Realkredit Danmark A/S Issuer Rating Report

SCOPE A+ NEGATIVE

Overview

Scope assigns an Issuer Rating of A+ to Realkredit Danmark A/S ('RD'). The rating has a Negative Outlook. Both rating and outlook are aligned with those of RD's parent, Danske Bank A/S, within which it is closely integrated. Both ratings were confirmed with a Negative Outlook on 27th September 2018, when Scope concluded its review for possible upgrade of both Danske Bank and RD. The rating action reflected negative credit connotations for Danske Bank arising from the ongoing investigation into money-laundering activities that occurred within the non-resident portfolio (since closed) in its Estonian branch.

Note: The rating is provided on a solicited basis, and the issuer has participated in the rating process

Highlights

- RD is considered a core subsidiary of Danske Bank, and acts as the Group's specialised mortgage bank. While it has its own governance structures, RD is closely integrated with its parent, and risk management of the two are aligned.
- Stand-alone financial fundamentals are reassuring, with improving profitability, a low cost of risk and prudential capital ratios comfortably above the minimum.
- Scope also considers 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 position as Denmark's second largest mortgage lender, 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 27.1% domestic mortgage market share as of 1H19.
- **RD is dependent on wholesale funding; however, Denmark's 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, maintains prudential capital ratios comfortably in excess of requirements.

Ratings & Outlook

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

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Bloomberg: SCOP

Rating-change drivers

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.

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.

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.

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 2018 36% 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

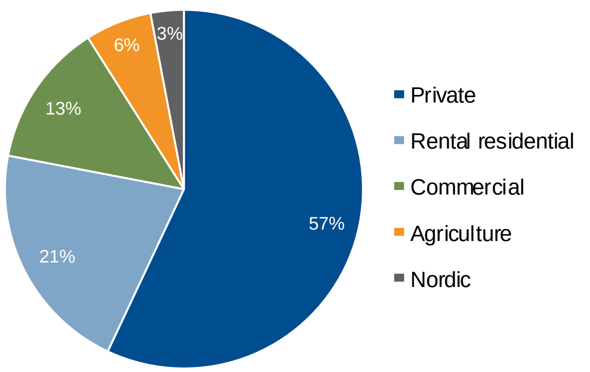
Lending by mortgage banks is at the heart of the Danish credit market, and the amount outstanding is about three times as large as that provided by universal banks. Since the financial crisis, mortgage banks have taken an increasing share of domestic lending, supported by moderate growth in property 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 as of 1H19 had a 27.1% market share of the domestic mortgage loan stock, spread across all business segments (see Figure 1). Denmark is a mature market, with high entry barriers, and market shares have remained fairly stable in recent years. RD saw some net customer outflows in 1H19 it its homeowner portfolio, some of which is related to the need to rebuild trust following the Estonia case, as Danske Bank is RD's main channel for customer recruitment. Levels of outflows appear manageable and are also partly a consequence of high levels of re-mortgaging, due to record low interest rates.

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 many others available in the Danish market, although it has sparked other banks to provide similarly-featured products. By the end of 2018 it accounted for 11% of RD's gross loans. Standard margins on FlexLife loans are 10bps higher than on other RD mortgages.

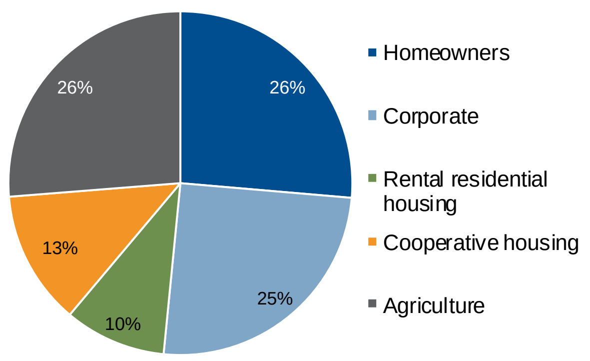
RD's lending is primarily in Denmark, with a particular focus in the Greater Copenhagen region. It also selectively provides mortgage loans to business customers in Norway and Sweden (most of which are referred through Danske Bank, and which make up about 3% of the portfolio). RD's main lending focus 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 26% 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.

