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Ratings

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Danmarks Skibskredit A/S

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Danmarks Skibskredit A/S

SACP	bbb	+	Support	0	+	Additional Factors	+1

Anchor	bbb+	
Business Position	Weak	-2
Capital and Earnings	Very Strong	+2
Risk Position	Adequate	0
Funding	Below Average	-1
Liquidity	Adequate	

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating
BBB+/Negative/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Very strong capitalization. • Sound risk management with conservative underwriting and prudent provisioning. • Superior funding metrics and strong liquidity buffers.	• Business and revenue concentration in the highly cyclical and ongoing very difficult shipping industry. • No access to central bank for funding needs.

Outlook: Negative

The negative outlook on Danmarks Skibskredit (DS), internationally known as Danish Ship Finance, reflects the ongoing difficulties in the international shipping and offshore markets and the potential for further deterioration in DS' asset quality metrics over S&P Global Ratings' two-year outlook horizon. In our base case, we assume DS will maintain its conservative risk profile as it reverses the downward trend in the loan book, report low realized loan losses, and demonstrate high-quality underwriting at this low point in the shipping cycle. Furthermore, we believe its relatively new ownership could expand the group's funding profile outside Denmark, but will not affect the conservative risk management.

We could lower the ratings if asset quality metrics do not improve in line with our expectations or if the issuer's share of exposures to Denmark and other lower risk countries declined materially. Furthermore, a significant weakening in DS' funding and liquidity metrics or a change to the prefunding strategy could lead us to remove our positive adjustment for the institution's superior performance relative to peers, leading us to lower the rating. We could revise the outlook to stable if operating and structural conditions in the shipping industry improved the outlook for DS' customers, resulting in a sustained improvement of DS' asset-quality metrics.

Rationale

We base our ratings on the characteristics of the operating company DS, which represents over 99% of the consolidated group assets. Our 'bbb' group credit profile (GCP) is based on its anchor of 'bbb+', the starting point of our ratings assessment for banks in Denmark, and its weak business position, reflecting its small size, narrow franchise, and concentrated business model on exclusive lending into ship financing (based on first-lien mortgage lending to the Danish shipping industry and select international shipping companies). This is partly mitigated by DS' successful operational track record and very strong efficiency in a highly volatile industry.

The ratings also reflect DS' very strong capital and earnings position and adequate risk position, because we believe that the bank remains a resilient and prudent shipping financier. This assessment incorporates our forecast of relatively stable risk-adjusted capital (RAC) ratios over the next two years, after 18.7% on a stand-alone basis at year-end 2018, well above our 15% threshold for a very strong assessment.

In our view, DS' strong capital position and risk-management performance, coupled with a strong risk culture of a conservative underwriting and provisioning policy that has resulted in a very strong track record of actual loan write downs versus peers in the segment, mitigate our concerns on its loan concentration risks in a very cyclical and capital-intense segment that continues to face a very difficult economic risk environment.

We consider DS' funding to be below average, since it has neither direct nor indirect access to central bank funding. DS is entirely wholesale-funded through bonds. It has a match-funded lending book fully backed by the issuance of wholesale mortgage bonds, based on the balance principle that requires strict matching of interest rates and currencies, which results in a funding ratio of 139% as of Dec. 31, 2017, significantly better than all its domestic peers. However, as of April 1, 2015, DS' bonds are no longer eligible for repurchase transactions with the central bank. Despite this, we regard DS' liquidity as strong, based on generous buffers of good quality liquid assets to adequately cover its short-term wholesale needs. This is indicated by a ratio of broad liquid assets to short-term wholesale funding at 3.4x on Dec. 31, 2017.

The stand-alone credit profile (SACP) is 'bbb', to which we add a one-notch upward adjustment, reflecting DS' superior funding metrics and resilience to stress and to lack of market access to funding compared with peers. We expect that DS will continue to manage its funding and liquidity risk far more conservatively than most direct peers, exemplified by fully matched loans and bonds. Similarly, we expect DS will continue demonstrating superior metrics and a stronger resilience to abrupt market dislocations, which partly offsets our concerns about lack of access to central bank funding.

