

# Realkredit Danmark A/S Issuer Rating Report



## Overview

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

## Highlights

- ✓ RD is a wholly owned subsidiary of Danske Bank A/S, to which Scope assigns a rating of A+, on review for possible upgrade. It acts as the Group's specialised mortgage bank in Denmark. While it has its own governance structures, RD is closely integrated into the Danske Bank Group, of which it is considered a core subsidiary. Risk management is aligned with that of the parent.
- ✓ Stand-alone financial fundamentals are reassuring, with improving profitability, a low cost of risk and prudential capital ratios comfortably in excess of the minimum.
- ✓ Scope also takes into account the well-tested funding model, while also noting the highly interconnected nature of the Danish banking sector, and thus the role of market confidence in achieving system stability. RD match-funds its loans with covered bonds, eliminating interest rate, currency and other market risks. Its exposure is therefore to the credit risk arising from the property assets it finances.

## Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- **RD 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, displaying a low cost of risk in a mature but still expanding market historically characterised by low credit losses throughout the business cycle.** RD has a 28% market share across all market segments, and also a 28% share of loans to homeowners.
- **Although RD is dependent on wholesale funding, the Danish covered bond market is well-established and liquid, with a broad range of domestic and international investors.** These include 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. RD seeks to upstream excess capital to its parent; however, it maintains prudential capital ratios comfortably in excess of requirements.

## Ratings & Outlook

Issuer Rating	A+
Outlook*	
Short-term debt rating	S-1+
Short-term rating outlook	Stable
Covered Bonds rating	AAA
Covered Bonds outlook	Stable

\*Issuer Rating is under review for upgrade.  
The issuer has solicited the assigned ratings and participated in the rating process.

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Bloomberg: SCOP

### Rating-change drivers

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**A change in Danske Bank's Issuer Rating.** RD's Issuer Rating is aligned to that of its parent; therefore, any change is likely to lead to a concurrent change for RD.

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**Weakening of RD's positioning as a core subsidiary within the Danske Bank Group.** Scope does not view this as likely, given RD's prominence within the Group. Although some loans are originated by RD, a very high proportion of its business is sourced through Danske Bank's network.

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**Material weakening in RD's reassuring financial position.** This would be of particular concern if coupled with any sign that the parent's commitment to RD could be reduced.

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### Rating drivers (details)

**RD is a core subsidiary of the Danske Bank group, and closely integrated into it, with a wholly consistent strategy and risk management principles.**

RD is the specialised Danish mortgage lending subsidiary of Danske Bank Group, Denmark's largest banking group. RD was formed in 2001 when Danske Bank and RealDanmark A/S merged, absorbing the mortgage lending activities previously carried out by Danske Kredit and BG Kredit. As a specialised lender (supervised by the Danish FSA) its activities are confined to mortgage lending funded with covered bonds, and it is prohibited from granting loans that do not meet the eligibility criteria specified in covered bond legislation. RD does not take deposits, although it may issue other types of debt.

RD is responsible for providing the majority of the loans made by Danske Bank Group to personal and business customers in Denmark. Loans are originated through the branch networks of Danske Bank, RD Large Real Estate (which serves RD's largest property customers, as well as clients in Norway and Sweden) and RD's wholly owned subsidiary, Danish estate agent 'Home'. RD also originates loans through online channels and its Home Direct telephone service.

RD accounts for about one quarter of the Danske Bank Group's assets and over 40% of the loan book. It is closely integrated into the Group, although also maintaining its own governance structures, including an eight-member Board of Directors, an Executive Board in charge of day-to-day management, and its own risk management function. The internal audit function is shared with Danske Bank.

Several activities are outsourced to Danske Bank, in exchange for internal fee transfers. These include (but are not confined to):

- Advice to customers, sales, underwriting and credit risk management, through the Danish banking network and Corporate and Institutional Bank;
- The management and development of IT operations, and mortgage processing;
- Portfolio management;
- Risk and valuation modelling, through the Group Risk Management function.
- Finance and accounting;
- Compliance and anti-money laundering functions.

RD performs certain tasks on behalf of the Group, including property valuations.

RD is to some extent covered against loan losses, as under a management agreement Danske Bank provides (for a fee) a first loss guarantee for loans arranged by the bank, effectively covering the top 20% of these loans. At the end of 2017 38% of RD's loan book was partly covered by such guarantees.