Figure 1: Realkredit Danmark A/S loan portfolio split by segment, YE 2018 (%)



Source: Company Data

Figure 2: Realkredit Danmark A/S accumulated impairments by segment, YE 2018 (%)

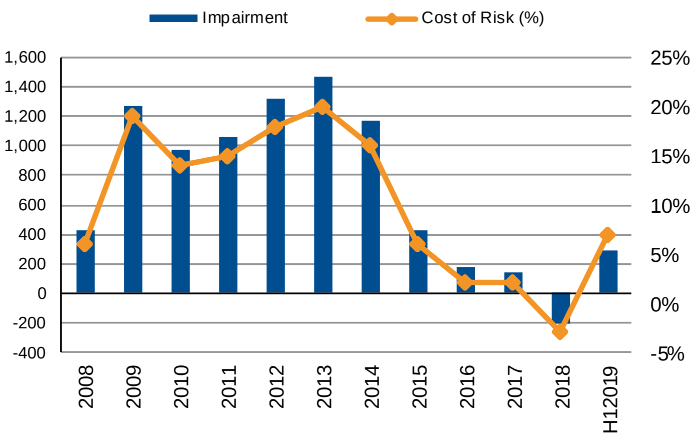


Source: Company Data

Despite the fall in house prices experienced during the crisis, RD's overall asset quality indicators remained strong. The cost of risk fell into negative territory in 2018, as demonstrated in Figure 3, and remains at low levels. The uptick in 1H19 was due to a management add-on relating to model-specific changes to the impairment model used by the Danske Bank group.

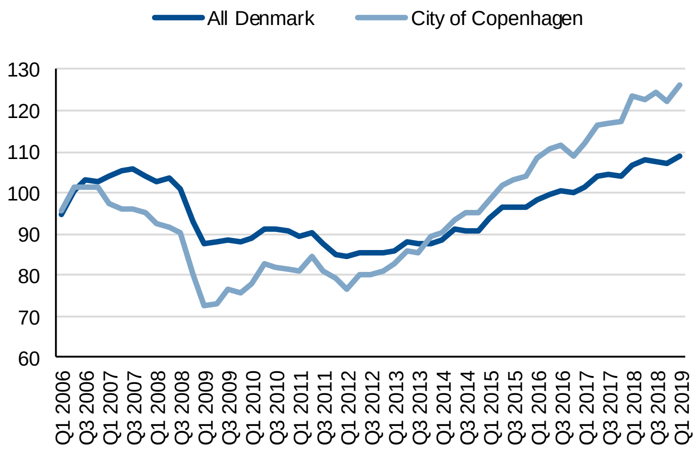
The agriculture and co-operative housing segments have experienced some volatility, generating impairments in recent years, but the levels have stabilised, and in the latter case partly reversed. At present impairment charges in all segments are low or negative.

Figure 3: Realkredit Danmark A/S impaired loans (DKKm) vs. cost of risk, 2007-2019



Source: Company Data

Figure 4: Index of house prices in Denmark and for Copenhagen, 2006-2019



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 has been falling in recent years, and was 241% in 2018, down from 247% in 2017 (having hit an all-time high of 279% in 2009). The most recent Financial Stability Analysis published by Danmarks Nationalbank[1] notes that Danish households have become less vulnerable to interest rate increases, choosing mortgage loans with longer fixed interest periods or fixed rate loans. Clearly this is partly a consequence of historically low interest rates, making it more

[1] 1st Half 2019, published 27th May 2019

attractive for highly indebted borrowers to lock interest periods. At the same time, it has become more expensive to take out loans with deferred amortisation periods or short fixed-interest periods. Changes to banks' credit policies in recent years have focused more on borrowers' ability to pay. In turn these have reflected regulatory changes. For example, the Danish FSA in 2016 introduced guidelines on prudent lending to highly-indebted households and insufficient wealth. More recent regulatory measures took effect in 2018, restricting fixed interest periods and deferred amortisation for loans to highly indebted households with a loan-to-income ratio above four and a loan-to-value ratio of more than 60%. Such households will not have access to floating rate mortgages with reset intervals of less than five years.

RD believes that the regulatory changes were appropriate, especially in the cities of Greater Copenhagen and Aarhus, where the restrictions are most relevant. Their success is reflected in its own portfolio. The level of interest-sensitive new loans with a debt-to-income ratio above 4 and a loan-to-value ratio above 60% fell from 10% in 1Q17 to 2% in 1Q19.