We do not factor in any external support to DS' SACP. We consider DS to have low systemic importance in Denmark and, following the implementation of the bail-in provisions in the Bank Recovery and Resolution Directive in June 2015, we view government support as uncertain for senior unsecured creditors. As such, we do not add any notches to the issuer credit rating for government support.

Anchor:'bbb+', the same level for banks operating predominantly in Denmark

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) 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 '3'. In recent years, Danmarks Skibskredit A/S has diversified its lending to different countries and reduced its exposure to Danish counterparties. We assign an anchor of 'bbb+' by combining the weighted average economic risk of the countries where it lends, which we calculate as 3.3, with the industry risk score of 3 for Denmark.

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 continues to expand. Although this growth means that household debt as a share of GDP is decreasing, it remains one of the highest of all global BICRAs according to our metrics--and a constraint to our assessment of economic risk. However, credit conditions have been improving in recent years and we expect credit losses will remain low in 2018. While we observe a decline in the coverage of nonperforming loans, it remains higher than pre-crisis--in line with 2009 levels in nominal terms.

Our assessment of Denmark's industry risk is supported by the improvement seen in the banking sector's profitability over the past 10 years. We see this improvement as having been supported by cost efficiency measures, decreasing credit losses, and higher mortgage margins, rather than a generally higher risk appetite. We expect the sector as a whole--including lower yielding mortgage banks--to report a return on equity (ROE) of at about 11% in 2018, despite a negative central bank deposit rate. We note the banking sector's higher reliance than peers' on functioning wholesale markets. However, we also acknowledge the continued stability and strong track record of the Danish covered bond market. We view the regulatory environment in Denmark as in line with that of other EU countries.

Table 1

Danmarks Skibskredit A/S Key Figures					
	--Year-ended Dec. 31--				
(Mil. DKK)	**2017**	**2016**	**2015**	**2014**	**2013**
Adjusted assets	58,161	62,621	64,873	69,374	67,222
Customer loans (gross)	37,083	42,328	45,128	45,321	45,454
Adjusted common equity	9,041	8,944	9,955	9,955	9,568
Operating revenues	692	974	729	1,057	912
Noninterest expenses	143	122	114	99	99
Core earnings	334	188	413	1,568	477

DKK--Danish krone.

Business position: Good management, with significant revenue and business concentration

We expect DS' business profile to remain weak, because its small size, narrow franchise, and very concentrated business model (based on first-lien mortgage lending to the Danish shipping industry and select international shipping companies) leaves DS highly exposed to a structurally very cyclical industry. At the same time, however, we continue to believe that these risks are partly mitigated by management's strong expertise and intimate customer and asset knowledge in the international shipping industry, as demonstrated by a robust operational track record and very strong efficiency.

With total assets of DKK58.1 billion (€7.81 billion) at Dec. 31, 2017, and a 1% global market share in shipping, DS is expected to remain a small, specialized lender to the shipping industry that services a selection of very large clients by financing vessels against a first-lien mortgage. The largest share of lending is to shipping companies in Denmark (25%) followed by Germany (11%) and Norway (13%). The shipping loan portfolio will remain highly concentrated but tilted toward stronger ship owners, reflecting the company's unchanged dedicated strategy of working primarily with the best shipping companies, with diversified fleets--for example, more highly rated shipping operators able to manage difficult markets and adjust operating capacity. DS has approximately 75 clients, for which it finances over 550 vessels, exposing the institution to significant revenue concentration risk in a highly cyclical industry sector. Although we recognize that client concentrations are decreasing, we still view them as very high. The 10-largest customers represented 46% of the loan book in 2017, versus 66% in 2009.

Partly counterbalancing its narrow business franchise, DS has shown a strong operational track record and performed robustly since the 2009 downturn in global shipping markets. We also recognize DS' strong operating efficiency, as reflected by its cost-to-income ratio remaining average at 15% for the last five years, significantly outperforming the peer average of nearly 50%. This creates, in our view, a sound first line of defense against severe dislocations in the cyclical shipping industry and enables DS to maintain a conservative provisioning policy.

