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DLR Kredit A/S

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DLR Kredit A/S

SACP	bbb+

\+

Support	+1

\+

Additional Factors	-1

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

GRE Support	0
Group Support	0
Sovereign Support	+1

Issuer Credit Rating
BBB+/Stable/A-2

Major Rating Factors

Strengths:	Weaknesses:
• A leading provider of financing to Denmark's agriculture industry. • A well-entrenched business model that generates stable revenue. • Robust capitalization compared with peers'.	• Concentration risk from the narrow business model. • Wholesale-based funding. • Structural mismatch of assets and liabilities.

Outlook: Stable

The stable outlook on Danish mortgage bank DLR Kredit A/S reflects Standard & Poor's Ratings Services' expectation that DLR Kredit will strengthen its capitalization, resulting in a risk-adjusted capital (RAC) ratio close to 15%. We believe DLR Kredit will continue to benefit from its position as the preferred and specialized product provider for its owner banks to the agriculture, cooperative housing, residential rental property, and commercial real estate sectors.

We could revise the outlook to positive over the next 24 months if DLR Kredit improved its funding and liquidity metrics, reduced its sensitivity to market confidence, sustained its current earnings performance, and continued building capital.

We could revise the outlook to negative or lower the ratings if economic deterioration, particularly in Denmark's agriculture sector, triggered a material increase in DLR Kredit's credit losses or nonperforming assets that exceeded industry averages.

Rationale

The ratings reflect our view of DLR Kredit's "adequate" business position as a leading provider of first-lien mortgage financing to Denmark's agriculture industry and its integration with its 70 owner banks, and its "strong" capital as we assess it by our RAC framework. The ratings also incorporate the company's "moderate" risk position, reflecting primarily its sector concentration in the agriculture industry, and its "average" funding and "adequate" liquidity profile, which balances DLR Kredit's reliance on wholesale funding against implicit support from its participation in the well-functioning Danish covered bond market.

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

Our bank criteria 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. The anchor for a commercial bank operating only in Denmark is 'bbb+'. The economic risk score reflects our view that Denmark is a politically stable, wealthy, and high-income country, which has suffered from weak economic growth and financial deleveraging since the 2008-2009 financial crisis. Although develeraging has come quite far, we still expect economic growth to be weak over the short to medium term. However, this is partly balanced by fiscal policy flexibility, due to still-manageable government debt. Moreover, Denmark has posted sizable current account surpluses for more than a decade, and we expect this to continue over the next few years.

We expect the fallout from the financial crisis to lead to increased consolidation, as weak institutions are either taken over by stronger competitors or eliminated from the market. Further bank failures in Denmark are a possibility, in our view. The Danish banking system has a fairly low share of core customer deposits, at 20% of total loans, and quite a high share of net external funding, at 18% of total loans. The latter is, however, related to the structure of the Nordic banking sector, with considerable cross-border activity. These higher-risk characteristics are partly offset by a well-developed domestic bond market that remained open and functioning throughout the financial crisis.

Table 1

DLR Kredit A/S Key Figures					
		--Year-ended Dec. 31--			
(Mil. DKK)	**2013***	**2012**	**2011**	**2010**	**2009**
Adjusted assets	141,472.0	148,886.7	154,946.4	144,532.8	149,329.5
Customer loans (gross)	135,792.6	135,970.0	133,560.7	132,897.0	130,908.1
Adjusted common equity	9,160.3	8,944.5	7,561.8	7,087.7	6,509.6
Operating revenues	437.9	894.3	703.9	634.8	811.9
Noninterest expenses	102.8	204.7	194.1	192.3	203.3
Core earnings	215.8	450.7	275.3	251.1	336.9

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

Business position: A product provider to Denmark's local and regional banks

DLR Kredit's business position is "adequate" reflecting the balance between its expected sustainable close cooperation with its 70 owner banks and its comparatively narrow client base and lending to the Danish agriculture sector. Its business model is to provide first-lien mortgage loans, mainly on agriculture properties. The loans are to clients in

Denmark and on a very limited scale to clients on the Faroe Islands and Greenland. DLR Kredit's assets totaled Danish krone (DKK) 141.5 billion (€19 billion at DKK7.44 to €1) on June 30, 2013.

The company has maintained a 30% share of the agriculture lending market over many years, which we expect to continue. Its client relationships are long term, although distribution is managed by the owner banks. Revenue is based primarily on net interest income, and after the Danish financial crisis started in 2008 the company has been able to counter increasing impairment costs with higher margins on lending. Our base-line forecast is that DLR Kredit will be able to maintain the higher lending margins achieved in 2012 and 2013, which should result in a stable bottom-line performance at a higher level than before the crisis.

