Realkredit Danmark A/S

Danish Covered Bonds – Performance Update on Capital Centre S and Capital Centre T

Ratings rationale (summary)

The AAA ratings with a Stable Outlook on the Danish mortgage-covered bonds (særligt dækkede realkreditobligationer, SDROs) issued out of Realkredit Danmark A/S (Realkredit) capital centres S and T are based on the bank's issuer rating, enhanced by the programmes' fundamental credit support.

Cut-off date	CC[1]	Eligible cover pool	Cover asset type	Covered bonds[2]	Rating/Outlook
30 Jun 2020	S	DKK 298.3bn	Residential and commercial mortgage loans	DKK 277.6bn	AAA/Stable
30 Jun 2020	T	DKK 468.0bn		DKK 439.3bn	AAA/Stable

1. Capital centre (CC) S & T; 2. særligt dækkede realkreditobligationer (SDROs) – Danish mortgage-covered bonds issued under the strict balance principle under the Danish Mortgage Act.

Fundamental credit support is the primary rating driver for both capital centres. It provides six notches of uplift above the issuer rating. Only four notches are needed to raise the covered bonds' ratings to the highest achievable level. Our cover pool analyses provide further stability.

Cover pool support benefits from the strong credit characteristics of both capital centres and the balance principle, almost fully eliminating market risk, particularly asset-liability mismatches.

FUNDAMENTAL CREDIT SUPPORT	COVER POOL SUPPORT	MAXIMUM RATING DISTANCE	RATING UPLIFT
	Cover pool support +3	D9	(unused)
	Cover pool support +2	D8	(unused)
	Cover pool support +1	D7	(unused)
Resolution regime +4	Covered Bonds Rating Floor = Fundamental Credit Support	D6	(unused)
Resolution regime +3		D5	(unused)
Resolution regime +2		D4	AAA
Resolution regime +1		D3	AA+
Legal framework +2		D2	AA
Legal framework +1		D1	AA-
Issuer rating		D0	A+

Stable Outlook

The Stable Outlook on the covered bonds reflects the rating buffer provided by our fundamental and cover pool support analysis, shielding the covered bond ratings from a multi-notch issuer rating deterioration.

Changes since the last performance update

Since our last analysis one year ago, both the asset balance and the outstanding covered bonds of capital center S have increased by around 8%. All relevant risk characteristics have remained more or less unchanged. Capital center T balances have dropped by 4.5%. As a result, some risk characteristics have improved since our last analysis. For example, the loan to value (LTV) has dropped by around 4pp to 57.1% at present.

The Danish housing market has been relatively unaffected by Covid-19 so far. Corrections may come, but historical house price increases have been moderate compared to Nordic peers, which may soften price declines should pandemic pressure persist.

Ratings & Outlook

Issuer rating	**A+/ S-1+**
Outlook	Negative
Last rating action	Affirmed
Last rating action date	18.08.2020
Covered bond rating	**AAA**
Outlook	Stable
Rating action	Affirmed
Last rating action date	18.08.2020

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Related research

Scope Ratings affirms Realkredit Danmark's A+ Issuer rating with a Negative Outlook 19 August 2020

Covered Bond Rating Report: Danish Mortgage-Covered Bonds – Capital Centre S & T – 29 August 2018

