S&P Global Ratings

Research

Transaction Update: Danmarks Skibskredit A/S (Ship Covered Bond Program)

Skibskreditobligationer

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Ratings Detail

Reference Rating Level	a-
Resolution Regime Uplift	+1
Systemic Importance	Moderate
Adjusted Issuer Credit Rating	bbb+
GRE And Sovereign Support	0
Issuer Credit Rating	BBB+

+

Jurisdiction-Supported Rating Level	a
Assigned Jurisdictional Support Uplift	+1
Jurisdictional Support Assessment	Moderate
Legal Framework	Very Strong
Systemic Importance	Moderate
Sovereign Credit Capacity	Very Strong

+

Maximum Achievable Covered Bond Rating	a
Collateral Support Uplift	N/A
Overcollateralization Adjustment	-1
Liquidity Adjustment	-1
Potential Collateral Based Uplift	N/A

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Covered Bond Rating	A/Negative
Rating Constraints	a
Counterparty Risk	a
Country Risk	aaa

Major Rating Factors

Strengths	Weaknesses
• The covered bonds are issued in Denmark, which we consider to provide a very strong level of support to the mortgage covered bond product. • Although, the characteristics of the ship loans do not directly match the characteristics of the covered bonds, the issuer must comply with the Danish balancing principle. • The program benefits from a public commitment to maintain a level of overcollateralization of 10%.	• With the relatively small volume of outstanding ship covered bonds and the low importance for ship construction in Denmark our assessment of jurisdictional support is moderate. • No replacement language for counterparties limits the rating in line with our counterparty criteria. • No committed coverage of 180 days of liquidity.

Outlook: Negative

S&P Global Ratings' negative outlook on the 'A' credit ratings on Danmarks Skibskredit A/S' general capital center ship covered bonds reflects the negative outlook on the issuer credit ratings (ICR) on the the issuer, Danmarks Skibskredit A/S, as the covered bonds do not benefit from an unused notch of rating uplift under our covered bonds criteria (see "Covered Bonds Criteria," published on Dec. 9, 2014). Therefore, if we were to lower our long-term ICR on Danmarks Skibskredit, we would lower our ratings on the covered bonds, all else being equal.

Rationale

We are publishing this transaction update following our periodic review of the Danmarks Skibskredit general capital center ship covered program and related issuances.

Our covered bond ratings process follows the methodology and assumptions outlined in our "Covered Bonds Criteria" and "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

From our analysis of Danmarks Skibskredit's program documentation and the Danish legislative covered bond framework, we have concluded that the assets in the cover pool are isolated from the issuer's insolvency risk. The asset isolation allows us to potentially assign a higher rating to the covered bond program than our long-term ICR on the issuer.

We conducted a review of Danmarks Skibskredit's operations, which we view as prudent. We believe satisfactory operational procedures are in place to support our ratings on the covered bonds.

Danmarks Skibskredit, internationally known as Danish Ship Finance (DSF), is a Danish lender specializing in first-lien mortgage lending to the Danish shipping industry and select international shipping companies. As an issuer of covered bonds in Denmark, DSF is exempt from the EU's Bank Recovery and Resolution Directive (BRRD). We consider that DSF's covered bonds in this jurisdiction have a moderate systemic importance. These factors increase the likelihood that Danmarks Skibskredit would continue servicing its covered bonds without accessing the cover pool or receiving jurisdictional support, even following a bail in of its senior unsecured obligations.

Under our covered bonds criteria, we assess the reference rating level (RRL) as 'a-'. We then consider the likelihood of jurisdictional support for covered bonds backed by shipping collateral, in addition to considering the relatively small volume of such covered bonds. Our assessment of the total covered bond market--including mortgage-backed covered bonds--is very strong. As covered bonds backed by ship collateral fund less than 5% of the total estimated market of this asset type, we adjust the systemic importance by one category. in our view, ship collateral has lost importance for ship construction in Denmark, and we therefore believe that the sovereign would provide more support to mortgage-backed covered bonds than covered bonds backed by shipping assets, which play a smaller role for the general economy. Therefore, we further reduced our assessment of systemic importance to moderate. This leads us to apply one notch of uplift from the RRL to determine the jurisdiction-supported rating level (JRL), which we therefore assess as 'a' (see "Assessments For Jurisdictional Support According To Our Covered Bonds Criteria," published on

Oct 16, 2018).