**Second largest mortgage lender in Denmark, displaying a low cost of risk in a mature but still expanding market historically characterised by low credit losses throughout the business cycle**

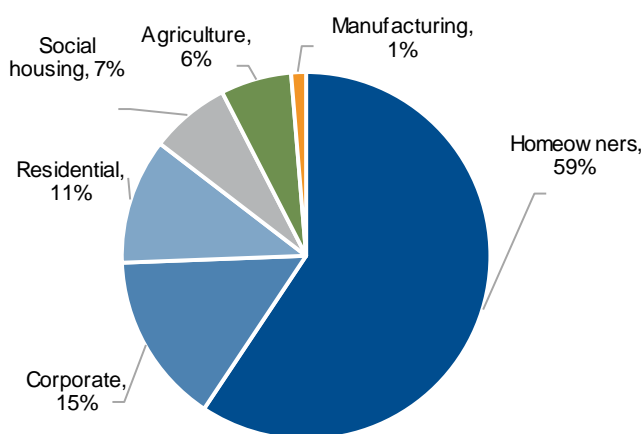
Lending by mortgage banks is at the heart of the Danish credit market, and the amount outstanding is about three times as large as that provided by universal banks. Since the financial crisis, mortgage banks have taken an increasing share of domestic lending, supported by moderate growth in property prices, which as loan-to-value ('LTV') ratios reduce has encouraged households to refinance unsecured borrowings with mortgage loans.

RD is one of five main players in the market, second to Nykredit, and has a 28% market share of the domestic loan stock, spread across all business segments (see Figure 1). RD also has a 28% share of loans to homeowners. Denmark is a mature market, with high entry barriers, and market shares have remained fairly stable in recent years.

RD's lending is primarily in Denmark, with a particular focus in the Greater Copenhagen region. It also selectively provides mortgage loans to business customers in Norway and Sweden (most of which are referred through Danske Bank, and which make up about 3% of the portfolio). RD's main lending focus in Denmark is on residential housing, including owner-occupied housing and holiday homes (see Figure 1). This accounts for 59% of the loan book, but only 19% of accumulated impairments (see Figure 2). RD also provides mortgages to the corporate sector, which could include customers with property in urban trade, agriculture and residential rental property.

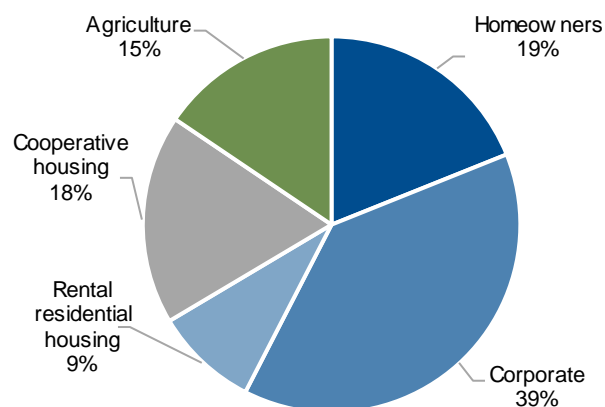
RD does not seek to undercut competitors to win market share; rather it focuses on the quality of its product range. For example, in 2017 a new mortgage product, FlexLife, was launched, for business and personal customers with greater than 25% equity. FlexLife allows the customer to adjust loan repayments within pre-agreed limits, and also pre-agrees the effect of interest rate changes on the loan. In some cases, part of the loan may be eligible for an interest-only period of up to 30 years, although individual lending decisions are taken based on the borrower's financial situation. This is considered a more flexible product than others available in the Danish market. By the end of 2017 it accounted for 3% of RD's gross loans.

**Figure 1: Realkredit Danmark A/S loan portfolio split by segment, YE 2017 (%)**



Source: Company Data

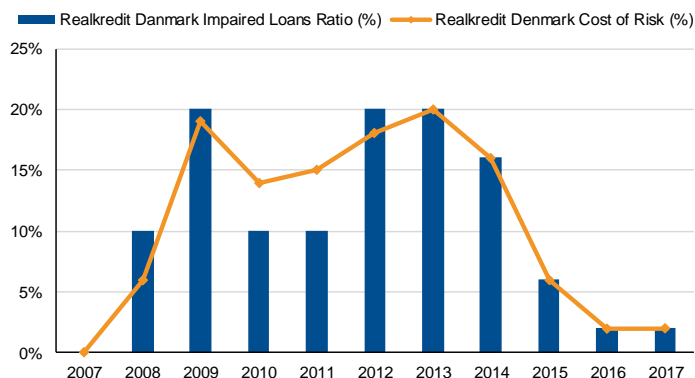
**Figure 2: Realkredit Danmark A/S accumulated impairments by segment, YE 2017 (%)**