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.

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.

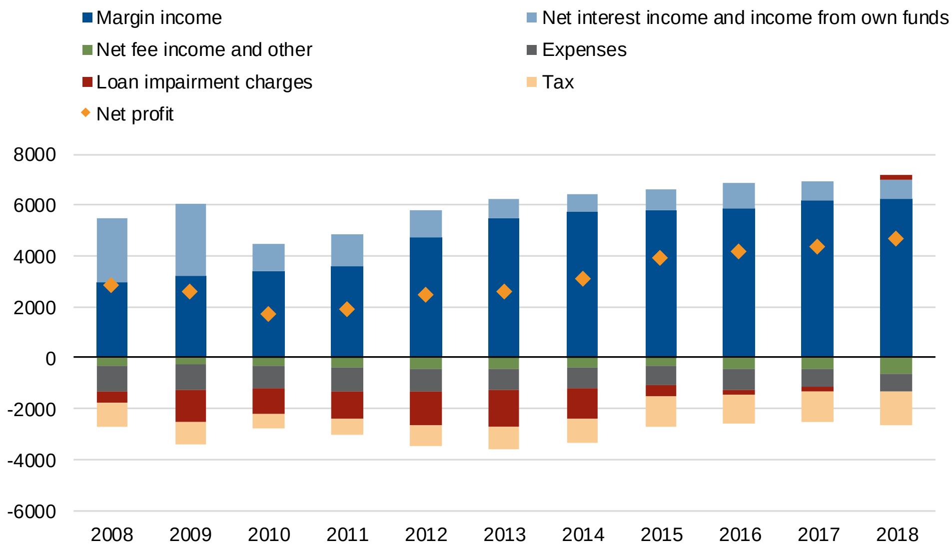
Since July 2007, SDROs have been issued by RD out of its Capital Centre S. Existing RO series in the General Capital Centre were closed at the end of 2007 and are grandfathered under CRDIV. Since 2011, RD has issued all new interest-reset loans out of Capital Centre T, while a large portion of the interest reset loans in Capital Centre S have been refinanced into Capital Centre T.

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 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.

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 Profit and net profit drivers, 2008-2018 (DKKm)

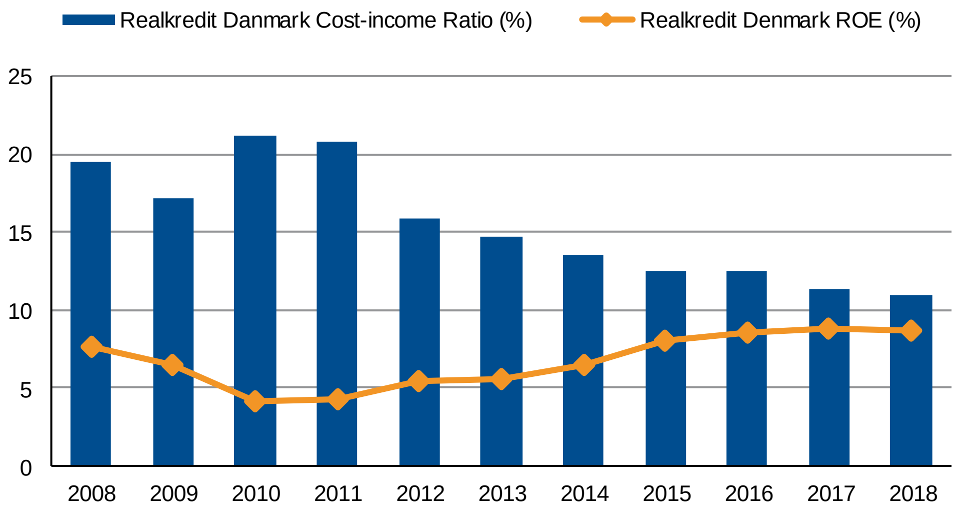


Source: Scope Ratings, Company Data

RD's margin income, the largest contributor to the bottom line, stems mainly from its lending to housing segments (see Figure 1), which account for 76% of the total. At the same time, housing segments account for the lowest level of impairments – as of YE18 loans to homeowners accounted for 26% 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 7), and at 10.9% in FY18 was the lowest amongst its mortgage bank peers, in large part a function of its membership of the Danske Bank Group.