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The issuer

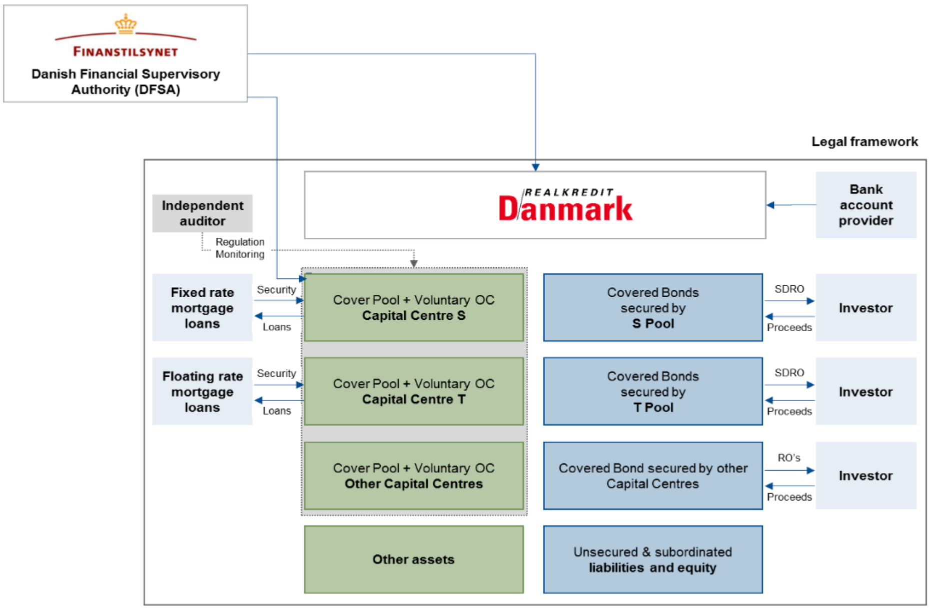
Realkredit, a core subsidiary of the Danske Bank Group

We have assigned A+ ratings to Realkredit Danmark A/S, the issuer of the rated mortgage-covered bonds, with a Negative Outlook. Realkredit is the second-largest Danish mortgage bank, with a market share of 25% of Danish mortgage lending. It is a core subsidiary of the Danske Bank Group, acting as the group's specialised mortgage bank in its domestic market. Realkredit's stand-alone financial profile is supported by strong asset quality, high capitalisation and its position as a major covered bond issuer in Denmark. Nevertheless, margins and market share are under pressure at a time when prudential requirements are rising.

For further details on the bank's credit analysis see www.scoperatings.com.

Covered bond structure

Figure 1: On-balance sheet issuance structure



Source: Scope, Realkredit Danmark

Realkredit operates as a specialised mortgage bank, originating the majority of domestic mortgage loans within Danske Group. The loans are refinanced using SDROs, with issuances governed by the Danish Mortgage Act and supervised by Denmark's Financial Supervisory Authority (Finanstilsynet).

Fundamental credit support analysis

Full fundamental credit support of six notches

Ratings for the SDROs issued out of capital centres S and T are primarily supported by a six-notch credit uplift provided by the fundamental legal and resolution framework for Danish covered bonds. This enhances the ratings to their highest achievable level (AAA). Cover pool support is therefore not needed.

Two notches of credit differentiation result from our legal framework analysis. This is driven by the benefits afforded by Denmark's covered bond framework, which we consider one of Europe's strongest, particularly due to the strict 'balance principle' applicable to SDROs. Our resolution regime analysis provides an additional four-notch uplift. It reflects the programmes' preferential status and exclusion from bail-in, our view on the resolvability and likely maintenance of Realkredit in the hypothetical scenario of regulatory intervention in the bank, and the very high importance of covered bonds in Denmark, where a strong domestic stakeholder group maintains confidence in the high credit quality of the covered bonds. For more information see also related research.

Pool characteristics

Capital centre	S	T
Balance (DKK bn)	298.3	468.0
Residential (%)	74.7	65.8
Commercial (%)	18.4	28.1
Substitute (%)	6.9	6.1

General information

Capital centre	S	T
No. of exposures	166,829	232,428
Avg expos ('000)	1,788	2.013
Top 10 (%)	1.0	1.7
Remaining life (y)	24	22
LTV (%)	59.5	57.1

Interest rate type (%)

Capital centre	S	T
Floating	1.2	100
Fixed	98.8	0

Repayment type (%)

Capital Centre	S	T
Bullet	25.4	51.8
Amortising	74.6	48.2

Cover pool analysis

The programmes' fundamental credit support of up to six notches already provides the highest ratings. It is the key rating driver and, as such, cover pool support is not needed. However, we still assess whether or not cover pool support could further stabilise the ratings. Cover pool support could stabilise the current AAA ratings even if the bank was downgraded to BBB-. Accordingly, an additional three-notch cover pool uplift is likely to be warranted for both programmes if the current level of overcollateralisation is maintained.

Cover pool composition

Both capital centres are predominantly secured by Danish commercial and residential mortgage loans denominated in Danish kroner. As of June 2020, only 0.6bps of mortgage loans in capital centre S are denominated in euros. For capital centre T, 2.7% are denominated in Swedish kroner, 1.2% in euros, and 1.2% in Norwegian kroner.