Source: Company Data

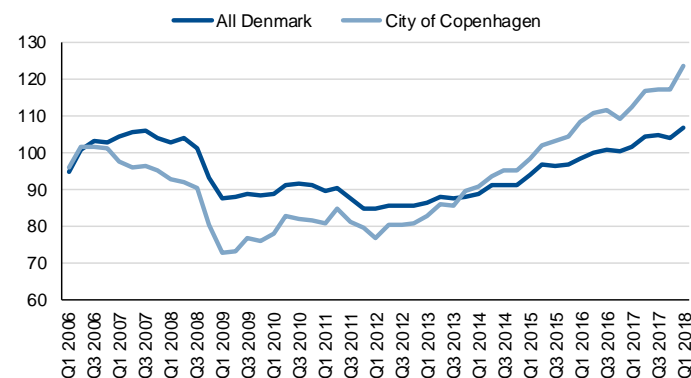
Despite the fall in house prices experienced during the crisis, RD's overall asset quality indicators remained strong. The cost of risk continues to fall, as demonstrated in Figure 3. The agriculture and co-operative housing segments have experienced some volatility, generating impairments in recent years, but the levels have stabilised, and in the latter case partly reversed. At present impairment charges in all segments are low or negative.

**Figure 3: Realkredit Danmark A/S impaired loan ratio vs cost of risk, 2007-2017 (%)**



Source: Company Data

**Figure 4: Index of house prices in Denmark and for Copenhagen, 2006-2018**



Source: StatBank Denmark (index at 100 in 2006).

House prices in Denmark have staged a recovery since the dip that occurred during the financial crisis, which had most effect on houses and apartments in Greater Copenhagen (see Figure 4). Prices have since risen most strongly in the Copenhagen region, supported by structural factors including a steadily rising population, upward pressure on demand for home ownership due to the composition of the housing stock, with a far higher proportion of co-operative and rental housing than in Denmark as a whole, and higher than average employment and income growth.

**Although RD is dependent on wholesale funding, the Danish covered bond market is well-established and liquid, with a broad range of domestic and international investors**

RD funds itself with covered bonds (see Figure 5). Its bond issuance makes it largely self-financing, and it manages its own funding and liquidity risks separately from those of the rest of the Danske Bank group.

We note that the Danish banks are very reliant on wholesale markets, albeit primarily covered bond funding. The financial sector is large relative to the size of the economy, and also strongly interconnected, which may hurt market confidence even in sounder banks at times of stress.

At the same time, Denmark is characterised by high levels of household debt, albeit this is balanced by substantial accumulated household wealth. Debt affordability remains strong, in part due to the prevailing low-interest rate environment. According to Eurostat the ratio of household debt to disposable income was 241% in 2017, down from 244% in 2016 (having hit an all-time high of 270% in 2009). Household interest payments in 2017 represented around 5% of disposable income (14% in 2008).

The largest investors in Danish covered bonds comprise domestic financial institutions, followed by long-term investors in the form of insurance companies and pension funds, and mutual funds and asset managers. At YE17 foreign investors (which could be considered less reliable in a crisis) held about 23% of all bonds.

However, the Danish market has a strong track record as the world's largest covered bond market, measured both against GDP and in absolute terms. It is also one of the oldest, with its origins in the 1850s. Danish covered bonds are considered a tried and tested liquid funding source, with a strong legislative framework (Denmark's Mortgage Act) and low levels of arrears and repossessions, demonstrated even during times of considerable economic stress – most recently when Danish house prices fell by c.20%

between 2007 and 2012. Investor protection is enhanced by the well-defined nature of property rights, tracked through a comprehensive general register and a relatively straightforward and timely system allowing the lender to seize and sell a property in the event of a default.

Mortgage loans and securities serving as covered bond collateral come from all segments of the loan book, and must meet restrictive eligibility criteria, including LTV limits and valuation of property requirements.

Danish covered bonds have over time undergone some changes to the legal framework underpinning them, most recently in 2007, when Denmark's covered bond framework was made compliant with the EU's Capital Requirements Directive.

Before 2007 mortgage banks all adhered to a strict balance principle in their covered bond issuance. This involves a legal pass-through structure and means that:

- All mortgages are pooled and funded by means of covered bonds precisely mirroring their interest and repayment characteristics;
- All funding costs are absorbed by the borrowers;
- Amounts of interest, redemptions and margins from borrowers fall due in advance of interest payments and principal repayments to bondholders;
- Covered bonds are issued on tap daily when the mortgages are originated.

The effect of the balance principle is that interest rate, exchange rate and liquidity risks are largely eliminated.