Figure 7: Realkredit Danmark A/S ROE vs Cost-income ratio, 2008-2018



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%. Prudential capital metrics are comfortably in excess of the minimum requirements. At YE18 the CET1 ratio stood at

30.3%. As Basel III requirements are fully phased in towards 2027 solvency needs will rise, but it is expected that the amount of capital upstreamed will be reduced to cover this. 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:

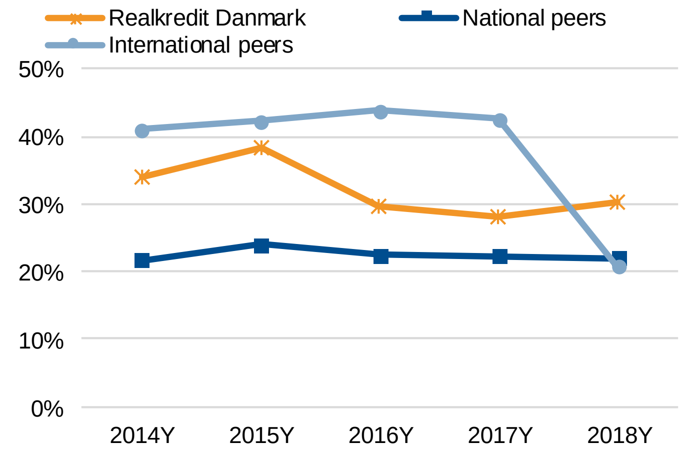
- A capital conservation capital buffer equal to 2.5% of REA (phased in from 2016 to 2019);
- A discretionary counter-cyclical capital buffer, which has been set at 0.5% of REA with effect from 31 March 2019;
- A SIFI buffer of 3.0%, phased in between 2015 and 2020.

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.

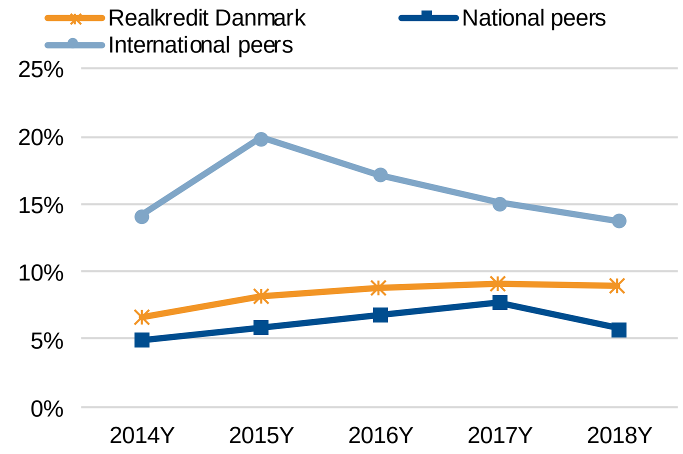
In the absence of an MREL requirement, Danish mortgage banks are required to establish a debt buffer equal to 2% of total (unweighted) mortgage lending, on top of current capital requirements and capital buffers. The buffer may consist of excess capital relative to current capital requirements and capital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

I. Appendix: Peer comparison

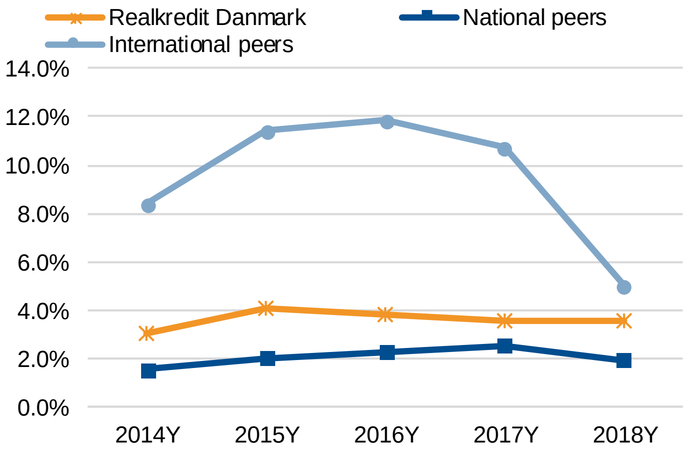
CET1 Ratio (%, transitional)