The cover pool comprises loans secured by ships or ships under construction and a reserve fund. Our ratings currently do not reflect any collateral-based uplift because the replacement framework in the counterparty documentation is not in line with our counterparty criteria (see "Counterparty Risk Analysis In Covered Bonds," published on Dec. 21, 2015).

Therefore, under these criteria, our ratings on the covered bonds are constrained at 'A' and are not eligible for any of the potential four additional notches of collateral-based uplift. The four notches are potentially adjusted to two due to the lack of committed overcollateralization and 180 days' liquidity coverage.

We assess country risk by applying our structured finance ratings above the sovereign (RAS) criteria (see "Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published on Aug. 8, 2016). In light of our 'AAA' long-term sovereign rating on Denmark, country risk does not constrain our 'A' ratings on the covered bonds.

Program Description

Table 1

Program Overview*	
Jurisdiction	Denmark
Year of first issuance	1961
Covered bond type	Legislation-enabled
Covered bonds amount (bil. DKK)	43.3
Redemption profile	Hard bullet
Underlying assets	Ship mortgages
Jurisdictional support uplift	1
Unused notches for jurisdictional support	0
Available credit enhancement (%)	21.26
Credit enhancement commensurate with rating (%)	8

*Based on data as of September 2018. DKK--Danish krone.

Table 2

Covered Bond Program Participants

Role	Name	Rating	Rating dependency
Issuer	Danmarks Skibskredit A/S	BBB+/Negative	Yes
Collection/bank account provider	Danske Bank A/S	A/Negative/A-1	No
Bank account provider	Jyske Bank A/S	A-/Positive/A-2	No
Collection/bank account provider	Nordea Bank Abp	AA-/Stable/A-1+	No
Bank account provider	Skandinaviska Enskilda Banken AB	A+/Stable/A-1	No
Bank account provider	Svenska Handelsbanken AB	AA-/Negative/A-1+	No
Bank account provider	Sydbank A/S	NR	No
Swap counterparties (IR)	Bank of America Corporation	A-/Stable/A-2	No
Swap counterparties (CC)	Danske Bank A/S	A/Negative/A-1	No
Swap counterparties (IR)	Deutsche Bank	BBB+/Stable/A-2	No

Table 2

Covered Bond Program Participants (cont.)

Role	Name	Rating	Rating dependency
Swap counterparties (CC)	Jyske Bank A/S	A-/Positive/A-2	No
Swap counterparties (IR)	Natixis SA	A+/Stable/A-1	No
Swap counterparties (CC)	Nordea Bank Abp	AA-/Stable/A-1+	No
Swap counterparties (IR)	Nykredit Bank A/S	A/Stable/A-1	No
Swap counterparties (CC)	Royal Bank of Scotland PLC	A-/Positive/A-2	No
Swap counterparties (CC)	Skandinaviska Enskilda Banken AB	A+/Stable/A-1	No
Swap counterparties (IR)	Sydbank A/S	NR	No

CC--Cross currency. IR--Interest rate.

DSF is a small, specialized lender to the shipping industry that services very large clients by financing vessels against a first-lien mortgage, reporting total assets of DKK52.5 billion as of Sept. 30, 2018.