Post-2007, there are now three types of covered bonds:

- SDO – særligt dækkede obligationer. These can be issued by universal banks or specialised mortgage banks. While a stringent balance principle applies, it is slightly more flexible than the simple pass-through structure.
- SDRO – særligt dækkede realkreditobligationer. These may only be issued by specialised mortgage banks and adhere to the strict traditional pass-through balance principle. RD focuses on issuing SDROs.
- Realkreditobligationer (RO) – covered bonds issued by mortgage banks. Those issued before 31 December 2007 are CRDIV compliant, but those issued after 31 December 2007 are not.

As noted above, RD continues to fund its mortgage lending activities by issuing SDROs, and (to a very limited extent) with legacy ROs, which it ceased to issue after the end of 2007. A sole exception was one RO issued in 2015, which does not comply with CRDIV and hence does not get preferential treatment in terms of risk weighting.

The balance principle allows for interest-reset loans with maturities ranging up to 30 years, while the underlying bonds are typically issued with maturities ranging from one to five years. Refinancing risk is mitigated by caps on the volume of interest-reset loans to be refinanced each quarter and each year. As a last resort, the maturity of maturing covered bonds can be extended in case of a refinancing failure.

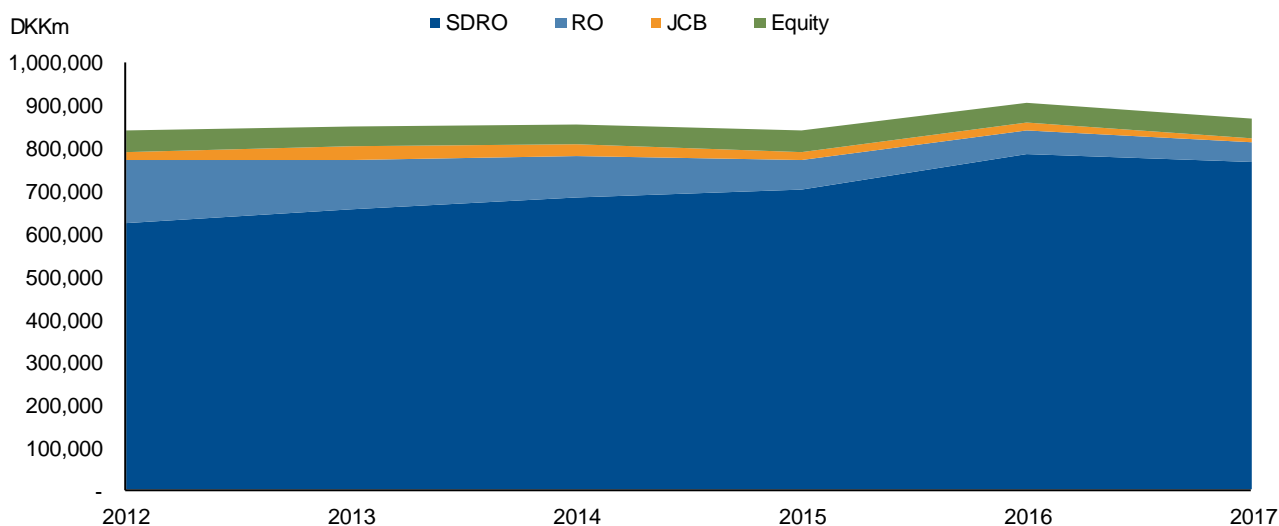
Danish mortgage bank issuers are permitted to run multiple 'capital centres', each with its own segregated cover pool. Each capital centre is regulated subject to a balance principle – either general or specific, as elected by the issuer.

Since July 2007, SDROs have been issued by RD out of its Capital Centre S. Existing RO series in the General Capital Centre were closed at the end of 2007 and are

grandfathered under CRDIV. Since 2011, RD has issued all new interest-reset loans out of Capital Centre T, while a large portion of the interest reset loans in Capital Centre S have been refinanced into Capital Centre T.

We note that RD has outstanding a small amount of what is classified as senior debt on its balance sheet, but this can be viewed as a legacy instrument. RD has no current programme for issuing senior unsecured debt, and the small amount outstanding (see Figure 5) represents so-called Junior Covered Bonds ('JCBs') – although they are not covered bonds. The implementation of CRDIV into Danish law imposes continuous compliance with LTV limits for senior covered bonds. With no deposit funding, in the past issuance of JCBs has helped RD to manage its cover pools while keeping senior covered bonds CRD compliant. JCB creditors have a secondary claim against all the assets in the associated capital centre.