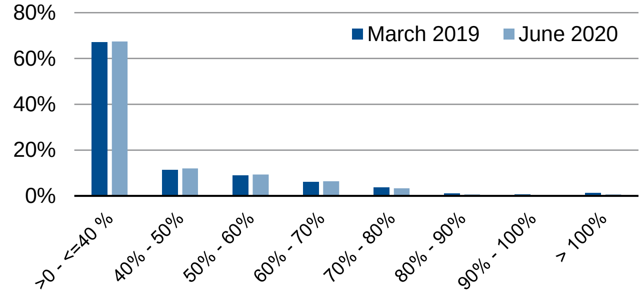
Both pools are highly granular with 166,829 mortgage loans for capital centre S and 232,428 for capital centre T as of June 2020. The top 10 borrowers account for 1.0% in capital centre S and 1.7% in capital centre T, respectively.

Since our last analysis as of 30 March 2019, the asset balance of capital centre S has increased by around 8% and decreased by 4.5% for capital centre T over the same time period. Furthermore, the overall LTV dropped by 3.7 percentage points down to 57.1% for capital centre T, while remaining relatively stable at 59.5% (from 60.3%) for capital centre S.

The main, and most important, difference between the two capital centres is the interest rate fixing: 98.8% of the mortgage loans in capital centre S are fixed for life; all of the loans in capital centre T are floating-rate and reset loans (adjustable rate mortgages), most of which have reset periods of under five years.

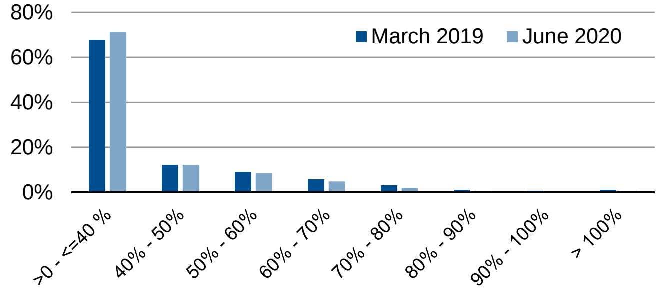
The share of commercial loans in capital centre S remains lower. Residential mortgage loans account for 74.7% of the total asset balance. If we include private rental residential, cooperative housing and subsidised housing, residential accounts for only 89% of the total asset balance in capital centre S, and 65.8% and 73.7% (if private rental residential included) in capital centre T, respectively.

Figure 2: LTV distribution (capital centre S)



Source: Scope Ratings, Realkredit Danmark

Figure 3: LTV distribution (capital centre T)



Source: Scope Ratings, Realkredit Danmark

Asset risk analysis

The credit quality of the two granular capital centres is strong. Changes in our lifetime mean default rate of 3.9% (from 3.1%) for capital centre S and 3.2% (from 2.6%) for capital centre T, respectively, result from less credit given to historical cure rates. Stronger recovery rates for capital centre T were driven by lower LTVs, while those for capital centre S remained unchanged.

Our projection of default on mortgage loans uses an inverse Gaussian distribution, based on available credit performance data provided by the bank (in particular 90+dpd vintage data) and benchmarking. While the updated vintage data did not show any material changes in the performance of the mortgage assets, we limited the benefit we gave to the historical cure rates of defaulted loans to 50% (from up to 64%). This was done to reflect a rating dependency on cure rates and to address uncertainties around default volatility driven by Covid-19.

Despite the higher share of commercial loans and exposure to interest rate movements from adjustable rate mortgage loans, capital centre T benefits from a lower lifetime default probability than capital centre S. This is driven by its higher seasoning, positively affecting lifetime defaults.

We assumed a volatility of defaults (weighted average coefficient of variation) of 50% for capital centre S and 75% for capital centre T. Assumptions for capital centre T incorporate a potential increase in borrower defaults if margins increase by up to 500bps – in the event that a covered bond's refinancing fails. Capital centre S is not exposed to refinancing risk because loans are fixed rate for life.