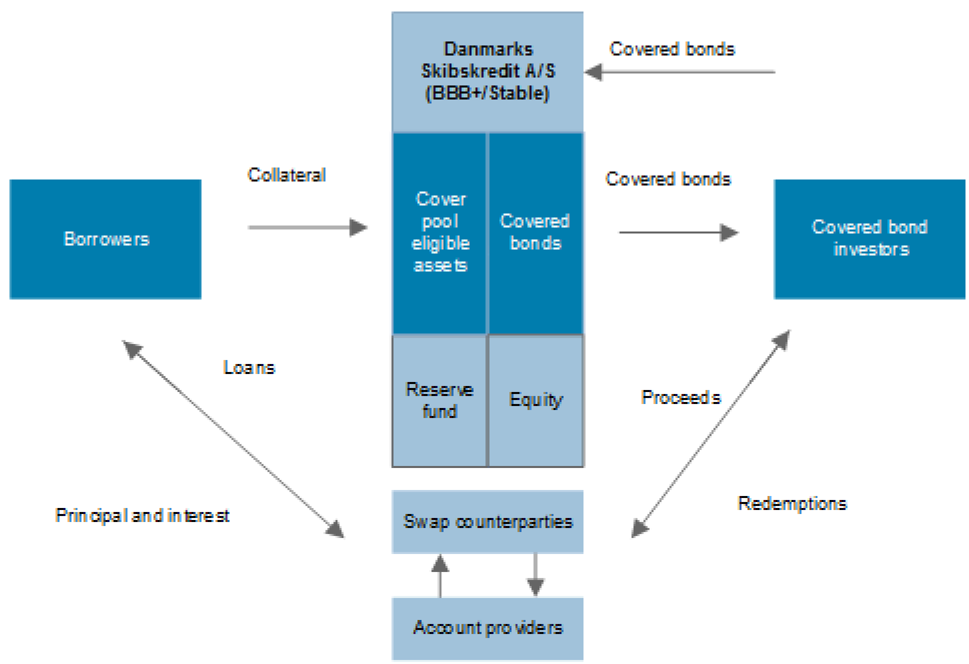
The loan portfolio is concentrated with the 10 largest exposures making up more than 40%, which reflects the company's chosen strategy of working primarily with select shipping companies, e.g., shipping operators the issuer considers able to manage difficult markets and adjust operating capacity. DSF has approximately 80 clients, for which it finances about 734 vessels, exposing the institution to significant revenue concentration risk in a highly cyclical sector. Although we recognize that client concentrations are decreasing, we still view them as very high. The 10 largest customers represented 43% of the loan book in 2018, down from 66% in 2009.

Partly counterbalancing its narrow business franchise, DSF has shown a strong operational track record also in the 2009 downturn in global shipping markets. We also recognize DSF' proven track record of issuing covered bonds in the Danish market. Under the covered bond program, DSF issues covered bonds denominated in Danish krone (DKK) and euro and primarily aimed for investors of the Nordic capital market. The Danish covered bond law governs each covered bond and the issuer's operations are under the supervision of the Danish financial services authority (FSA).

The mortgage borrowers pay into transaction accounts held with various counterparties. As there is no replacement language, in our view, there is a risk that if the issuer becomes insolvent, payments may be caught up in the default or default of the counterparties.

The issuer currently issues Danish ship covered bonds ("skibskreditobligationer" or SOs) but has a number of Danish covered bonds ("særligt dækkede obligationer" or SDOs) outstanding. These SDOs are grandfathered SOs (comparable to Danish Realkreditobligationer apart from the collateral), which received the designation SDO as the Danish covered bond law was changed in 2007 (the difference between SOs and SDOs are mainly the requirement to update the valuation of the collateral and that SDOs attract lower risk-weights. The issuer currently has no active issuance of SDOs.

Program Structure



Rating Analysis

Legal and regulatory risks

We base our analysis of legal risk on the guidelines in "Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017.

In our opinion, the Danish covered bond legal framework satisfies the relevant legal requirements of our covered bond criteria. This enables us to rate the covered bonds above our long-term ICR on the issuer.

SOs are issued in line with the same law as Danish mortgage covered bonds while the assets are regulated by the law and the executive order for ship finance. The covered bond framework was amended in 2008 to allow for the issuance of SDOs. The issuer has not sought approval for the issuance of SDOs, which can only be done from a new capital center (cover pool) as the law requires issuances of SOs and SDOs to be kept separate.

The issuer is regulated by the law "the consolidated act on a ship finance institute, executive orders for a ship finance institute bond issuance, balance principle and certain provisions in the Danish Financial business act. The law regulates how the issuer may originate loans and defines limits for maturity and amortization, currency/interest/liquidity risk, and overcollateralization requirements.

The Danish FSA regulates the issuer, inspections regularly occurs on the issuer's business address, and the FSA receives frequent reports from the issuer.