The business model is concentrated in the agriculture industry. However, a large part of DLR Kredit's portfolio (about DKK40 billion or 30% of loans) is effectively residential real estate lending, as we understand many farmers do not only depend on farming, but have other stable income. We reflect this in our calculation of the RAC ratio.

The company does not pay dividends, but commissions to its owners for loan servicing. The owners' support for the company was illustrated by their decision in June 2012 to increase DLR Kredit's share capital by DKK500 million and raise DKK1.3 billion in hybrid Tier 1 capital. Furthermore, in December 2012 the owners made an additional rights issue of DKK432 million, and on Sept. 4, 2013, they increased share capital by another DKK545 million.

In all, DLR Kredit has been able to successfully generate revenue for its owners, while controlling its credit risk and improving its long-term value. We consider this strategy appropriate for the business focus. At the same time, we consider the owners' support critical to our assessment of DLR Kredit's business position. The company's business model is in our view well entrenched, and we don't expect it to change or any pressure from the owner banks to expand the business into new areas.

Table 2

DLR Kredit A/S Business Position

		--Year-ended Dec. 31--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Total revenues from business line (mil. DKK)	437.9	894.3	703.9	634.8	811.9
Return on equity	4.8	5.4	3.7	3.7	5.5

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

Capital and earnings: Recapitalization plan should result in higher RAC ratios through to 2019

Our view of DLR Kredit's capital and earnings as "strong" reflects the increase in total adjusted capital (TAC), resulting from retained earnings, planned rights issues, and issuance of Tier 1 hybrid capital instruments. The RAC ratio increased to 11.6% in 2012 from 8.21% in 2011, and we forecast it to reach nearly 15% over the next 18 months.

DLR Kredit launched a recapitalization plan in 2012, which runs until 2019 and will ensure that the company will be able to meet forthcoming regulatory capital requirements. We therefore expect DLR Kredit's core Tier 1 capital to rise gradually. The plan includes the repayment of hybrid instruments sold to the government during the crisis and other hybrid capital instruments, which is a requirement under EU law.

On balance, we forecast DLR Kredit's TAC to increase steadily until 2019, and combined with expected modest risk growth to result in a RAC ratio sustainably at the higher end of the 10%-15% range in 2015. We believe that DLR Kredit will report limited risk growth as we anticipate the Danish agriculture sector to continue its financial consolidation following 2004 to 2008, when debt increased markedly. Furthermore, we understand DLR Kredit, like most Danish banks, is keen to prepare early for higher regulatory capital requirements.

While we foresee mortgage lending remaining a low-margin business, margins have improved to about 100 basis points, and will likely stay close to this level over the next few years. The three-year average earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, is at about 25 basis points. This is low compared with international peers', but the normalized loss assumption we use to calculate this measure is conservative in view of the company's low losses since it began operations in 1960. Our normalized loss assumption is DKK574 million annually and the highest loss DLR Kredit reported over 2007-2012 was DKK159 million, in 2009. In our view, this supports our assumption that many agricultural and commercial facilities are lower risk, due to additional cash flows available for repayment.

Table 3

DLR Kredit A/S Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Tier 1 capital ratio	12.6	13.2	12.2	12.0	11.6
S&P RAC ratio before diversification	N.M.	11.6	8.2	N.M.	N.M.
S&P RAC ratio after diversification	N.M.	9.0	6.5	N.M.	N.M.
Adjusted common equity/total adjusted capital	87.6	87.3	100.0	100.0	100.0
Net interest income/operating revenues	157.8	138.4	176.4	134.9	129.0
Fee income/operating revenues	(25.0)	(21.2)	(42.4)	(43.7)	(29.5)
Market-sensitive income/operating revenues	(34.8)	(19.4)	(36.7)	5.3	(1.6)
Noninterest expenses/operating revenues	23.5	22.9	27.6	30.3	25.0
Preprovision operating income/average assets	0.5	0.5	0.3	0.3	0.4
Core earnings/average managed assets	0.3	0.3	0.2	0.2	0.2

*Data as of June 30. N.M.--Not meaningful.