**Figure 5: Realkredit Danmark A/S funding and capital structure evolution, 2012-2017**

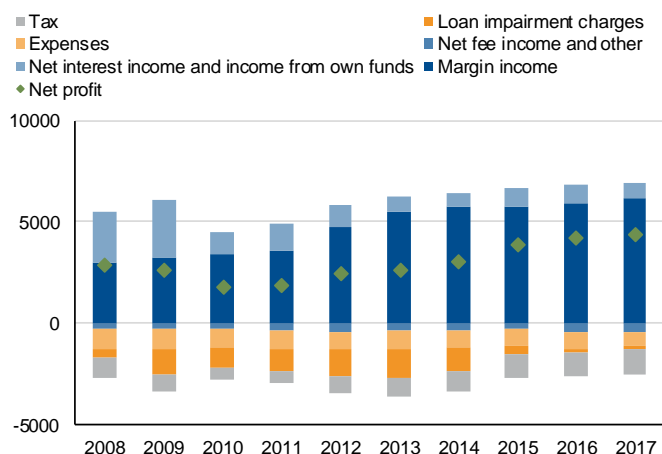


Source: Scope Ratings, Company Data

### Reassuring profitability and prudential capital metrics.

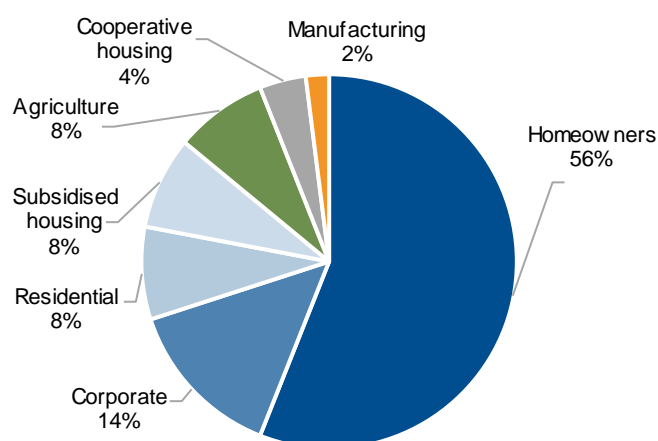
RD has been able to improve its profitability in recent years, through a combination of higher margins on both the new and back books, cost discipline, and a return to low levels of impairments since the financial crisis, as demonstrated in Figure 3. The low interest-rate environment has restrained growth in profitability by reducing the income from RD's investment of its own funds.

**Figure 6: Realkredit Danmark A/S's net profit and drivers, 2008-2017 (DKKm)**



Source: Scope Ratings, Company data

**Figure 7: Realkredit Danmark A/S's margin income by segments, 2017 (%)**



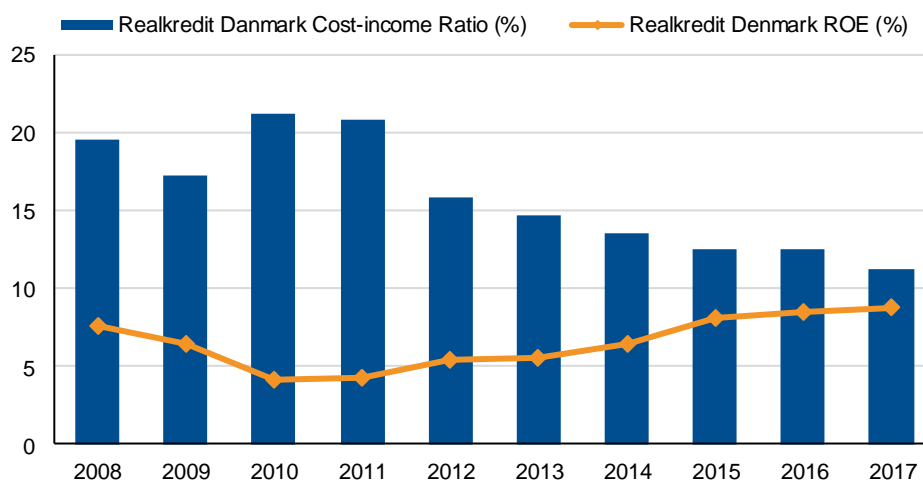
Source: Scope Ratings, Company data

RD's margin income, the largest contributor to the bottom line, stems mainly from its lending to housing segments (see Figure 7), which account for 76% of the total. At the same time, housing segments account for the lowest level of impairments – as of YE17 loans to homeowners accounted for 19% of accumulated impairments (see Figure 2). The highest levels of impairments are in co-operative housing, agriculture and corporate segments.

RD's cost/income ratio has been falling since 2011 (see Figure 8), and at 11.3% in FY17 was the lowest amongst its mortgage bank peers, in large part a function of its membership of the Danske Bank Group.