The cover pool comprises loans secured on ships or ships under construction, mainly in Europe and Northern America, and a reserve fund. Under the law, mortgages may be used as security up to a certain estimated value of the collateral of 70%. The loan-to-value (LTV) ratio can be higher if additional collateral is made available (the LTV above 70% must be covered by the overcollateralization in the capital center). LTV ratios up to 80% can be granted to customers of particularly good credit quality given the contract follows a format in line with the agreement for such contracts between the issuer and the Ministry of Business. Construction loans can be granted without security in ship collateral if security of a particularly high quality is pledged. Construction loan have higher risk weights compared with other assets when calculating the regulatory required overcollateralization, and the volume of construction loans cannot exceed 125% of the regulatory required overcollateralization.

There is minimum required overcollateralization of 8% of risk-weighted assets. The Danish covered bond law does not directly require that issuers cover 180 days of liquidity needs at all times, but the balancing principle requires that the issuer maintains sufficient liquidity to repay obligations as they come due.

An independent inspector monitors the cover pool as long as the issuer is solvent. The law does not provide for a separate cover pool administrator if the issuer becomes insolvent. Instead, the receiver-in-bankruptcy represents all investors and also regularly conducts special covered bond supervision.

Operational and administrative risks

In our opinion, systems and processes mitigate operational risk from the cover pool's management and loan origination that would otherwise constrain the covered bond rating to the same level as the long-term ICR.

Although there are currently no other specialized financers of ship finance, a number of Scandinavian and European banks remain active in the market. Therefore, we believe that it is highly likely that a replacement cover pool manager could be appointed if the issuer were to become insolvent. We consider Denmark to be an established covered bond market and we believe that the ship assets in the cover pool do not comprise product features that would materially limit the range of available replacement servicers.

Danmarks Skibskredit was founded on Dec. 22. 2003, replacing "Danmarks Skibskreditfond". Danmarks Skibskreditfond was established June 6, 1961, by Danish banks, insurance companies, shipping companies, shipyards--represented by their respective industry associations--and Danmarks Nationalbank (the Danish central bank).

DSF changed its ownership in late 2016. A consortium consisting of private equity and the pension funds now own approximately 86.5% of DSF's shares. "Den Danske Maritime Fund" still holds 10% of the share capital and has a claim on 15% of net profits.

All mortgage loan originations are made from DSF's own offices, which also provides in house shipping analysis and asset monitoring. Their underwriting criteria include LTV ratio caps of 90% and straight amortization rules for all loans. Current mortgage loans as well as new origination are concentrated in Europe and Northern America.

We view DSF's underwriting criteria as prudent. Our view is also supported by the low level of delinquencies and realized losses from the bank's loan book.

Our analysis of operational and administrative risks follows the guidelines in our criteria (see "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015).

Resolution regime analysis

DSF is a Danish issuer of covered bonds with a global focus operating from Denmark. Denmark is subject to the EU's Bank Recovery and Resolution Directive (BRRD), while issuers of covered bonds are generally exempt from bail in and will be separated from a defaulted a parent after a potential bail in. We assess the systemic importance for ship covered bonds in this jurisdiction as moderate.

Under our covered bonds criteria, this means that the RRL can be one notch above the adjusted long-term ICR (adjusted by removing the uplift allocated to reflect extraordinary government support to the issuer, if it exists). This uplift recognizes that resolution regimes increase the probability that an issuer could service its covered bonds even following a default on its senior unsecured obligations because the law exempts covered bonds from bail-in risk if there is a bank resolution. We consider this as an internal form of support, because the bail in of certain creditors of the issuer does not require direct government support.

Under our covered bonds criteria, we assess the RRL as 'a-', that is, one notch above the ICR on DSF.

Jurisdictional support analysis

Under our analysis of jurisdictional support in our covered bonds criteria, we determine a JRL, which is our assessment of the creditworthiness of a covered bond program once we have considered the level of jurisdictional support, but before giving credit to the amount of collateral.

In our jurisdictional support analysis, we assess the likelihood that a covered bond program facing stress would receive support from a government-sponsored initiative instead of from the liquidation of collateral assets in the open market. Our assessment of the jurisdictional support for Danish ship covered bond programs is moderate. Under our covered bonds criteria, this means that the program can receive one notch of jurisdictional uplift from the RRL. This leads to a JRL for DSF's ship covered bonds of 'a'. The JRL cannot exceed the rating on the sovereign providing the support to the covered bond, which in this case is 'AAA'.