Table 4

DLR Kredit A/S RACF [Risk-Adjusted Capital Framework] Data

(DKK 000s)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**Standard & Poor's RWA**	**Average Standard & Poor's RW (%)**
Credit risk					
Government and central banks	1,153,741	0	0	35,410	3
Institutions	29,445,054	5,348,563	18	6,442,484	22
Corporate	80,943,158	80,943,163	100	60,707,369	75
Retail	35,038,326	13,247,913	38	10,511,498	30
Of which mortgage	35,038,326	13,247,913	38	10,511,498	30
Securitization	0	0	0	0	0
Other assets	3,302,389	3,302,363	100	3,715,188	113
Total credit risk	149,882,668	102,842,000	69	81,411,948	54

Table 4

DLR Kredit A/S RACF [Risk-Adjusted Capital Framework] Data (cont.)

Market risk					
Equity in the banking book¶	54,977	109,950	200	377,967	688
Trading book market risk	--	3,449,988	--	5,174,981	--
Total market risk	--	3,559,938	--	5,552,948	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	1,395,575	--	1,341,450	--
(DKK 000s)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		107,797,513		88,306,346	100
Total adjustments to RWA		--		25,874,472	29
RWA after diversification		107,797,513		114,180,818	129
(DKK 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		14,220,914	13.2	10,244,500	11.6
Capital ratio after adjustments§		14,220,914	13.2	10,244,500	9.0

*Exposure at default. Securitisation exposure includes the securitisation tranches deducted from capital in the regulatory framework. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. DKK--Danish krone. Sources: Company data as of Dec. 31, 2012, Standard & Poor's.

Risk position: Stable performance counterbalances concentration in agriculture

Our assessment of DLR Kredit's risk position as "moderate" reflects its sector concentration in agriculture, on the one hand, and its stable portfolio composition and performance on the other. The company's loss experience during the financial crisis was better than the industry average, based in part on its portfolio of first-lien mortgage loans, its right to refuse loan applicants distributed from its owner banks, and first-loss guarantees from the distributing banks.

Although some agriculture businesses remain under pressure from economic conditions, interest rates will likely remain low and the portfolio's quality should in our view continue to benefit from this situation. Based on this, we forecast effective losses well below the normalized loss level of DKK574 million annually. The ratio of new loan loss provisions to average customer loans was 0.11% or DKK87 million in 2012 compared with an average of 0.09% in 2007-2011.

The owners' guarantees for DLR Kredit comprise one joint and several guarantee signed by all the owner banks with respect to the agriculture portfolio, and a loan-by-loan bilateral guarantee scheme covering all nonagriculture lending.

The guarantees on the agriculture portfolio stipulate that:

- DLR Kredit will incur a minimum first loss of DKK200 million or 1.5x the five-year average of losses; and
- If losses exceed this threshold in any one year, the owner banks will guarantee a maximum of 5x DLR Kredit's five-year average losses or 2.5% of the outstanding agriculture loans.

The company is therefore protected against a sudden decline in the credit quality of agriculture loans. But if losses increase for several consecutive years, the first-loss threshold increases, and DLR Kredit will have to absorb a larger portion of its credit losses. This is due to the gradual rise in the average loss reported if asset quality deteriorates. In addition, DLR Kredit has the right to set off commission payments against incurred losses and may do so retroactively for four years. We note that the guarantee has never been called as losses have been lower than the threshold. We see this as a factor that clearly distinguishes DLR Kredit from other market participants and an important buffer against risk.

The nonagriculture loan portfolio of DKK49 billion as of Dec. 31, 2012, is covered by guarantees on exposures with loan-to-value ratios of 35%-70% for commercial real estate and 60%-80% for residential rental property and cooperative housing. The aggregate value of these guarantees was DKK17.6 billion at year-end 2012.

Our RAC framework slightly overstates the risk of the loan portfolio because it cannot fully account for borrowers' additional income and the guarantee mechanisms.

Table 5

DLR Kredit A/S Risk Position					
		--Year-ended Dec. 31--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Growth in customer loans	(0.3)	1.8	0.5	1.5	7.2
Total diversification adjustment / S&P RWA before diversification	N.M.	29.3	26.2	N.M.	N.M.
Total managed assets/adjusted common equity (x)	15.4	16.6	20.5	20.4	22.9
New loan loss provisions/average customer loans	0.1	0.1	0.1	0.1	0.1
Net charge-offs/average customer loans	0.1	0.1	0.1	0.1	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.0	3.0	2.6	2.7	3.6
Loan loss reserves/gross nonperforming assets	N.M.	8.3	10.3	9.3	6.4

*Data as of June 30. N.M.--Not meaningful.

Funding and liquidity: Wholesale funding model reliant on implicit government support

In our view, DLR Kredit's funding is "adequate" and liquidity "average," reflecting the proven liquidity of the Danish covered bond market over the past several years of financial market turmoil. However, we also consider the industry's structural weakness that we associate with long-term loan commitments being financed by short-term borrowings. In this market, DLR Kredit is the smallest issuer, with DKK160 billion outstanding at year-end 2012.

