Credit Rating Announcement

29 August 2018

Scope assigns A+ to Realkredit Danmark, review for upgrade, AAA to Capital Centres S&Tcovered bonds

Scope assigns first-time A+ issuer rating to Realkredit Danmark, on review for upgrade in line with parent Danske Bank. AAA covered bond ratings primarily reflect strong fundamental support for Danish covered bonds, strong cover pool also supports rating.

Rating action

Scope today assigned an A+ issuer rating, on review for potential upgrade, and S-1+ short-term rating to Danish Realkredit Danmark A/S (RKD). These levels place RKD 's ratings in line with those of its parent, Danske Bank A/S ('Danske'). This reflects RKD's close integration with Danske, but also its reassuring financial fundamentals and capital position, improving profitability, strong underwriting with a consistently low cost of risk and very high efficiency.

Today Scope has also assigned AAA ratings with a Stable Outlook to DKK 727bn of Danish mortgage covered bonds (særligt dækkede realkreditobligationer – SDRO) issued out of the two covered bond programmes: Capital Centres S and T (other capital centres: N/R). The covered bond ratings are higher than the bank rating, reflecting the fundamental support from the very strong legal framework which imposes a 'special balance principle' on SDROs. Issuer and product-specific benefits established in the agency's resolution and systemic importance analysis provide further fundamental support. Covered bonds issued under Capital Centres S and T are individually ringfenced against the potential insolvency of the issuer, and covered bonds issued under a capital centre only have recourse to the respective cover pool. The bonds are not exposed to a cross-default, and covered bond ratings of the different Capital Centres can change independently of each other.

Bank ratings rationale

Scope assigns an initial Issuer Rating of A+ to Realkredit Danmark A/S, in line with the rating of its parent. Consistent with Danske's rating, that of RKD is on review for potential upgrade.

RKD is a wholly owned subsidiary of Danske Bank and acts as the Group's specialised mortgage bank. Although RD has a degree of operational independence, it is also closely integrated into the Danske Bank Group, of which Scope considers it to be a core subsidiary. Risk management is aligned with that of the parent.

Scope also takes into account the well-tested funding model, while also noting the highly interconnected nature of the Danish banking sector. RKD match-funds its mortgage loans with covered bonds, eliminating most market risks. Its main exposure is therefore to credit risk.

The rating drivers are as follows:

- RKD is a core subsidiary of the Danske Bank group, and closely integrated into it, with a consistent strategy and risk management principles. The parent also provides a first loss guarantee for mortgages originated through its own network.

- A solid market position as the second largest mortgage lender in Denmark, with a 28% market share.

- Although RKD is dependent on wholesale funding, the Danish covered bond market is well-established and liquid. A broad range of domestic and international investors exist for the bonds, including other Danish financial institutions, insurance companies and pension funds.

- Reassuring profitability and prudential capital metrics. Profitability has been improving in recent years, supported by higher margins, cost reductions and low impairments. RKD seeks to upstream excess capital to its parent, however, maintains prudential capital ratios comfortably in excess of requirements.

Covered bond ratings rationale

Scope has assigned AAA ratings with a Stable Outlook to RKD's covered bonds issued under Capital Centre S and Capital Centre T. Ratings take into account the A+ issuer rating, further enhanced by:

- fundamental credit support factors which are the primary rating driver, providing up to six notches of uplift above the bank's rating. Only four notches are used to support the rating uplift. Fundamental credit support can stabilise the covered bond rating against a two-notch deterioration in the issuer rating.; and

- cover pool support which could equally support the uplift from the bank rating for the covered bond ratings, given the pool's credit quality and characteristics. For RKD's SDROs, the possible uplift could be up to nine notches. Both capital centres exhibit strong credit characteristics and the balance principle almost fully eliminates market, and in particular, mismatch risks. Available overcollateralisation mitigates remaining risks and supports an uplift from the issuer rating of at least four notches.

For the covered bond rating report please click HERE.

Key rating drivers for the covered bond ratings

- Sound issuer credit rating (positive)

- Fundamental credit support resulting from the strength of the Danish legal and resolution framework – including systemic importance, which supports a six-notch uplift to the issuer rating (positive)

Fundamental credit support: benefits from the Danish legal framework and resolution regime assessment

Fundamental credit support factors are the primary support for the ratings and provide the covered bonds with a six-notch uplift above the issuer rating on RKD. Two notches of uplift are driven by the strong Danish covered bond legal framework. Four additional notches of uplift are driven by the support afforded by the resolution regime and the systemic importance of RKD’s covered bonds. Fundamental credit support effectively provides a rating floor for the covered bonds which is six notches above the issuer rating.

