

Transaction Update: Danske Hypotek AB (Mortgage Covered Bond Program)

Säkerställda Obligationer (Mortgage Covered Bonds)

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Ratings Detail

Reference Rating Level	aa-	+	Jurisdiction-Supported Rating Level	aaa	+	Maximum Achievable Covered Bond Rating	aaa	=	Covered Bond Rating	
Resolution Regime Uplift	+2		Assigned Jurisdictional Support Uplift	+3		Collateral Support Uplift	+2		AAA/Stable	
Systemic Importance	Very Strong		Jurisdictional Support Assessment	Very Strong		Overcollateralization Adjustment	0		Rating Constraints	aaa
Resolution Counterparty Rating	A+		Legal Framework	Very Strong		Liquidity Adjustment	0		Counterparty Risk	aaa
Issuer Credit Rating	A*		Systemic Importance	Very Strong		Potential Collateral Based Uplift	+2		Country Risk	aaa
			Sovereign Credit Capacity	Very Strong						

*We use the long-term rating on Danske Bank A/S, to which the issuer is deemed a core entity.

Major Rating Factors

Strengths

- There is a public commitment to maintain a level of overcollateralization commensurate with the current rating and hedge liquidity risk for at least 180 days.
- The program benefits from two unused notches of collateral support.
- Interest rate risk mismatches between the assets in the cover pool and the covered bonds are hedged.

Weaknesses

- About 56.5% of the mortgage loans in the pool have interest-only repayment profiles, which we view as having higher credit risk compared to standard repayment loans.
- The Swedish real estate market shows signs of overvaluation, in our view.

Outlook: Stable

The stable outlook reflects the fact that the ratings on Danske Hypotek AB's mortgage covered bonds benefit from two unused notches of collateral-based uplift under our covered bonds criteria (see "Covered Bonds Criteria," published on Dec. 9, 2014). This means that the ratings on the covered bonds would be unaffected if we were to lower our long-term issuer credit rating (ICR) on Danske Hypotek up to two notches all else being equal.

Rationale

We are publishing this transaction update following our periodic review of Danske Hypotek's mortgage covered bond program.

Our covered bond ratings process follows the methodology and assumptions outlined in our covered bonds criteria and "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

From our analysis of the covered bond program and the Swedish legislative covered bond framework, we have concluded that the assets in the cover pool are isolated from the issuer's insolvency risk. The asset isolation allows us to potentially assign a higher rating to the covered bond program than our long-term ICR on the issuer.

We conducted a review of Danske Hypotek's mortgage operations, which we view as prudent. We believe satisfactory procedures are in place to support our ratings on the covered bonds.

Danske Hypotek is domiciled in Sweden and is a wholly owned subsidiary of Danske Bank A/S, which is domiciled in Denmark. We understand from the European resolution directive that institutions with operations in more than one jurisdiction would be subject to the cooperation from the authorities in the relevant jurisdictions in a resolution scenario. Both Sweden and Denmark are subject to the EU's Bank Recovery and Resolution Directive (BRRD) and we consider that mortgage covered bonds in both jurisdictions have a very strong systemic importance. These factors increase the likelihood that Danske Hypotek would continue servicing its covered bonds without accessing the cover pool or receiving jurisdictional support, even following a bail-in of its senior unsecured obligations.

Under our covered bonds criteria, we assess the reference rating level (RRL) as 'aa-'. We then consider the likelihood of jurisdictional support, which we assess as very strong for mortgage programs in Sweden. This leads us to apply three notches of uplift from the RRL to determine the jurisdiction-supported rating level (JRL), which we therefore assess as 'aaa'.

We have reviewed the asset and liability information provided as of June 30, 2019. The portfolio comprises solely Swedish residential mortgage loans. Based on our cash flow analysis, we believe that the available credit enhancement exceeds the required credit enhancement for a 'AAA' rating.

The covered bonds are currently eligible for two notches of potential collateral-based uplift from the JRL. We have not applied any adjustments to this collateral-based uplift given that, in April 2019, Danske Hypotek committed to maintain a minimum level of overcollateralization commensurate with the 'AAA' rating on the program and to

maintain liquid assets in the cover pool to cover at least 180 days of liquidity risk.

There are currently no rating constraints to the 'AAA' ratings relating to counterparty and country risks.

We have based our analysis on the criteria articles referenced in the Related Criteria section.

Program Description

Table 1

Program Overview*	
Jurisdiction	Sweden
Year of first issuance	2017
Covered bond type	Legislation-enabled
Covered bonds (SEK/bn)	63.5
Redemption profile	Hard bullet
Underlying assets	Residential mortgages
Jurisdictional support uplift	3
Unused notches for jurisdictional support	0
Available credit enhancement (%)	21.49
Credit enhancement commensurate with rating (%)	8.65

*Based on data as of June 2019.

