

Research Update:

# Danmarks Skibskredit Outlook Now Stable On The Improving Credit Quality Of Its Loan Book; 'BBB+/A-2' Ratings Affirmed

August 14, 2019

## Overview

- Danmarks Skibskredit has reduced its nonperforming exposure, and we expect its asset quality to remain stable amid the slowing global economy and trade tensions, which are likely to put pressure on segments of the shipping industry.
- We are revising our outlook on Danmarks Skibskredit to stable from negative and affirming the 'BBB+/A-2' issuer credit ratings.
- The stable outlook indicates our expectations that, over the next two years, the bank will maintain robust capitalization, considering it's a resilient and prudent shipping financier with very strong capital and a strong risk culture.

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## Rating Action

On Aug. 14, 2019, S&P Global Ratings revised its outlook on Denmark-based financial institution Danmarks Skibskredit A/S (DS) to stable from negative. At the same time, we affirmed the 'BBB+' long-term and 'A-2' short-term issuer credit ratings on the bank.

## Rationale

We believe that DS' reduced exposure to nonperforming assets and its robust capitalization would muffle the potential repercussions from the shipping sector's cyclical and operating challenges over the next 24 months. We continue to believe that DS maintains a prudent underwriting and provisioning policy. This was illustrated by the 23% decrease in nonperforming loans between 2016 and 2018 and its historically very low loss history.

Although several sub-segments of the shipping industry have seen recent improvements, we expect the wider sector to continue showing cyclical and remain challenged over the next decade due to structural changes, surplus capacity, and evolving regulatory environments.

However, we expect DS will remain focused on a selected niche of relatively strong and diverse clients in the shipping segment. We anticipate that the existing loan loss reserves, representing 6.4% of its loan book at end-December 2018, and existing capital, with equity at 14.4% of total assets, will continue to protect the bank from deep and long-lasting deterrents in the shipping and offshore industries.

In our view, DS' strong capital position and cautious risk management policies mitigate its concentration on a limited number of clients that operate in a very cyclical and capital-intensive segment. Although the bank's nonperforming exposure is relatively high at 13.7% of gross loans at end-2018 (versus 16.5% in 2016), its loss rate is much lower due to conservative collateral requirements. Net write-offs were 65 basis points (bps) of average gross loans in 2018, compared with a low 15 bps on average over the past 20 years, mostly as the bank works out its stressed offshore portfolio. The bank's prudent provisioning policy also supports its creditworthiness. Current provisions are 1.7x the total net write-offs that the bank has accumulated since its creation in 1961. This means that the bank could sustain a hypothetical default of all its credit exposures and a drop of more than 30% in all collateral values without reducing its capital.

We anticipate that the loan book will grow slowly in the next two years and that dividend payments to the new shareholder group will result in stable risk-adjusted capital (RAC) ratios of 17.0%-18.5% over the next two years. We measure DS' RAC ratio on a stand-alone basis at 18.7% at end-December 2018 and at 16.7% at the consolidated level. The consolidated capital ratio includes the same portion of the tied-up capital reserve as is currently required in regulatory capital. As of end-2018, including the remainder of the tied-up reserve would have improved the consolidated RAC ratio by an additional 7.3%, which we see as underpinning our very strong capital assessment of the combined entity and meaningful for the combined view of risk and capital.

DS represents over 99% of the consolidated group assets. As such, the rating is based on the bank's stand-alone characteristics, including its weak business position, strong liquidity, and excellent funding.

## **Outlook**

The stable outlook reflects our view that DS' high-quality underwriting policy will allow it to continue navigating cycles in its various shipping segments with stable nonperforming loans in the next 24 months, and low realized losses through the cycle. We also anticipate that DS will maintain its strong capital position. Moreover, we think funding will remain fully matched with loans and that DS will maintain strong liquidity buffers against adverse scenarios.

A negative rating action could stem from an increased risk appetite, for instance, if DS took on new clients with weaker credit quality or new business is underwritten with lower standards. This would most likely lead us to negatively reassess the bank's risk position and could follow a pronounced shift in the bank's strategy, given that we regard a change to weak underwriting by the current management as remote. Significantly deteriorating conditions in the shipping industry could also trigger a downgrade. A marked worsening of DS' funding and liquidity metrics could prompt us to remove our positive adjustment for the institution's superior performance relative to that of peers.

We consider a positive rating action on DS as remote at this stage. This is because we believe we would likely remove our notch of positive adjustment for performance compared with peers' if we revised up our assessment of funding due to the institution's renewed central bank access. We see also limited upside to our assessment of DS' business model, given its business concentration.

## Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB+/Stable/A-2	BBB+/Negative/A-2
Stand-alone credit profile	bbb	bbb
Anchor	bbb+	bbb+
Business position	Weak (-2)	Weak (-2)
Capital & earnings	Very strong (+2)	Very strong (+2)
Risk position	Adequate (0)	Adequate (0)
Funding & liquidity	Below average & adequate(-1)	Below average & adequate(-1)
Support	0	0
ALAC support	0	0
GRE support	0	0
Group support	0	0
Sovereign support	0	0
Additional factors	+1	+1

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Full Analysis: Danmarks Skibskredit, Aug. 28, 2018

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
<b>Danmarks Skibskredit A/S</b>		
Issuer Credit Rating	BBB+/Stable/A-2	BBB+/Negative/A-2

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