Credit Rating Announcement

27 August 2019

Scope affirms at AAA/Stable the covered bonds issued out of Realkredit's capital centres S and T

The issuer rating of A+ combined with fundamental credit support results in the highest achievable ratings for the mortgage covered bonds. The cover pool provides additional rating stability.

Rating action

Scope Ratings has today affirmed the AAA ratings assigned to the Danish mortgage covered bonds (særligt dækkede realobligationer – SDRO) issued by Realkredit Denmark A/S (RD) out of capital centre S and capital centre T. All ratings have a Stable Outlook. The ratings reflect RD's issuer rating of A+ enhanced by fundamental credit support of up to six notches.

Rating rationale

The affirmation of the mortgage covered bonds reflects the solid issuer rating of RD – the analytical anchor for the covered bonds – enhanced by the stable fundamental credit support available to the covered bonds. This results in the highest achievable ratings. As such, cover pool support is not a rating driver.

Scope performed a cover pool analysis to identify whether cover pool support could further stabilise the ratings – if needed. The agency performed a full analysis, supported by detailed data provided by RD, concluding that cover pool support stabilises the current AAA ratings, even upon a downgrade of RD by up to five notches to BBB-.

Key rating drivers

Issuer rating (positive). RD is a core subsidiary of Danske Bank A/S, with a solid market position as the second largest mortgage lender in Denmark and reassuring profitability and prudential capital metrics.

Fundamental credit support (positive). The legal covered bond framework of Denmark meets Scope's expectation for a two-notch rating uplift. Four additional notches stem from i) the exclusion of SDROs from bail-in upon a potential regulatory intervention in the issuer; ii) the very high likelihood of the regulators maintaining the issuer as a going concern; iii) the high ongoing importance of covered bonds in Denmark and the high visibility of RD as a covered bond issuer; and iv) the cohesion of the country's covered bond stakeholders and their willingness to preserve and enhance the bonds as an attractive funding instrument.

Rating-change drivers

The covered bond ratings may be downgraded upon a deterioration in: i) the issuer rating by six notches or more; and/or ii) Scope's view on fundamental support factors relevant to the issuer and Danish mortgage-covered bonds in general.
RD's covered bond ratings are not impacted by the Negative Outlook on the issuer due to the strong buffer provided by fundamental credit support. The issuer's Negative Outlook mirrors that of its parent, Danske Bank A/S. This reflects the ongoing investigation regarding the alleged money laundering by Danske's Estonian branch.

Transaction overview

As of 31 March 2019, the DKK 490.3bn of cover assets under capital centre T provided 6.6% of overcollateralisation for the DKK 459.8bn of covered bonds. For capital centre S, DKK 274.7bn of cover assets provided 6.9% of overcollateralisation for the DKK 256.9bn of covered bonds.

Both pools are highly granular with 168,039 mortgage loans for capital centre S and 252,343 for capital centre T. The top 10 borrowers account for 2.2% in capital centre S and 4.5% in capital centre T, respectively. Driven by the size and granularity the pools' attributes have remained broadly stable, with only minor variations since our analysis from one year ago.

The main difference between the two capital centres is the fixing of interest rates: 97.7% of mortgage loans in capital centre S are fixed for life; all loans in capital centre T are floating-rate and reset loans, of which most have reset periods of below five years. Also, the share of commercial loans in capital centre S is lower than in capital centre T. Mortgage loans with a residential purpose (including private rental residential, cooperative housing and subsidised housing) account for 88% in capital centre S and 72% in capital centre T. Both have not changed since last year's analysis.

The average indexed loan-to-value ratio is similar: 60.3% (down from 61.1% as of last year's analysis) for capital centre S and 60.8% (from 62.9%) for capital centre T. These levels would provide strong protection against credit losses upon a mortgage borrower's default. The decrease in loan-to-value since last year is predominantly driven by increased indexed market values, reflecting the rise in the country's property prices by 4.2% in 2018.

The cover pool is mostly exposed to credit risks. Market risks are limited and mainly result from the substitute assets held as minimum regulatory and voluntary overcollateralisation.

Asset sales due to asset-liability mismatches from the remaining hard-bullet bonds do not constitute a risk driver because of the available cash stemming from prepayment stresses applied. Around 3.3% (from 8.5%) of bonds in capital centre T are hard-bullet as they were issued before the March 2014 amendment and were grandfathered. Around 1.2% (from 1.7%) of bonds in capital centre S were issued as hard-bullet.

Further research on the issuer and a performance update on the bank's covered bonds is or will in due course be available on www.scoperatings.com or ScopeOne.

Quantitative analysis and assumptions

Scope tested the programmes' stability upon an issuer downgrade by performing an asset analysis using the assumptions detailed below.

The cash flow analysis projected cover pool defaults assuming a normal inverse distribution. 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%), and a weighted average coefficient of variation of 50% and 75%, respectively. These assumptions were based on credit performance data provided by the bank, in particular vintage and loss data, as well as benchmarking. Scope also assumed asset recovery rates ranging between 90.0% in the base scenario and 75.3% in the stressed scenario for capital centre S, and between 93.5% and 75.3%, respectively, for capital centre T.

Scope established total security value haircuts for the properties securing the mortgage loans of 22.5%-65% in the base scenario and 42.5%-80% in the stressed scenario, with the level depending on the location and type of property.

The agency's credit risk analysis of substitute assets accounted for 6.5% of capital centre S' cover pool and 6.2% of capital centre T's, using a portfolio analysis framework. The portfolio's default and loss distribution did not materially contribute to the credit risk of the mortgage portfolios due to its strong credit quality.

Scope tested for low (0%) and high (up to 20%) prepayments to stress the programme's sensitivity to unscheduled repayments. Both programmes are most sensitive to high prepayments as these reduce the available excess spread over the life of the transaction.

Recovery lag assumptions were 18 months for residential loans and 30 months for commercial loans and substitute assets. A weighted annual average servicing fee of 27 bps was assumed for capital centre S and 32 bps for capital centre T.

Stress testing & cash flow analysis

No stress testing and no cash flow analysis was performed to affirm the rating. However, for fundamental credit support-based covered bond ratings Scope identifies whether the cover pool, including available overcollateralisation, would be very likely to provide rating stability in the event of an issuer downgrade. Scope used its covered bond expected loss model (CobEL) to determine the ratings' stability.

Methodology

The methodology used for the ratings and rating outlooks is Scope's Covered bond Rating Methodology which is available on www.scoperatings.com.
Historical default rates of the entities rated by 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 definitions of default and rating notations can be found at https://www.scoperatings.com/#governance-and-policies/rating-scale.
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 and/or its agents 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/or outlook and the principal grounds on which the credit rating and/or 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.
Lead analyst Mathias Pleißner, Director
Person responsible for approval of the rating: Karlo Fuchs, Managing Director
The ratings/outlooks were first released by Scope on 29 August 2018.

Potential conflicts

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Directors: Torsten Hinrichs and Guillaume Jolivet.

About Scope Ratings GmbH

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Contact

Analyst Mathias Pleissner m.pleissner@scoperatings.com
Team leader Karlo Fuchs k.fuchs@scoperatings.com

Scope Ratings GmbH • Lennéstraße 5 • Phone: +49 30 27891-0 • Fax: +49 30 27891-0
www.scoperatings.com

Executive Board: Torsten Hinrichs, Guillaume Jolivet • District Court: Berlin: HRB 192993 B • VAT identification number: DE226486027

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