DS changed its ownership in late 2016. A consortium consisting of the private equity fund Axcel and the pension funds PFA and PKA now own approximately 33% each of 86.5% of DS' shares, through a newly formed holding company Danmarks Skibskredit Holding A/S. Den Danske Maritime Fund still holds 10% of the share capital and has a claim on 15% of net profits. We believe that the influence of the pension funds will ensure the stability of DS' future operations. In particular, we anticipate that the three parties will maintain equal representation on key decisions regarding the future of DS' stand-alone and consolidated capitalization, including the newly formed holding company. In line with expectations, we have not observed that the partial financial sponsor ownership led to higher risks related to financial policy or risk appetite, and our understanding remains that the new owners will preserve DS' business model and conservative underwriting practices. As a result we expect that the current business strategy will remain broadly intact and that the conservative management strategy and risk culture will stay in place.

Demand in the global shipping industry, especially in the segments of dry bulk, tankers, and containers, is expected to outstrip supply for the first time in several years. While we expect DS will remain a small player within a volatile niche market, we see its position and revenue generation as relatively stable and anticipate that its prudent provisioning and funding policies will support it during the sector's current challenges, given its own reputation and assortment of solid, profitable shipowners with diversified fleets.

Table 2

Danmarks Skibskredit A/S Business Position

	--Year-ended Dec. 31--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Total revenues from business line (currency in millions)	692	974	729	1,057	912
Commercial banking/total revenues from business line	100	100	100	100	100
Commercial & retail banking/total revenues from business line	100	100	100	100	100
Return on average equity	3.6	1.9	3.8	14.8	4.8

Capital and earnings: Very strong capitalization and earnings, benefiting from strong operating efficiency

We view DS' capital and earnings as very strong, primarily based on our expectations that the bank will maintain a superior loss absorption capacity relative to its concentrated business model. This is reflected in our projected risk-adjusted capital (RAC) ratio, our main measure for capital adequacy, remaining materially above our 15% threshold over the next two years.

We measure stand-alone RAC ratio at 18.7% at end-2017, up from 17.4% year-end 2016.We anticipate stable RAC ratios between 18.0%-18.5% over the next two years on our expectation of a moderate roughly 2% annual high quality loan book growth coupled with a stable higher dividend policy that limits earnings retention in capital.

While our main focus remains the rated entity's capitalization, we also consider the consolidated capital situation, including that of Danmarks Skibskredit Holding A/S. At the consolidated level, we calculate the RAC ratio as 15.6% at end-2017. This includes the same portion of the tied-up capital reserve as is eligible in regulatory capital at the consolidated level. This portion of tied-up capital at the group level is expected to increase as a proportion of risk. Therefore, including the remaining portion of the tied-up reserve would improve the capital ratio by 8.1 percentage points, which we see as supportive of our very strong capital assessment of the combined entity and meaningful for our combined view of risk and capital.

Table 3

Danmarks Skibskredit A/S Capital And Earnings

	--Year-ended Dec. 31--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Tier 1 capital ratio	19.7	17.2	17.3	16.4	17.0
S&P RAC ratio before diversification	18.7	17.4	18.0	19.4	19.9
S&P RAC ratio after diversification	10.6	9.9	11.9	11.8	3.9
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	91.8	83.9	118.7	77.6	97.7
Fee income/operating revenues	2.9	3.3	5.6	10.8	4.9
Market-sensitive income/operating revenues	5.3	12.7	(24.3)	11.6	(2.7)
Noninterest expenses/operating revenues	20.7	12.5	15.6	9.4	10.9
Preprovision operating income/average assets	0.9	1.3	0.9	1.4	1.1
Core earnings/average managed assets	0.6	0.3	0.6	2.3	0.6

Table 4

Danmarks Skibskredit A/S RACF [Risk-Adjusted Capital Framework] Data

(Mil. DKK)	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global RWA**	**Average S&P Global RW (%)**
Credit risk					
Government and central banks	824	153	19	25	3
Of which regional governments and local authorities	521	0	0	16	3
Institutions and CCPs	7,108	1,069	15	1,256	18
Corporate	37,876	36,438	96	36,786	97