Strong credit quality translates into mean loss rates below 1% for both programmes

We estimated a weighted average recovery rate for capital centre S ranging from 92.1% (from 93.0%) for the base case to 74.7% (from 75.3%) for the most stressful scenario; for capital centre T, the respective figures are 94.7% (from 93.5%) and 77.1% (from 74.4%). This translates into a mean loss rate for capital centre S of 0.31% (from 0.22%) in the base case and 0.99% (from 0.77%) in the most stressful scenario; for capital centre T, these were unchanged at 0.17% and 0.73% (from 0.67%), respectively.

Cash flow risk analysis

The overcollateralisation supporting the AAA ratings is 0% for both pools and is based on fundamental support only. Consequently, cover pool support does not constitute a rating driver.

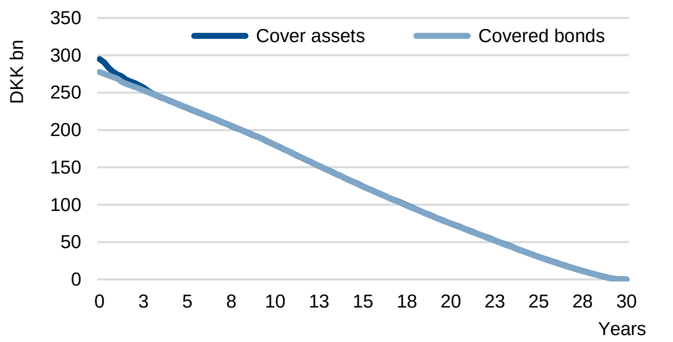
To test the stability of the ratings we established the overcollateralisation levels needed to support the current rating uplift. We performed a full analysis supported by the detailed data provided by Realkredit. Our analysis showed that the cover pool support could stabilise the current AAA ratings even if the bank was downgraded by up to five notches to BBB-.

The main risk driver from the cover pool is credit risk, but this remains low reflecting the strong credit quality of the two pools.

Aided by the balance principle, market risks mainly result from minimum, regulatory and voluntary overcollateralisation, but are negligible in terms of the total balance and remaining term.

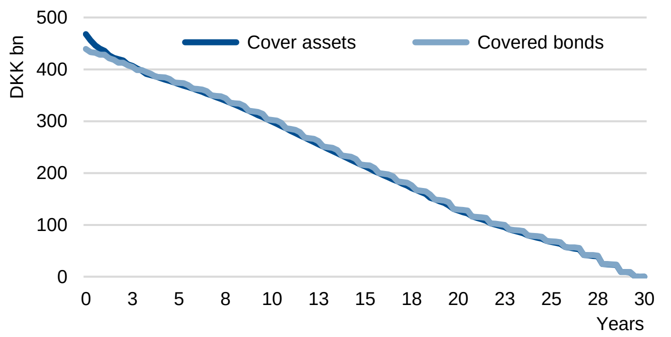
Asset sales due to asset-liability mismatches from remaining hard bullet bonds do not constitute a risk driver due to their immateriality. Around 1.0% (from 3.3%) of bonds in capital centre T are grandfathered hard-bullet bonds as they were issued before the March 2014 legal amendment introducing soft bullets. Around 0.2% (from 1.2%) of bonds in capital centre S were issued as hard-bullet bonds.

Figure 4: Amortisation profile (capital centre S)



Source: Scope Ratings, Realkredit Danmark

Figure 5: Amortisation profile (capital centre T)