Danske Hypotek is a wholly owned subsidiary of Danske Bank. On June 26, 2017, the Swedish FSA (SFSA) granted Danske Hypotek a license to conduct financing business as a credit market company to issue covered bonds under the Covered Bonds Act. It has been primarily established for the purpose of managing the group's issuance of covered bonds in Swedish krona backed by Swedish krona assets. Under the program, Danske Hypotek can issue covered bonds in Swedish krona or euro, primarily aimed for investors on the Swedish domestic covered bond market. The covered bonds are governed by Swedish law and the operations from the issuer are supervised by the Swedish FSA (SFSA).

The issuer's main activity is to acquire Swedish mortgages from Danske Bank's Swedish branch funded with the issuance of covered bonds. The acquired mortgages are included in the cover pool and must comply with the requirements under the Covered Bonds Act. There is a transitional period in which the issuer can acquire Swedish mortgage loans from Danske Bank's cover pool I as the covered bonds backed by them mature.

Mortgage borrowers pay into their respective account number with Danske Bank. Upon the sale and inclusion of a mortgage loan in the cover pool of Danske Hypotek, borrowers are informed of the sale and their registration number within their account number changes. At that point, Danske Hypotek becomes the account provider and Danske Bank the loan servicer. Commingling risk is covered through the Swedish covered bond law, as long as the funds belonging to the cover pool are always identifiable, which is the case in this structure.

Danske Hypotek has entered into an interest rate swap agreement with Danske Bank to mitigate interest rate risk.

The covered bonds issued under the program are senior, direct, secured, and unconditional obligations of Danske

Hypotek. The covered bond noteholders benefit from the ownership of Danske Bank and have recourse to the portfolio of mortgage loans included in Danske Hypotek.

Chart 1

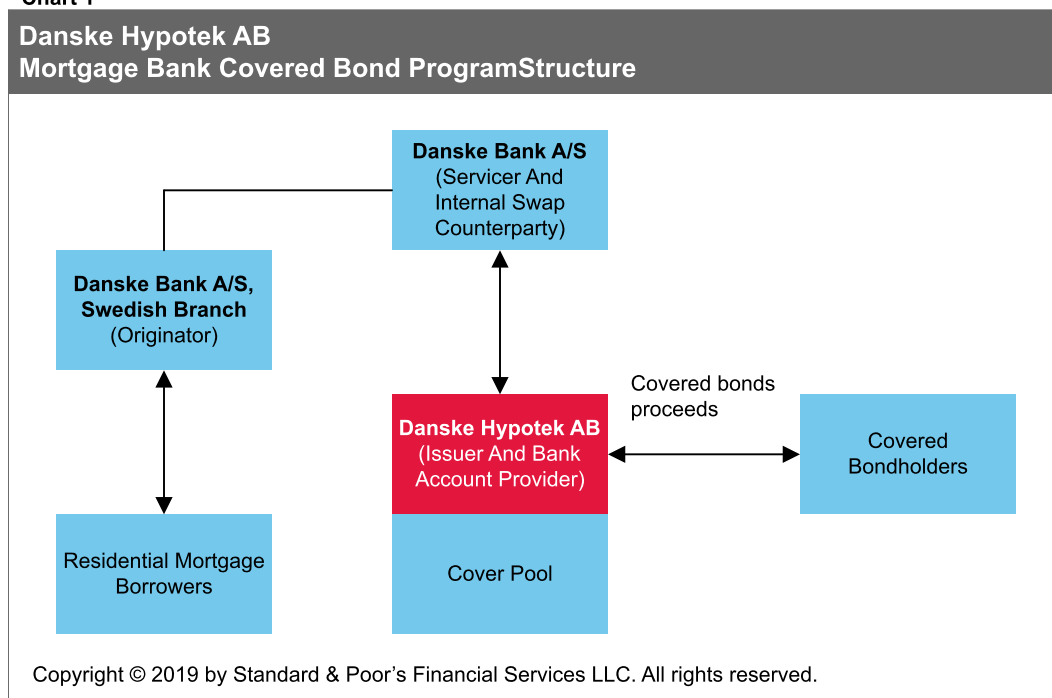


Table 2

Covered Bond Program Participants			
Role	Name	Rating	Rating dependency
Issuer	Danske Hypotek	N/A*	Yes
Originator	Danske Bank A/S	A/Negative/A-1	No
Bank account provider	Danske Hypotek	N/A*	No
Swap provider	Danske Bank A/S	A/Negative/A-1	Yes

*There is no public rating on Danske Hypotek but we use the long-term rating on Danske Bank A/S, to which the issuer is deemed a core entity.