Analysis of the Danish covered bond legal framework

In Scope’s view, the Danish framework, in particular the strict balance principle applicable to SDROs, currently provides one of the strongest European covered bond frameworks. It meets the rating agency’s criteria for protecting covered bond investors and allows Scope to assign the highest, two-notch credit differentiation for a supportive legal framework.

The Danish legal covered bond framework is mainly based on the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds Act (the ‘Mortgage Act’) the Danish Financial Business Act, the Capital Requirements Regulation as well as specific bankruptcy regulations for covered bond issuers (sections 247a-247i of the Financial Business Act and sections 22-33 of the Mortgage Act). In general, three types of covered bond can be issued in Denmark: Særligt Dækkede Obligationer (SDOs – issued by universal and mortgage banks), SDROs and Realkreditobligationer (ROs – the latter two can only be issued by mortgage banks). RKD’s main funding tool are SDROs. The issuer also maintains some legacy capital centres with ROs that are gradually being wound down. The covered bonds rated by Scope are SDROs issued out of capital centre S&T – both of which need to comply with the specific balance principle. Credit-positive aspects for the SDRO:

- The use of a specialist, independently licensed mortgage bank which facilitates the segregation and isolation of the cover assets.
- Covered bond holders benefit from a senior claim on the eligible cover pool assets.
- The definition of eligible assets follows European standards with a maximum 80% loan-to-value (LTV) limit for RKD’s main collateral type, residential mortgages, and 60% LTV for commercial (including agricultural) mortgage loans.
- Non-performing loans will not be removed from the cover pool but will not be fully included in cover pool tests.
- As the specialist mortgage bank is a non-deposit taking institution, the covered bonds are not exposed to set-off risk.
- The specific balance principle almost fully eliminates market and mismatch risks.
- Derivatives can be used to mitigate market risks and there are no limits on the issuer’s ability to further buffer risk with overcollateralisation.
- Danish SDROs benefit from ongoing covered bond-specific regulatory oversight, also supported by macro-prudential monitoring as per the ‘supervisory diamond’ of the Danish Financial Supervisory Authority (Finanstilsynet). SDROs fully fit the Undertakings for the Collective Investment of Transferable Securities and the Capital Requirements Regulation definition, allowing investors to attach preferential risk weights.

Resolution regime and systemic importance considerations for RKD’s covered bond programme

The agency has provided RKD's covered bonds with four additional notches of uplift to reflect the general and issuer-specific benefit provided by the resolution regime as well as the systemic importance of covered bonds in Denmark.

One notch of uplift reflects the exclusion of Danish SDROs from a bail-in. Scope also assigns one additional notch for its view on the resolvability and likely maintenance of RKD in a resolution scenario. Scope acknowledges the benefits of being part of Danske Bank – a systemically important financial institution (SIFI) – as well as the resolvability of RKD. Danish mortgage banks, such as RKD, are exempt from the 'classic' Minimum Required Eligible Liabilities requirement. However, they do need to comply with a debt buffer comprising 2% of their unweighted lending which can be increased to 8% by 2020 for SIFI mortgage banks to allow the central bank to pursue its preferred resolution strategy.

One additional notch of uplift reflects the agency's view on the high domestic and international visibility of RKD as a covered bond issuer and the extremely high systemic importance of covered bonds in Denmark in general. Scope considers RKD's covered bond issuing activities and market share of about 28% to result in a high systemic importance. RKD has a longstanding history of covered bond issuance and is the second largest covered bond issuer in Denmark. Scope generally classifies Danish covered bonds as a systemic funding product, particularly used for the refinancing of residential mortgages. With a 221-year track record, the Danish covered bond market is one of the oldest worldwide and, on average, the combined outstanding covered bond volumes account for more than 140% of GDP. With EUR 398bn of outstanding covered bonds at year-end 2017, the Danish covered bond market is the largest covered bond market globally. Over the last five years, average annual issuance volumes have been high, at EUR 145bn. At present, nine banks are licensed to issue covered bonds, altogether maintaining 23 active covered bond programmes.

The fourth additional notch of uplift reflects the existence of a very cohesive and supportive domestic stakeholder group. Covered bond issuers work together actively under the umbrella of Finance Denmark and the Danish Mortgage Bank Association, promoting the product and initiating changes to the domestic or even international covered bond framework if needed (including the March 2014 amendment, introducing the option to continuously extend the repayment of a covered bond upon failed refinancing, changes to the Bank Recovery and Resolution Directive, the Capital Requirements Regulation or the planned European covered bond directive). Domestic covered bond investors such as banks and insurers actively use covered bonds as a substitute for long-dated, scarce DKK-denominated government debt as well as for liquidity management purposes. Moreover, the central bank has demonstrated its support by allowing the use of covered bonds in its repo operations. Finanstilsynet is also an active stakeholder, given the widespread use of covered bonds as a refinancing tool for residential mortgage lending.