**Figure 8: Realkredit Danmark A/S ROE vs Cost-income ratio, 2008-2017**



Source: Scope Ratings, Company Data

RD's strategy for managing return on capital is to upstream most net profits and to reduce excess capital, while still maintaining a strong prudential capital position. Thus, in recent years the dividend payout ratio has been 80-100%. However, prudential capital metrics are comfortably in excess of the minimum requirements. At YE17 the CET1 ratio stood at 28.6%. Danish mortgage banks are not subject to MREL, but (as defined in EU directives), capital must be a minimum of 8% of the risk exposure amount (REA); and common equity tier 1 capital and tier 1 capital must equal at least 4.5% and 6%, respectively, of the REA.

Danish mortgage banks must also comply with capital buffer requirements, as follows:

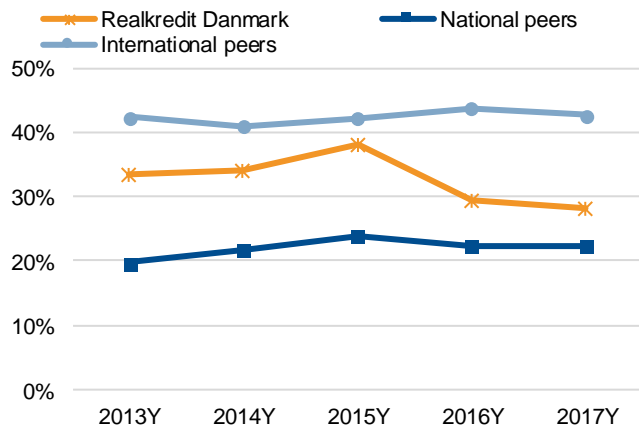
- A capital conservation capital buffer equal to 2.5% of REA (phased in from 2016 to 2019);
- A discretionary counter-cyclical capital buffer, which will be set at 0.5% of REA with effect from 31 March 2019;
- A SIFI buffer of 3.0%, phased in between 2015 and 2020.

In practice all assets and liabilities are assigned to a specific capital centre within the bank, and each of these would form a separate legal entity should RD face insolvency. Each capital centre is therefore separately assessed against the minimum capital requirements.

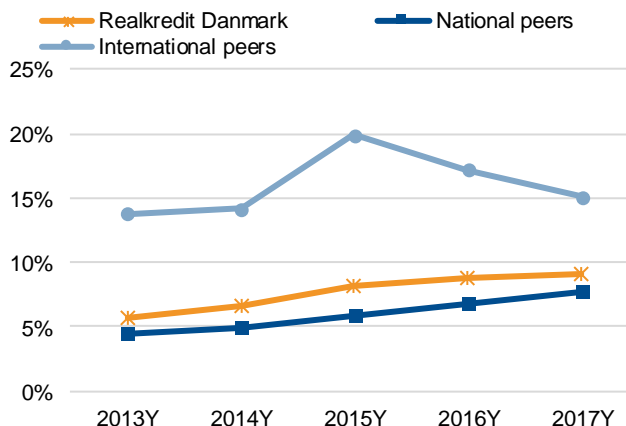
In the absence of an MREL requirement, Danish mortgage banks are required to establish a debt buffer equal to 2% of total (unweighted) mortgage lending, on top of current capital requirements and capital buffers. The buffer may consist of excess capital relative to current capital requirements and capital buffers. In addition, they may use senior (unsecured) debt, although in RD's case this has not been necessary.