DLR Kredit's funding and liquidity profile 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 between assets and liabilities than international peers. At year-end 2012, DLR Kredit's broad liquid assets represented only 0.13x its short-term wholesale funding, and the funding ratio was stable at 38.0%. Both ratios have been largely unchanged over the past three years, and reflect that the bank has insufficient short-term funds to meet payments due over the subsequent 12 months, but stable funding resources beyond that time frame.

Because we expect that the Danish government will provide ongoing support to systemically important financial institutions, we continue to assess DLR Kredit's liquidity position as neutral to the ratings. However, we note the ongoing debate in the Danish government about funding imbalances and the proposal by the committee on the regulation of systemically important financial institutions (SIFIs) to introduce measures that reduce maturity mismatches in the sector. We believe that changes to the regulatory framework for Danish banks will serve to reduce the banking sector's reliance on short-term refinancing, eventually leading to a material reduction in funding mismatches.

DLR Kredit's funding and liquidity ratios mainly reflect the Danish mortgage market, which is characterized by a widespread preference for one-year fixed-rate refinancing of 30-year loan commitments. This is further exacerbated by the "balance principle" regulation in Denmark, which requires domestic mortgage banks to refinance loans and bonds simultaneously, resulting in minimal balance-sheet liquidity. This makes Danish mortgage banks stand out against their Norwegian and Swedish peers, whose liability maturity profiles tend to be marginally longer than their asset profiles. We note that Danish regulations prevent banks from cooperating with each other on product design, which underlines regulators' important role in defining market boundaries. Should DLR Kredit's structural mismatch of asset and liability maturities decline as a consequence of regulatory changes or at the initiative of the bank, we expect a very direct positive impact on our core measures of funding and liquidity.

Table 6

DLR Kredit A/S Funding And Liquidity

		--Year-ended Dec. 31--			
(%)	**2013***	**2012**	**2011**	**2010**	**2009**
Core deposits/funding base	1.9	1.8	1.7	1.8	0.0
Customer loans (net)/customer deposits	5,601.8	5,654.8	5,501.0	5,580.1	N.M.
Long term funding ratio	37.6	35.6	38.5	39.6	48.5
Stable funding ratio	38.5	37.9	43.1	41.3	N/A
Short-term wholesale funding/funding base	67.5	69.3	64.8	63.7	54.0
Broad liquid assets/short-term wholesale funding (x)	0.1	0.1	0.2	0.1	N/A
Short-term wholesale funding/total wholesale funding	68.0	69.9	65.9	64.8	54.0
Narrow liquid assets/3-month wholesale funding (x)	0.1	0.2	0.3	0.2	N/A

*Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

External support: One notch of uplift for the likelihood of government support

We include one notch of uplift in the long-term rating because we consider DLR Kredit to have moderate systemic importance in Denmark. It is the country's seventh largest financial institution in terms of total assets.

We base our classification of DLR Kredit's systemic importance on the company's role as a jointly owned institution serving the 70 local and regional banks in Denmark, and its business position as a leading provider of financial services to the agriculture sector. The Danish government's committee on defining and regulating SIFIs has identified DLR Kredit as a possible SIFI because of its role as lender to the agriculture sector.

Additional rating factors: A one-notch deduction because DLR Kredit is an institution in transition

However, the rating on DLR Kredit is at the level of the SACP because we have removed a notch owing to the company's relatively short record of improved earnings and liquidity. Stronger sustainable earnings might lead us to reverse this negative adjustment, resulting in a higher rating. Conversely, DLR Kredit's inability to reduce its asset-liability maturity mismatch could weaken its funding and liquidity, causing us to maintain the downward adjustment.

Related Criteria And Research

- Banking Industry Country Risk Assessment: Denmark, May 7, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

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 September 5, 2013)	
DLR Kredit A/S	
Counterparty Credit Rating	BBB+/Stable/A-2
Junior Subordinated	BB+
Senior Secured	AAA
Senior Secured	AAA/Stable
Senior Secured	BBB+/Stable
Short-Term Secured Debt	A-1+
Counterparty Credit Ratings History	
19-Jul-2013	BBB+/Stable/A-2
07-Sep-2012	BBB+/Positive/A-2
18-Jun-2012	BBB+/Watch Pos/A-2

Ratings Detail (As Of September 5, 2013) (cont.)	
31-May-2012	BBB+/Stable/A-2
Sovereign Rating	
Denmark (Kingdom of)	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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