Cover pool also supports highest rating achievable

RKD's Capital Centre S and Capital Centre T are, in themselves, able to support a four-notch uplift for the covered bonds issued under each respective programme. As of 31 March 2018, DKK 269.3bn of cover assets has provided an overcollateralisation of 5.9% for the DKK 254.2bn of SDROs issued under Capital Centre S. DKK 508.3bn in cover assets or an overcollateralisation of 7.4% have been provided for the DKK 473.0bn of SDROs issued under Capital Centre T.

The credit quality of the cover pool is sound and the overcollateralisation needed to cover for credit risk is based on our analysis at low absolute levels. (Credit risk contribution to support a four-notch uplift: Capital Centre S: 0.86%; Capital Centre T: 0.80%). RKD's two covered bond programmes broadly reflect the different interest rate fixings the bank offers to its customers. Whereas Capital Centre S predominantly comprises fixed for life mortgage loans (96%), Capital Centre T entirely comprises floating rate mortgages (split between interest-only floaters at 56%, and amortising mortgage loans at 44%). At 86%, Capital Centre

S is more strongly geared towards residential mortgage borrowers (with properties, including commercial rental properties, defined as being for residential purposes) than Capital Centre T (67.5%). While eligibility criteria for LTVs differ between residential and commercial mortgage loans, the average LTV does not significantly differ between both programmes (S: 63% vs T: 62%). Capital Centre S comprises 99.9% domestic Danish mortgages while Capital Centre T also comprises some Swedish (3.31%) and Norwegian (0.8%) mortgage loans.

In a European context, Danish SDROs and ROs are the least sensitive to changes in market risk and are generally not exposed to mismatch risk. The application of the specific balance principle means that assets and liabilities need to be almost perfectly matched with regard to rates, currencies and maturities – also resulting in regular tabs of outstanding covered bonds. Effectively, once a new mortgage loan is granted by a bank, an already outstanding covered bond with the same terms and conditions will be increased in size.

Mismatches are generally a result of the minimum regulatory as well as voluntary overcollateralisation, typically creating a very moderate negative asset liability mismatch. Despite the almost perfect maturity match, the combination of interest-only and adjusted rate mortgage products introduces refinancing risk as certain bonds needs to be refinanced during the life of the loan. Regulators have mitigated the risk by introducing an automatic mandatory extension of such bonds, effectively resulting in conditional pass-throughs. Currently, only Capital Centre T comprises bonds for which investors might be exposed to such an extension risk as Capital Centre S refinanced loans are fixed for life.

The agency also acknowledged the fact that around 8.5% of bonds in Capital Centre T are hard bullet bonds, issued before and grandfathered from the legislative changes in March 2014 that introduced maturity extensions. Around 1.7% of bonds are issued as hard bullets in Capital Centre S. Scope analysed the covered bond programmes to establish the overcollateralisation needed to also support a four-notch cover pool analysis-based uplift. This results in an overcollateralisation of 1.3% for Capital Centre S and 2.5% for Capital Centre T. RKD has consistently provided overcollateralisation above those levels. A downgrade of the issuer would only slightly increase the supporting overcollateralisation to 1.6% and 3.5%, respectively, also because of the balance principle. Cover pool support is not the primary rating driver. However, with an available overcollateralisation of 5.9% for S and 7.5% for T, cover pool support could equally benefit the rating.

Quantitative analysis and assumptions for the cover pool analysis

Scope performed a cash flow analysis and projected the cover pool defaults assuming a normal inverse distribution. Based on the credit performance data provided by the bank, in particular vintage and loss data as well as benchmarking, the agency derived an effective, weighted average lifetime mean default rate of 3.1% for Capital Centre S (applying a cure rate of 62%) and 2.6% for T (cure rate of 64%), as well as a weighted average coefficient of variation of 50% and 75%, respectively. Scope also assumed an asset recovery rate which for Capital Centre S ranges between 89.2% in the base and 72.5% in a stressed scenario. For Capital Centre T, the respective asset recovery rates are 87.9% and 69.3%, respectively.

In order to determine the recovery rates, Scope applies rating distance-dependent market value declines. Assumptions are based on an analysis of Danish housing market developments and characteristics. Scope established market value declines for the properties securing the mortgage loans of 22.5%-65% in its base scenario and 42.5%-80% in a stressed scenario (depending on the location and type of property). In addition to a correction of the indexed LTV to a sustainable level, this market value decline incorporates a general fire sale discount.

Scope analysed the credit risk of the substitute assets accounting for 5.6% of the Capital Centre S cover pool and 6.9% of the Capital Centre T cover pool. Both primarily consist of sovereign exposures and other domestic covered bonds. The agency estimated the sub-portfolio's default characteristics using a portfolio analysis framework. The low default rate and high coefficient of variation for the default distribution of substitute assets reflect the high credit quality but also the high obligor concentration in the respective sub portfolios.