Collateral support analysis

The cover pool comprises a mixed portfolio of loans backed by ship collateral originated by DSF. As the rating is currently constrained by counterparty risk, we have not conducted an analysis of the loans currently in the capital center.

The following capital center information is as per Sept. 30, 2018.

The DKK52.5 billion cover pool comprises loans secured by first-lien claims on shipping collateral and a reserve fund. It includes loans granted to borrowers in U.S. dollars and DKK, but also euro and Swedish krona. The average LTV ratio of the loans is 53.1%, considerably below the maximum 70% LTV ratio allowed for shipping assets by the legislation, partly due to the portfolio's high seasoning.

The covered bonds are secured by different ship types, with more than 50% of the pool consisting of bulk carriers, container liners, and product tankers. The ship tonnage varies dependent on the type of ship, but most collateral is <100.000 tons. The majority of loans in the cover pool have a size of < DKK300 million.

Most loans are money-market-based loans, while a minority of loans have fixed-interest periods of between one and 10 years. The loans have relatively short maturities and the majority matures within a five-year period. Most of the remaining loans mature between five and 10 years. At September 2018, the issuer reported DKK190 million as more than 90 days non-performing, which constitutes 0.5% of the total portfolio.

The issuer hedges interest rate and currency exposure using hedges included in the cover pool. There are currently DKK43.3 billion of outstanding covered bonds resulting in 21.26% overcollateralization.

Table 3

Cover Pool Composition

	As of Sept. 30, 2018		As of Sept. 30, 2017	
Asset type	**Value (bil. DKK)**	**Percentage of cover pool**	**Value (bil. DKK)**	**Percentage of cover pool**
Ship mortgages	43,322	82.47	40,974	81.56
Substitute assets	9,211	17.53	9,265	18.44
	52,533		50,239	

Table 4

Key Credit Metrics

	As of Sept. 30, 2018	**As of Sept. 30, 2017**
Weighted-average current LTV ratio (%)	53.1	59.50
Weighted-average customer seasoning (months)	138.18	Not reported
Balance of loans in arrears (%)	0	0.0
10 largest exposures	43.8	41.6
Interest-only loans (%)	4.1	3.4
Floating rate loans	87.0	81.8
Number of shipping loans	499	547

LTV--Loan-to-value.

Table 5

Covered Bond Program LTV Ratios

	As of Sept. 30, 2018	**As of Sept. 30, 2017**
Current LTV ratio (%)	Percentage of portfolio	Percentage of portfolio
>0 - <=20 %	37.7	33.7
>20 - <=40 %	34.2	30.9
>40 - <=60 %	21.0	23.2
>60 - <=70 %	3.3	5.9
>70 - <=80 %	1.4	2.3
>80 - <=85 %	0.4	0.7
>85 - <=90 %	0.4	0.5
>90 - <=95 %	0.3	0.4
>95 - <=100 %	0.2	0.3

Table 5

Covered Bond Program LTV Ratios (cont.)

	As of Sept. 30, 2018	As of Sept. 30, 2017
>100%	1.2	2.0
Weighted-average LTV ratio	53.1	59.5

LTV--Loan-to-value.

Table 6

Loan Seasoning Distribution*

	As of Sept. 30, 2018	As of Sept. 30, 2017
Months	Percentage of portfolio	Percentage of portfolio
Up to 12 months	6.7	1.0
12 - 24 months	0.8	5.2
24 - 36 months	4.7	2.3
36 - 60 months	11.3	13.6
More than 60 months	76.5	77.8
Weighted-average customer seasoning (months)	138.18	Not reported

*Seasoning refers to the elapsed loan term.