### I. Appendix: Peer comparison

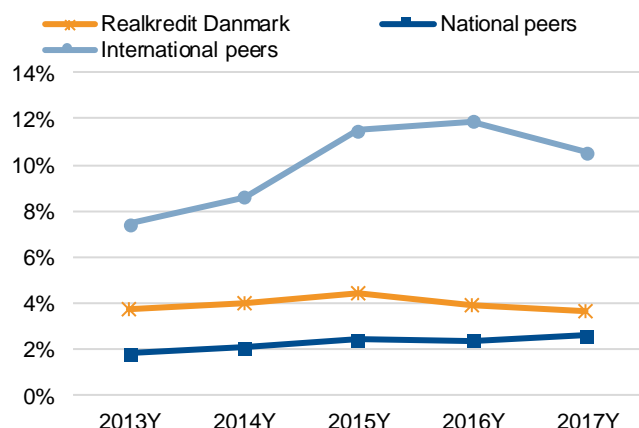
**CET1 Ratio (% , transitional)**



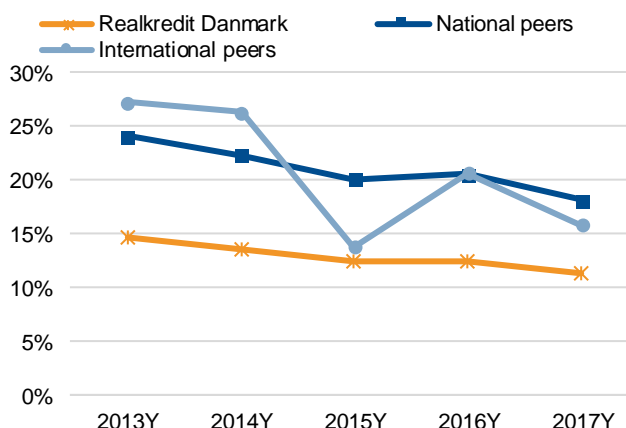
**Return on average equity (%)**



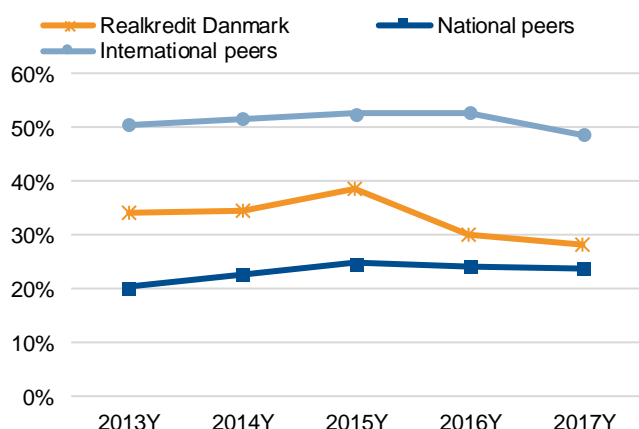
**Pre-Provision Income/RWA (%)**



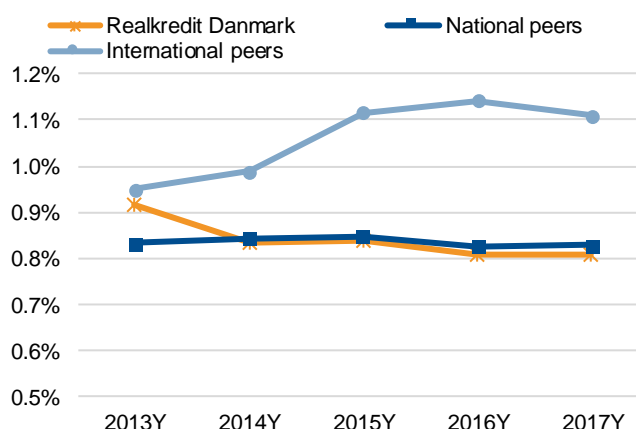
**Cost-to-Income (%)**



**Total Capital Ratio (%)**



**Net Interest Margin (%)**



Source: Source

\*National peers: TO COME



## II. Appendix: Selected Financial Information – Realkredit Danmark A/S

	2014Y	2015Y	2016Y	2017Y	2018H1
<b>Balance sheet summary (DKK m)</b>					
<b>Assets</b>					
Cash and interbank assets	25,882	28,696	31,491	30,072	7,116
Total securities	60,253	60,137	59,795	54,915	54,057
of which, derivatives	451	328	231	64	19
Net loans to customers	745,421	745,166	768,397	789,392	794,784
Other assets	2,999	2,575	2,994	2,511	2,443
<b>Total assets</b>	<b>834,555</b>	<b>836,574</b>	<b>862,677</b>	<b>876,890</b>	<b>858,400</b>
<b>Liabilities</b>					
Interbank liabilities	10,018	16,611	6,355	4,294	1,513
Senior debt	766,773	762,944	799,844	816,666	805,265
Derivatives	20	41	85	10	7
Deposits from customers	0	0	0	0	0
Subordinated debt	0	0	0	0	0
Other liabilities	9,873	8,232	7,046	6,029	3,870
<b>Total liabilities</b>	<b>786,684</b>	<b>787,828</b>	<b>813,330</b>	<b>826,999</b>	<b>810,655</b>
Ordinary equity	47,871	48,746	49,347	49,891	47,745
Equity hybrids	0	0	0	0	0
Minority interests	0	0	0	0	0
<b>Total liabilities and equity</b>	<b>834,555</b>	<b>836,574</b>	<b>862,677</b>	<b>876,890</b>	<b>858,400</b>
<i>Core tier 1/Common equity tier 1 capital</i>	44,854	45,171	45,437	45,446	45,417
<b>Income statement summary (DKK m)</b>					
Net interest income	6,992	7,065	6,860	6,940	3,417
Net fee & commission income	-524	-509	-611	-601	-311
Net trading income	-583	-441	-61	-32	157
Other income	131	196	141	179	67
<b>Operating income</b>	<b>6,016</b>	<b>6,311</b>	<b>6,329</b>	<b>6,486</b>	<b>3,330</b>
Operating expense	815	787	790	736	348
<b>Pre-provision income</b>	<b>5,201</b>	<b>5,524</b>	<b>5,539</b>	<b>5,750</b>	<b>2,982</b>
Credit and other financial impairments	1,171	432	182	147	209
Other impairments	NA	NA	NA	NA	NA
Non-recurring items	0	0	0	0	0
<b>Pre-tax profit</b>	<b>4,030</b>	<b>5,092</b>	<b>5,357</b>	<b>5,603</b>	<b>2,773</b>
Discontinued operations	0	0	0	0	0
Other after-tax items	0	0	0	0	0
Income tax expense	974	1,202	1,176	1,235	610
Net profit attributable to minority interests	0	0	0	0	0
<b>Net profit attributable to parent</b>	<b>3,056</b>	<b>3,890</b>	<b>4,181</b>	<b>4,368</b>	<b>2,163</b>