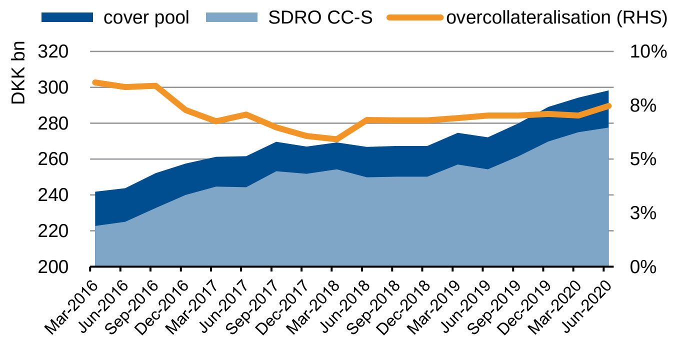


Source: Scope Ratings, Realkredit Danmark

Availability of overcollateralisation

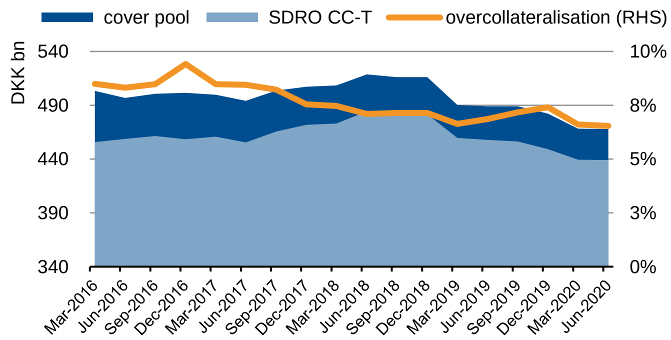
Realkredit's covered bond ratings are wholly supported by fundamental factors and therefore do not rely on the issuer's ability and willingness to provide overcollateralisation above the legal minimum. The current ratings would allow the provided overcollateralisation to be fully take into account, however.

Figure 6: Overcollateralisation (capital centre S)



Source: Scope Ratings, Realkredit Danmark

Figure 7: Overcollateralisation (capital centre T)



Source: Scope Ratings, Realkredit Danmark

Other risk considerations

Main counterparty exposure relates to Realkredit

The rated covered bonds have counterparty exposures to the issuer, as well as to its parent as loan originator, servicer, bank account provider and paying agent. There are no documented replacement mechanisms that would, for example, automatically shield the covered bonds from a credit deterioration of counterparties providing bank accounts. However, we believe that the strong alignment of interests between the bank and covered bond holders would prevent a negative impact from such risks before regulatory intervention became necessary. The bank's risk management process regularly monitors accounts to ensure that remedial action can be taken early on.

Country risk does not affect the ratings

Sovereign risk does not limit the ratings of Realkredit's mortgage-covered bonds. We believe the risks of an institutional framework meltdown, legal insecurity or currency-convertibility problems are currently remote.

No direct impact from ESG

We have not directly included ESG aspects in our rating of the covered bonds issued by Realkredit because information provided on the collateral and its performance does not allow us to determine impacts from energy efficiency or differences in recovery proceeds. However, we acknowledge the bank's green bond framework and first green covered bonds launched in 2019, opening up to a wider investor base and improving the attractivity and liquidity of covered bonds issued by Realkredit.

Appendix: Summary of covered bond characteristics

Reporting date	30-Jun-20	31-Mar-19	30-Jun-20	31-Mar-19
Issuer name	Realkredit Danmark A/S			
Capital centre	S		T	
Country	Denmark			
Covered bond name	særligt dækkede realkreditobligationer (SDROs) Danish mortgage covered bonds issued under the Danish mortgage act (Specific balance principle)			
Covered bond legal framework	Danish legal covered bond framework			
Cover pool type	Mortgage loans			
Composition	Residential = 74.68% Commercial = 18.37%[6] Substitute = 6.95%	Residential = 70.99% Commercial = 22.54% Substitute = 6.47%	Residential = 65.75% Commercial = 28.1%[6] Substitute = 6.14%	Residential = 56.34% Commercial = 37.52% Substitute = 6.14%
Issuer rating[1]	A+	A+	A+	A+
Current covered bond rating	AAA/Stable	AAA/Stable	AAA/Stable	AAA/Stable
Covered bond maturity type	Hard bullets	Hard bullets	Hard bullets	Hard bullets
Cover pool currencies	DKK (99.99%) EUR (0.01%)	DKK (99.99%) EUR (0.01%)	DKK (94.83%) EUR (1.24%) SEK (2.74%) NOK (1.19%)	DKK (93.95%) EUR (2.09%) SEK (2.96%) NOK (1.01%)
Covered bond currencies	DKK (99.99%) EUR (0.01%)	DKK (99.99%) EUR (0.01%)	DKK (94.48%) EUR (1.1%) SEK (3.09%) NOK (1.34%)	DKK (93.47%) EUR (1.99%) SEK (3.39%) NOK (1.16%)
Fundamental cover pool support	6	6	6	6
Maximum achievable covered bond uplift	9	9	9	9
Potential covered bond rating buffer	5	5	5	5
Cover pool (DKK m)	298,294	274,660	467,991	490,262
Thereof substitute assets (DKK m)	20,730	17,741	28,731	30,483
Covered bonds (DKK m)	277,564	256,919	439,260	459,779
Current overcollateralisation/ legal minimum overcollateralisation[3]	7.5% / 8%	6.9% / 8%	6.5% / 8%	6.6% / 8%
Overcollateralisation to support current rating	not applicable	not applicable	not applicable	not applicable
Overcollateralisation upon a one-notch issuer downgrade	not applicable	not applicable	not applicable	not applicable
Cover pool supporting overcollateralisation to support current rating	0.00%	0.00%	0.00%	0.00%
Cover pool overcollateralisation upon a one-notch issuer downgrade	0.00%	0.00%	0.00%	0.00%
Weighted average life of assets	24 years	24 years	22 years	23 years
Weighted average life of liabilities[5]	26 years	26 years	3 years	2 years
Number of exposures	166,829	168,039	232,428	252,343
Average loan size (in DKK '000s)	1,788	1,635	2,013	1,943
Top 10 residential	0.87%	0.99%	1.33%	0.74%
Top 10 commercial	4.46%	4.11%	5.78%	4.07%
Interest rate type – assets	Floating 1.2% Fixed 98.7%	Floating 2.3% Fixed 97.5%	Floating 0% Fixed 100%	Floating 0% Fixed 100%
Interest rate type – liabilities (fixed/floating)	Floating 0.1% Fixed 98.9% Other 1%	Floating 0.1% Fixed 98.5% Other 1.3%	Floating 25.3% Fixed 74.7% Other 0%	Floating 24.9% Fixed 75.1% Other 0%
Weighted average LTV (whole loan LTV)	59.5%	60.3%	57.1%	60.8%
Geographic split (top 3)	Denmark 100%	Denmark 99.8%	Denmark 96.8%	Denmark 97.1%

