, 2014
- Credit FAQ: Why Denmark's Proposed Covered Bond Law Doesn't Fully Eradicate Refinancing Risks, Feb. 4, 2014

Ratings List

Ratings Affirmed

DLR Kredit A/S	
Counterparty Credit Rating	BBB+/Stable/A-2
Junior Subordinated	BB+

Additional Contact:
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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 Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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.