Scope used the resulting loss distribution and default timing to project the covered bond programme's cash flows and reflect the programme's amortisation structure. The rating agency also incorporated the impact of rating distance-dependent interest rate and foreign exchange rate stresses in its analysis. Both covered bond programmes are most sensitive to rising interest rate scenarios. The Capital Centre S programme was most sensitive to a scenario in which interest rates rise after two years and plateau at 10%, whereas Capital Centre T is most sensitive to a scenario in which rates only start rising and plateau at 10% after 10 years.

Capital Centre S is exposed to an appreciation of the DKK against foreign exchange because substitute assets that are not funded with outstanding bonds are held in foreign exchange (SEK and NOK). In the most stressful scenario this incorporates devaluations of 26% (SEK) and 32% (NOK). Even though the two currencies are almost pegged, we also incorporated a devaluation stress of the EUR against the DKK of 7%. Capital Centre T is exposed to a depreciation of the DKK against foreign exchange even though assets and liabilities are nearly perfectly hedged naturally. However, an open position occurs with assets written down by losses and, accordingly, foreign exchange liabilities exceeding foreign exchange assets. In this case, Scope assumed an appreciation of 35.5% (SEK), 25% (NOK) and 7% (EUR).

To calculate a net present value of the cover pool in the event of an asset sale, a liquidity premium for Danish residential mortgage loans of 150 bps and 300 bps for commercial mortgage loans was added to the rating distance and scenario-dependent discount curve. Scope derived this liquidity premium by analysing the long-term development of trading spreads for Danish and other 'core country' covered bond spreads (both for EUR- and DKK-denominated covered bonds). Scope generally uses 150 bps as the lowest liquidity premium for residential-backed cover pools even though the Danish covered bond spreads observed are negative at present. Further, EUR-denominated covered bonds remained below 100 bps during the crisis and DKK-denominated bonds only reached a height of 147 bps for a short period in 2008.

Scope tested for low (0%) and high prepayments (up to 20%) to stress the programmes' sensitivity to unscheduled repayments. Both programmes are most sensitive against high prepayments as these reduce the available excess spread over the life of the transaction. Low prepayments are more beneficial, also because asset sales to repay remaining hard bullet bonds are limited.

An annual servicing fee of 27 bps was assumed for Capital Centre S and 32 bps for Capital Centre T. This fee was calculated as a weighted average based on a residential fee of 25 bps, a commercial fee of 50 bps and 10 bps for the substitute assets.

Stable Outlook assigned to the covered bonds

The Stable Outlook on the covered bonds reflects i) the stable fundamental credit support attributable to the banks covered bonds; well matched capital centres with cover assets exhibiting low LTV's. Cover pool support is currently not needed but could further enhance the covered bond ratings; ii) Scopes view that the European covered bond harmonisation will not negatively impact the fundamental support factors relevant for the issuers and Danish mortgage covered bonds in general.

Covered bond rating-change drivers

The covered bond ratings are already at the highest level and do not include cover pool support. Covered bond ratings could be negatively affected by i) a more than two-notch downgrade of the issuer and without cover pool support, or ii) the legal and resolution framework evolves toward a less supportive one for covered bonds including a changed view on the issuer's resolvability and lower cover pool support, both of which is not expected by Scope.

Both, the detailed rating reports on the issuer and the covered bonds are available on www.scoperatings.com.

Stress testing

No stress testing was performed for the bank or covered bond rating.

Cash flow analysis

No cash flow analysis was performed for the bank ratings. In order to determine the cover pool supported rating uplift, Scope performed a cash flow analysis to establish an expected loss for the covered bonds. The cash flow analysis uses the scheduled cash flows of the cover assets and covered bonds as a starting point. Scope applies rating distance-dependant stresses to simulate the impact of increasing credit and market risks to these cash flows. The cash flow analysis also includes the impact of stressed asset sales or other variables such as changing prepayment speeds or servicing costs.

Methodology

The methodology used for the bank rating and outlook was the Rating Methodology Bank Ratings. For the covered bond ratings and outlook the Covered Bonds Rating Methodology and the General Structured Finance Rating Methodology were used. The methodologies are available on www.scoperatings.com.
Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.
The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rated entity participated in the rating process.
The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources.
Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the rating or outlook action, the rated entity was given the opportunity to review the rating and outlook and the principal grounds on which the credit rating and outlook is based. Following that review, the rating was not amended before being issued.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.
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The ratings/outlooks were first released by Scope on 29.08.2018.

Potential conflicts

Please see www.scoperatings.com. for a list of potential conflicts of interest related to the issuance of credit ratings.

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