Source: SNL



### III. Appendix: Selected Financial Information – Realkredit Danmark A/S

	2014Y	2015Y	2016Y	2017Y	2018H1
<b>Funding and liquidity</b>					
Net loans/deposits (%)	NA	NA	NA	NA	NA
Liquidity coverage ratio (%)	NA	NA	NA	NA	NA
Net stable funding ratio (%)	NA	NA	NA	NA	NA
<b>Asset mix, quality and growth</b>					
Net loans/assets (%)	89.3%	89.1%	89.1%	90.0%	92.6%
NPLs/net loans (%)	NA	NA	NA	NA	NA
Loan-loss reserves/NPLs (%)	17.6%	21.1%	28.0%	35.5%	20.7%
Net loan growth (%)	1.9%	0.0%	3.1%	2.7%	1.4%
NPLs/tangible equity and reserves (%)	46.8%	36.2%	23.7%	17.1%	29.5%
Asset growth (%)	-1.6%	0.2%	3.1%	1.6%	-4.2%
<b>Earnings and profitability</b>					
Net interest margin (%)	0.8%	0.8%	0.8%	0.8%	0.8%
Net interest income/average RWAs (%)	5.3%	5.6%	4.8%	4.4%	4.3%
Net interest income/operating income (%)	116.2%	111.9%	108.4%	107.0%	102.6%
Net fees & commissions/operating income (%)	-8.7%	-8.1%	-9.7%	-9.3%	-9.3%
Cost/income ratio (%)	13.5%	12.5%	12.5%	11.3%	10.5%
Operating expenses/average RWAs (%)	0.6%	0.6%	0.6%	0.5%	0.4%
Pre-impairment operating profit/average RWAs (%)	3.9%	4.4%	3.9%	3.6%	3.7%
Impairment on financial assets /pre-impairment income (%)	22.5%	7.8%	3.3%	2.6%	7.0%
Loan-loss provision charges/net loans (%)	126.0%	52.1%	24.5%	20.5%	72.1%
Pre-tax profit/average RWAs (%)	3.0%	4.1%	3.8%	3.5%	3.5%
Return on average assets (%)	0.4%	0.5%	0.5%	0.5%	0.5%
Return on average RWAs (%)	2.3%	3.1%	2.9%	2.8%	2.7%
Return on average equity (%)	6.6%	8.2%	8.8%	9.1%	9.1%
<b>Capital and risk protection</b>					
Common equity tier 1 ratio (% , fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (% , transitional)	34.0%	38.3%	29.6%	28.1%	28.6%
Tier 1 capital ratio (% , transitional)	34.0%	38.3%	29.6%	28.1%	28.6%
Total capital ratio (% , transitional)	34.5%	38.8%	30.1%	28.3%	28.9%
Leverage ratio (%)	5.2%	5.3%	5.2%	5.1%	NA
Asset risk intensity (RWAs/total assets, %)	15.8%	14.1%	17.8%	18.5%	18.5%
<b>Market indicators</b>					
Price/book (x)	NA	NA	NA	NA	NA
Price/tangible book (x)	NA	NA	NA	NA	NA
Dividend payout ratio (%)	NA	NA	NA	NA	NA

Source: SNL



## Realkredit Danmark A/S

### Issuer Rating Report

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