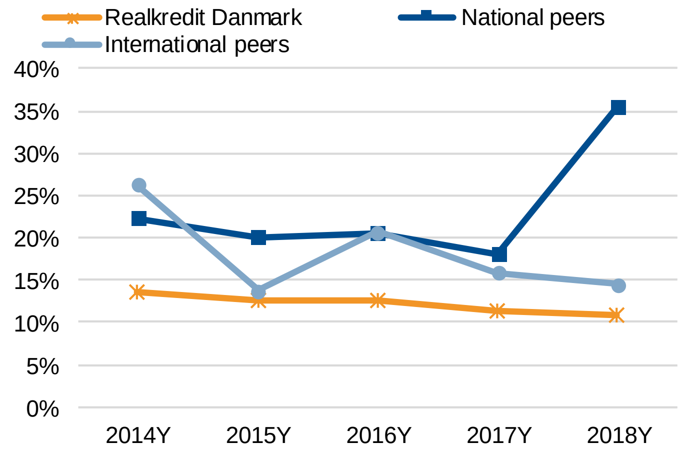
Return on average equity (%)



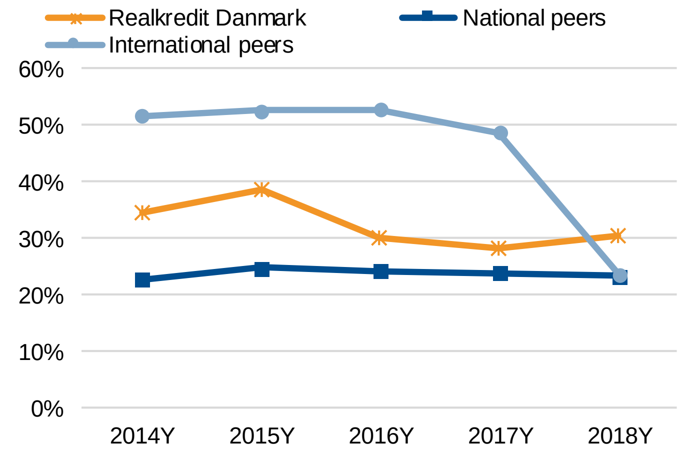
Pre-Provision Income/RWA (%)



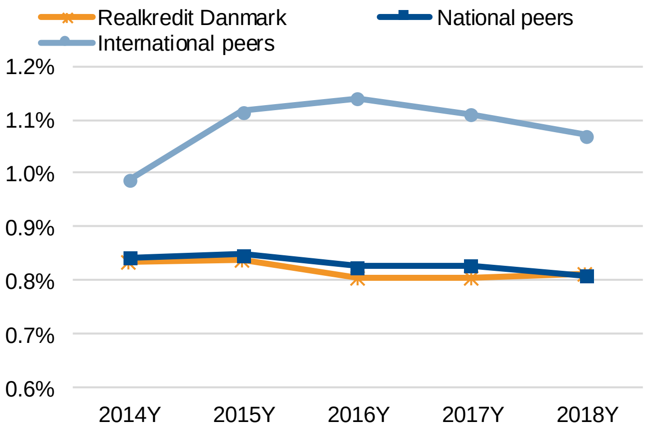
Cost-to-Income ratio (%)



Total Capital Ratio (%)



Net Interest Margin (%)



Source: Source

*National peers: Realkredit Danmark, DLRkredit, Nordea Kredit Realkredit, Nykredit, LR Realkredit

*International peers: Realkredit Danmark, Stadtshypotek, Swedbank Hypotek, Nordea Hypotek, DNB Boligkreditt, Nordea Mortgage Bank