Rating Analysis

Legal and regulatory risks

We base our analysis of legal risk on the guidelines in "Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017.

In our opinion, the Swedish covered bond legal framework satisfies the relevant legal requirements of our covered bonds criteria. This enables us to rate the covered bonds above our long-term ICR on the issuer.

Swedish covered bonds—"saekerstaellda obligationer"—are issued under the Swedish Covered Bond Act ("Lag 2003:1223 om utgivning av saekerstaellda obligationer"). The legal framework was then amended in 2010 to address the range of options available to the program to source external funding and regulatory provisions were passed to complement the framework. Covered bond investors have a preferential claim to a cover pool of assets and to the issuer (but not to its parent company). The cover pool may comprise exposures to properties and rights equivalent to real property located in Sweden or a member state of the European Union. Under the covered bonds law, mortgages may be used as security up to a certain estimated value of the property: 75% for residential properties, 70% for agricultural properties, and 60% for commercial properties. The cover pool may also include exposures to public-sector entities from a wider geographical area than is the case for the mortgage assets. Additionally, liquid assets meeting the eligible requirements of the Swedish Covered Bonds Act (or as defined in the Swedish Covered Bonds Act) can serve as substitute assets and can comprise up to 20% of the mortgage pool.

There is minimum required overcollateralization of 2%. The Swedish covered bond law does not directly require that issuers cover 180 days of liquidity needs at all times, but the SFSA requires that the issuer maintains sufficient liquidity to discharge obligations as they come due.

An independent inspector monitors the cover pool as long as the issuer is solvent. The law does not provide for a separate cover pool administrator if the issuer becomes insolvent. Instead, the receiver-in-bankruptcy represents all investors and also regularly conducts special covered bond supervision.

Operational and administrative risks

In our opinion, there is no operational risk from the cover pool's management and loan origination that would constrain the covered bond rating to the same level as the long-term ICR.

We believe that a replacement cover pool manager could be appointed if the issuer were to become insolvent. We consider Sweden to be an established covered bond market and we believe that the mortgage assets in Danske Hypotek's cover pool do not comprise product features that would materially limit the range of available replacement cover pool managers or servicers.

Danske Bank is the second largest bank in the Nordics, with a market share of 25%-30% in Denmark. Its operations cover retail and commercial banking, asset management, life insurance, and investment banking. The group operates primarily in Denmark, Finland, Sweden, and Norway.

Danske Bank views Sweden as a strategically important market and therefore views the establishment of Danske

Hypotek as a long-term funding solution for its target growth in this market.

Mortgage loan originations are first handled by middle office, branches, or by an automatic online process. Danske Bank's underwriting criteria include LTV caps at 85%, minimum amortization rules for certain loans, and maximum debt to income ratios, among other requirements. Current mortgage loans as well as new origination are concentrated in Greater Stockholm and specific growth centers in Sweden, with about 56.5% of the loans having interest-only repayment profiles.

We view Danske Bank's underwriting criteria as prudent. Our view is also supported by the low level of delinquencies on the bank's mortgages in Sweden.

Our analysis of operational and administrative risks follows the guidelines in our covered bonds rating framework criteria.

Resolution regime analysis

Danske Hypotek is domiciled in Sweden and is a wholly owned subsidiary of Danske Bank A/S, which is domiciled in Denmark. We understand from the European resolution directive that institutions with operations in more than one jurisdiction would be subject to the cooperation from the authorities in the relevant jurisdictions in a resolution scenario. Both Sweden and Denmark are subject to the EU's BRRD. We assess the systemic importance for mortgage covered bonds in both jurisdictions as very strong.

Under our covered bonds criteria, this means the RRL will be the greater of: (i) the ICR on the issuing bank, plus two notches, that is, 'aa-'; and (ii) the resolution counterparty rating (RCR) on the issuing bank, 'A+'. As a result, the RRL is 'aa-', two notches above the ICR.

This uplift recognizes that resolution regimes like the BRRD increase the probability that an issuer could service its covered bonds even following a default on its senior unsecured obligations because the law exempts covered bonds from bail-in risk if there is a bank resolution. We consider this as an internal form of support, because the bail-in of certain creditors of the issuer does not require direct government support. This increases the likelihood that the issuer would continue servicing its covered bonds without accessing the cover pool or receiving jurisdictional support, even if it were to face insolvency.

Jurisdictional support analysis

Under our analysis of jurisdictional support in our covered bonds criteria, we determine a JRL, which is our assessment of the creditworthiness of a covered bond program once we have considered the level of jurisdictional support, but before giving credit to the amount of collateral.