Table 4

Danmarks Skibskredit A/S RACF [Risk-Adjusted Capital Framework] Data (cont.)					
Retail	0	0	0	0	0
Of which mortgage	0	0	0	0	0
Securitization§	0	0	0	0	0
Other assets†	982	975	99	1,520	155
Total credit risk	46,791	38,635	83	39,586	85
Credit valuation adjustment					
Total credit valuation adjustment	--	569	--	0	--
Market risk					
Equity in the banking book	11	21	200	84	789
Trading book market risk	--	4,597	--	6,895	--
Total market risk	--	4,618	--	6,979	--
Operational risk					
Total operational risk	--	1,497	--	1,825	--
(Mil. DKK)		**Basel III RWA**		**S&P Global RWA**	**% of S&P Global RWA**
Diversification adjustments					
RWA before diversification		45,319		48,390	100
Total Diversification/Concentration Adjustments		--		36,526	75
RWA after diversification		45,319		84,917	175
(Mil. DKK)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		8,930	19.7	9,041	18.7
Capital ratio after adjustments‡		8,930	19.7	9,041	10.6

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡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, 2017, S&P Global.

Risk position: Concentration risks in highly cyclical shipping industry well balanced by proven management of conservative underwriting and prudent provisioning

We expect DS' risk position to remain adequate or neutral to our rating assessment. We regard its key weakness as its very high loan concentration risk in the highly cyclical shipping industry, but we continue to view its very conservative underwriting and provisioning policy as a positive. DS has demonstrated a very strong and longstanding track record of actual loan write downs, materially better than peers in the segment. The combination of DS' strong capital position and effective risk-management performance mitigate its concentration in a very cyclical and capital-intense segment, in our view.

DS' lending is exclusively into ship financing, with 25% of the loans to Danish shipping companies, 13% to Norwegian, 14% to Greek, and 11% to German. We also continue to view DS' loan portfolio as concentrated in terms of single-name exposures; its top-10 customers formed 46% of the loan book at Dec. 31, 2017. We acknowledge the material improvement in this regard, from a 66% top-10 customer concentration as of Dec. 31, 2009.

Despite high concentration risks, DS has demonstrated a notably stable track record of low impairment losses that compares very well to peers'. For 2017, new provisions increased slightly but were only 0.31% of loans, and provisioning levels have averaged 1 bps in the last five years, which includes a large reversal of 243 bps in 2014. We forecast provisioning at about 30 bps to 35 bps of loans between 2018 and 2020 based on DS' ongoing strong underwriting quality, benefits from gradual improvements in some segments of the shipping industry, and in the absence of an unexpected event risk at any of the bank's larger customers. Our projections also acknowledge DS' prudent provisioning policy, for example by assuming stressed collateral values and 100% default probabilities for all customers showing evidence of impairment. This compares to 65 bps average provision of loans in 2010-2013 when the shipping industry, to which DS lends, had its worst downturn ever. The minimal impact on DS' realized losses results from what we believe to be very conservative underwriting standards, focusing on reputable counterparties with material fleet sizes.

We expect that DS' lending will remain focused on a select niche of relatively strong clients in the shipping segment and that the allowance account, which was increased to 6.99% of loans from 5.95% a year ago, will remain a strong cushion against future write-offs associated with the deep and persistent stressed shipping and offshore environment.

We note the historic actual write-offs for DS differ materially from the provisioning levels, with 31 bps of loans written off in 2017 compared to nonperforming loans of 15.9% (table 5). However, current provisions are 2.3 times 30 years of cumulative write-offs, an indication that the current stress in DS' key segments is significant. In our view, we see only gradual improvements from this downturn due to persistent oversupply concerns, low shipping rates, and offshore customers' continued low oil exploration and drilling activity.

Table 5

Danmarks Skibskredit A/S Risk Position

	--Year-ended Dec. 31--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	(12.4)	(6.2)	(0.4)	(0.3)	(7.7)
Total diversification adjustment / S&P RWA before diversification	75.5	76.1	51.1	64.2	415.5
Total managed assets/adjusted common equity (x)	6.4	7.0	6.5	7.0	7.0
New loan loss provisions/average customer loans	0.3	1.4	0.1	(2.4)	0.4
Net charge-offs/average customer loans	0.3	0.2	0.2	0.1	0.1
Gross nonperforming assets/customer loans + other real estate owned	15.9	16.5	9.2	8.7	15.1
Loan loss reserves/gross nonperforming assets	44.0	36.0	46.9	50.0	44.6

Funding and liquidity: Prefunding balances a narrow wholesale-based funding model

We expect that DS' funding remains below average, since it does not have direct or indirect access to central bank funding. At the same time, however, we expect DS' liquidity to remain strong, reflecting its high level of liquid assets to adequately cover its short-term wholesale needs.