Table 7

Geographic Distribution Of Loan Assets

	As of Sept. 30, 2018	As of Sept. 30, 2017
Region	Percentage of portfolio	Percentage of portfolio
European Union	53.9	51.2
Belgium	0.7	0.5
Cyprus	0.6	0.7
Denmark	26.0	22.5
Finland	1.0	0.0
France	1.5	0.0
Germany	10.1	10.6
Netherlands	3.9	3.2
Italy	1.4	2.2
Luxembourg	3.0	3.9
Sweden	3.6	4.5
U.K.	2.2	3.2
European Economic Area (not member of EU)	12.8	14.9
Iceland	0.1	0.2
Norway	12.7	14.7
Other	33.3	33.9
Singapore	0.3	0.4
Other*	33.0	33.5

*Bahamas, Bermuda, Cayman Islands, Liberia, Marshall Islands, Panama, and Isle of Man.

Table 8

Collateral Type

	As of Sept. 30, 2018	As of Sept. 30, 2017
Bulk carriers	18.09	20.48
Car carriers	5.87	0.00
Chemical tankers	4.64	3.66
Container feeder	2.34	3.29
Container liners	18.40	6.95
Crude tankers	9.50	12.61
Ferries/RO-RO	6.01	7.68
LNG	1.54	2.19
LPG	5.22	5.67
Offshore units	1.20	15.90
Offshore vessels	9.13	2.01
Others	2.73	2.56
Product tankers	15.52	17.00

Counterparty risk

We have identified counterparty risks to which the payments on the covered bonds are exposed. As these not mitigated structurally or by the inclusion of replacement language in line with our current counterparty criteria, we believe that they constrain the rating from a counterparty risk perspective.

Bank account provider and commingling risk

For account risk, we consider that the issuer has an incentive to manage the risk and that the risk does not reduce the likelihood of jurisdictional support to the covered bond program. Therefore, bank account or commingling risk does not reduce the covered bond rating below the JRL on the covered bond program

Swaps

Our counterparty criteria considers that for derivatives by unrelated counterparties with no replacement framework irrespective of whether termination payments are subordinated, the covered bond rating is no higher than the higher of the JRL on the covered bond program, or the ICR on the counterparty (see "Counterparty Risk Analysis In Covered Bonds," published on Dec. 21, 2015). As one counterparty is unrated, our rating on the covered bonds are currently capped at the JRL.

Country risk

We assess country risk by applying our structured finance ratings above the sovereign criteria (see "Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published on Aug. 8, 2016). As we are currently not assigning any uplift based on collateral, the main constrain to the rating would be to the jurisdictional based uplift, which is capped at the rating of the sovereign of the issuing entity. Based on the current sovereign rating on Denmark (AAA/Stable/A-1+), country risk does not constrain our ratings on the covered bonds.

Potential Effects Of Proposed Criteria Changes

Our ratings are based on our applicable criteria, including our "Covered Bonds Criteria," published on Dec. 9, 2014, "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013, "Counterparty Risk Analysis In Covered Bonds," published on Dec. 21, 2015, and "Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published on Aug. 8, 2016.

However, these criteria are under review (see "Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings," published on Jan. 31, 2017, "Request For Comment: Counterparty Risk Framework: Methodology And Assumptions," published on Oct. 9, 2018, and "Request For Comment: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, published on Nov. 20, 2018). As a result of these reviews, we may amend certain paragraphs of our covered bonds criteria and our analysis of counterparty and country risks in a covered bond program. These changes may affect the ratings on the outstanding covered bonds issued under this covered bond program. Until this time, we will continue to rate and surveil these covered bonds using our existing criteria (see "Related Criteria").

Related Criteria

- Criteria - Structured Finance - General: Methodology And Assumptions: Assessing Pools Of European Residential Loans, Aug. 4, 2017
- Legal Criteria: Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Criteria - Structured Finance - General: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, Aug. 8, 2016
- Criteria - Structured Finance - Covered Bonds: Counterparty Risk Analysis In Covered Bonds, Dec. 21, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bonds Criteria, Dec. 9, 2014
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- General Criteria: Methodology: Credit Stability Criteria, May 3, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Request For Comment: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, Nov. 20, 2018
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Oct. 16, 2018

- Request For Comment: Counterparty Risk Framework: Methodology And Assumptions, Oct. 9, 2018
- Global Covered Bond Characteristics And Rating Summary Q3 2018, Sept. 19, 2018
- Danmarks Skibskredit A/S, Aug. 28, 2018
- Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings, Jan. 31, 2017