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

	2015Y	2016Y	2017Y	2018Y	2019H1
Balance sheet summary (DKK m)					
Assets					
Cash and interbank assets	28,696	31,491	30,072	21,446	57,150
Total securities	60,137	59,795	54,915	51,224	44,845
of which, derivatives	328	231	64	66	13
Net loans to customers	745,166	768,397	789,392	796,594	804,560
Other assets	2,575	2,994	2,511	1,953	3,974
Total assets	**836,574**	**862,677**	**876,890**	**871,217**	**910,529**
Liabilities					
Interbank liabilities	16,611	6,355	4,294	778	7,220
Senior debt	762,944	799,844	816,666	815,043	851,889
Derivatives	41	85	10	68	29
Deposits from customers	0	0	0	0	0
Subordinated debt	0	0	0	0	0
Other liabilities	8,232	7,046	6,029	5,413	3,748
Total liabilities	**787,828**	**813,330**	**826,999**	**821,302**	**862,886**
Ordinary equity	48,746	49,347	49,891	49,915	47,643
Equity hybrids	0	0	0	0	0
Minority interests	0	0	0	0	0
Total liabilities and equity	**836,574**	**862,677**	**876,890**	**871,217**	**910,529**
Core tier 1/ common equity tier 1 capital	45,171	45,437	45,446	45,448	45,457
Income statement summary (DKK m)					
Net interest income	7,065	6,860	6,940	7,008	3,398
Net fee & commission income	-509	-611	-601	-617	-291
Net trading income	-441	-61	-32	-67	130
Other income	196	141	179	125	56
Operating income	**6,311**	**6,329**	**6,486**	**6,449**	**3,293**
Operating expenses	787	790	736	703	397
Pre-provision income	**5,524**	**5,539**	**5,750**	**5,746**	**2,896**
Credit and other financial impairments	432	182	147	196	287
Other impairments	NA	NA	NA	NA	NA
Non-recurring items	0	0	0	0	0
Pre-tax profit	**5,092**	**5,357**	**5,603**	**5,550**	**2,609**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	1,202	1,176	1,235	1,213	574
Net profit attributable to minority interests	0	0	0	0	0
Net profit attributable to parent	**3,890**	**4,181**	**4,368**	**4,337**	**2,035**

Source: SNL

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

	2015Y	2016Y	2017Y	2018Y	2019H1
Funding and liquidity					
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
Asset mix, quality and growth					
Net loans/ assets (%)	89.1%	89.1%	90.0%	91.4%	88.4%
Problem loans/ gross customer loans (%)	2.5%	1.6%	1.1%	1.5%	1.4%
Loan loss reserves/ problem loans (%)	21.1%	28.0%	35.5%	24.7%	26.3%
Net loan growth (%)	0.0%	3.1%	2.7%	0.9%	2.0%
Problem loans/ tangible equity & reserves (%)	36.2%	23.7%	17.1%	22.0%	22.6%
Asset growth (%)	0.2%	3.1%	1.6%	-0.6%	9.0%
Earnings and profitability					
Net interest margin (%)	0.8%	0.8%	0.8%	0.8%	0.8%
Net interest income/ average RWAs (%)	5.6%	4.8%	4.4%	4.5%	4.5%
Net interest income/ operating income (%)	111.9%	108.4%	107.0%	108.7%	103.2%
Net fees & commissions/ operating income (%)	-8.1%	-9.7%	-9.3%	-9.6%	-8.8%
Cost/ income ratio (%)	12.5%	12.5%	11.3%	10.9%	12.1%
Operating expenses/ average RWAs (%)	0.6%	0.6%	0.5%	0.4%	0.5%
Pre-impairment operating profit/ average RWAs (%)	4.4%	3.9%	3.6%	3.7%	3.8%
Impairment on financial assets / pre-impairment income (%)	7.8%	3.3%	2.6%	3.4%	9.9%
Loan loss provision/ average gross loans (%)	0.1%	0.0%	0.0%	0.0%	0.1%
Pre-tax profit/ average RWAs (%)	4.1%	3.8%	3.5%	3.5%	3.4%
Return on average assets (%)	0.5%	0.5%	0.5%	0.5%	0.5%
Return on average RWAs (%)	3.1%	2.9%	2.8%	2.8%	2.7%
Return on average equity (%)	8.2%	8.8%	9.1%	9.0%	8.5%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	38.3%	29.6%	28.1%	30.3%	29.8%
Tier 1 capital ratio (%, transitional)	38.3%	29.6%	28.1%	30.3%	29.8%
Total capital ratio (%, transitional)	38.8%	30.1%	28.3%	30.6%	30.2%
Leverage ratio (%)	5.3%	5.2%	5.1%	5.1%	NA
Asset risk intensity (RWAs/ total assets, %)	14.1%	17.8%	18.5%	17.2%	16.7%
Market indicators					
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

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