DS is entirely wholesale-funded through bonds. It has a match-funded lending book fully backed by the issuance of wholesale mortgage bonds, based on the balance principle that requires strict matching of interest rates and currencies. This results in a stable funding ratio of 139% as of Dec. 31, 2017, which is significantly better than all its domestic peers. However, DS' bonds are, since April 1, 2015, no longer eligible for repurchase transactions with the central bank. The central bank's motivation is to decrease its administrative burden; Danish banks also have substantial mortgage bonds eligible for repurchase transactions with the central bank. We understand that no other direct or indirect access to the central bank is currently available to DS, which leads us to view DS' funding position as below average as prescribed by our methodology in cases where there is no central bank access as a lender of last resort in times of stress.

Despite this, we regard DS' liquidity as strong, based on generous buffers of good quality liquid assets. At year-end 2017, the company had DKK21.56 billion liquid assets in the form of bank deposits and liquid securities, almost exclusively consisting of repo-agreement-eligible 'AAA' rated covered bonds. The ratio of broad liquid assets to short-term wholesale funding stood at 3.4x at Dec. 31, 2017, with a five-year average of 2.9x in 2013-2017. DS could withstand a scenario where 30% of the portfolio is lost and make timely payments on outstanding debt for eight years without accessing wholesale markets. This is due to cash flows coming from performing loans and bonds that are fully matched, as well as the sizable liquidity portfolio amounting to DKK20.1billion (35% of the balance sheet) on Dec. 31, 2017. The regulatory liquidity coverage ratio was 520% for DS at end-December 2017.

Table 6

Danmarks Skibskredit A/S Funding And Liquidity

	--Year-ended Dec. 31--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Long term funding ratio	88.6	84.0	90.3	77.7	89.7
Stable funding ratio	139.2	118.3	122.6	114.3	135.6
Short-term wholesale funding/funding base	13.7	19.1	11.8	26.9	12.1
Broad liquid assets/short-term wholesale funding (x)	3.4	2.3	3.4	1.7	3.3
Short-term wholesale funding/total wholesale funding	13.7	19.1	11.8	26.9	12.1
Narrow liquid assets/3-month wholesale funding (x)	3.6	2.6	3.4	2.4	3.3

Support:

No uplift to the SACP, as no extraordinary support assumptions considered

We do not factor in any external support to DS' SACP. We consider DS to have low systemic importance in Denmark and, following the implementation of the bail-in provisions in the Bank Recovery and Resolution Directive in June 2015, we view government support as uncertain for senior unsecured creditors. As such, we do not add any notches to the issuer credit rating for government support.

Setting The ICR

Additional rating factors: One-notch uplift due to superior funding metrics

We add one notch of uplift to DS based on its superior funding metrics and resilience to stress or lack of market access to funding, even though it doesn't have access to the central bank for its funding needs. We expect that DS will continue to manage its funding and liquidity risk far more conservatively than most direct peers, exemplified by fully matched loans and bonds. Similarly, we expect DS will continue demonstrating superior metrics and a stronger resilience to abrupt market dislocations, which partly offsets our concerns about lack of access to the central bank.

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, Apr 07 2017
- General Criteria: Group Rating Methodology, Nov 19 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, Jul 17 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov 09 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov 09 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sep 14 2009

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 August 28, 2018)

Danmarks Skibskredit A/S	
Issuer Credit Rating	BBB+/Negative/A-2
Issuer Credit Ratings History	
28-Sep-2016	BBB+/Negative/A-2
04-Feb-2016	BBB+/Stable/A-2
Sovereign Rating	
Denmark	AAA/Stable/A-1+

*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 August 28, 2018) (cont.)

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