		Sweden 0.1%	Norway 0.8%	Norway 0.9%
			Sweden 2.3%	Sweden 2.9%
Domestic region split (top 3)	Hovedstaden 46%	Hovedstaden 42.5%	Hovedstaden 46.5%	Hovedstaden 43.5%
	Midtjylland 17.3%	Midtjylland 17.6%	Midtjylland 17%	Midtjylland 17.6%
	Syddanmark 16.8%	Syddanmark 17.4%	Syddanmark 17.8%	Syddanmark 18.3%
Default measure	Inverse Gaussian/ non-parametric			
Weighted average default rate (mortgage/substitute)	3.9%/ 0.06%	3.1%/ 0.09%	3.2%/ 0.05%	2.6%/ 0.09%
Weighted average coefficient of variation (mortgage/substitute)	50%/ 1546%	50%/ 1449%	75%/ 1438%	75%/ 1686%
Weighted average recovery assumption (D0/D9)[4]	92.1% / 74.7%	93.0% / 75.3%	94.7% / 77.1%	93.5% / 74.4%
Share of loans > three months in arrears (NPL)	0.126%	0.132%	0.398%	0.400%
Interest rate stresses (max./min.; currency-dependent)	-1 to 10%	-1 to 10%	-1 to 10%	-1 to 10%
FX stresses (max./min.; currency-dependent)	7% / -7%	7% / -7%	32% / -33%	26% / -36%
D9[1] liquidity premium	150bps/ 300bps	150bps/ 300bps	150bps/ 300bps	150bps/ 300bps
Servicing fee (mortgage)	27bps	27bps	32bps	32bps

[1] The issuer's rating Outlook is Negative.

[2] Covered bonds issued after 2014 can be extended if refinancing fails.

[3] 8% of legal overcollateralisation is calculated based on risk-weighted assets and effectively results in a lower overcollateralisation level as long as the risk-weighted assets are below 100% of the assets' nominal outstanding balance; Realkredit applies an internal rating-based risk weighting.

[4] D0 or D9 denote the stresses commensurate with the rating distance between the issuer rating and the covered bond ratings.

[5] Fixed rate bonds for capital centre T are refinanced regularly reflecting the reset cycles of the mortgage loans.

[6] The drop in commercial assets was driven by a reclassification of 'private rental' from the commercial segment into the residential segment. Without this reclassification the commercial assets would have slightly increased

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