In our jurisdictional support analysis, we assess the likelihood that a covered bond program facing stress would receive support from a government-sponsored initiative instead of from the liquidation of collateral assets in the open market. Our assessment of the expected jurisdictional support for Swedish mortgage covered bond programs is very strong. Under our covered bonds criteria, this means that the program can receive up to three notches of jurisdictional uplift from the RRL. This leads to a JRL for Danske Hypotek's mortgage covered bonds of 'aaa'. The JRL cannot exceed the rating on the sovereign providing the support to the covered bond, which in this case is 'AAA'.

Collateral support analysis

The cover pool comprises Swedish residential mortgage loans originated by the Swedish branch of Danske Bank. We based our analysis on loan-by-loan data as of a cut-off date of June 30, 2019.

The SEK77.1 billion cover pool is fairly granular. It includes loans granted to borrowers with multiple loan parts and, in some occasions, backed by different properties. The pool comprises loans that are secured on Swedish residential retail properties and tenant-owner rights.

Swedish property prices have risen over the past years and we expect this trend to continue. House prices and income levels have not tended to move in tandem over the past years, leading to a material overvaluation in the housing market, in our view. This overvaluation is incorporated in our loss severity calculation in line with our criteria.

The cover pool is fairly unseasoned compared to other Swedish covered bond programs that we rate, with a weighted-average seasoning of about four years and an average LTV ratio of 57%. The loans are concentrated in larger cities, like Stockholm, and 56% of the cover pool balance pays interest-only until maturity. Although these factors could drive upwards our foreclosure risk assessment, the portfolio's historical performance has been good and there are prudent origination and underwriting procedures in place. We have reflected this by applying a positive pool-level adjustment factor in our analysis.

We assess the credit quality of a typical residential mortgage cover pool by estimating the credit risk associated with each loan in the pool. For this program, we base our credit analysis on the application of our European residential loans criteria.

We then calculate the aggregate risk to assess the cover pool's overall credit quality. In order to quantify the potential losses associated with the entire pool, we weight each loan's foreclosure frequency and loss severity by its percentage of the total pool balance. The product of this WAFF and WALs estimates the required loss protection, assuming all other factors remain unchanged.

The WAFF and WALs for the pool are 15.74% and 56.47%, respectively, in a 'AAA' credit stress scenario.

We apply our covered bonds criteria and our European residential loans criteria to analyze the cash flows in the transaction.

Our analysis of the covered bonds' payment structure determines that cash flows from the cover pool assets would be sufficient, at the current rating level, to make timely payment of interest and ultimate payment of principal to the covered bondholders.

We consider that there is an active secondary market for Swedish residential mortgages such as those found in the cover pool. As a result, the program could benefit from up to four notches of collateral-based uplift. However, the available credit enhancement in the program is currently commensurate with up to two notches of collateral-based uplift above the JRL. We do not make any adjustments to these two notches because in April 2019, Danske Hypotek committed to maintain (i) a minimum level of overcollateralization commensurate with the 'AAA' rating on the program and (ii) liquid assets to cover at least 180 days of liquidity needs.

As of June 2019, the credit enhancement needed for coverage of 'AAA' credit risk is 8.65% and the target credit enhancement that is commensurate with the four notches of maximum potential collateral-based uplift is 26.41%.

The program's available credit enhancement is 21.49%, which exceeds the overcollateralization required for the second notch of collateral-based uplift. Since the 'AAA' rating is reached with jurisdictional support, the two notches of collateral-based uplift remain as unused notches in the program.

Table 3

Cover Pool Composition		
As of June 30, 2019		
Asset type	Value (SEK)	Percentage of cover pool
Residential mortgages	77,132,591,365.57	100.00

Tables 4 to 7 below show the characteristics of the June 30, 2019 pool we analyzed.

Table 4

Key Credit Metrics	
As of June 30, 2019	
Weighted-average current LTV ratio (%)	57.35
Weighted-average loan seasoning (years)*	3.93
Balance of loans in arrears (%)	0.09
Second homes (%)	4.38
Interest-only loans (%)	56.47
Loans backed by tenant-owner rights	41.40
Credit analysis results:	
Weighted-average foreclosure frequency (WAFF; %)	15.74
Weighted-average loss severity (WALS; %)	56.47
AAA credit risk (%)	8.65

*Seasoning refers to the elapsed loan term.

Table 5

Pool LTV Ratios	
As of June 30, 2019	
Current LTV (%)	Percentage of portfolio
0-10	0.52
10-20	2.34
20-30	5.25
30-40	8.77
40-50	13.79
50-60	17.94
60-70	19.52
>70	31.88
Weighted-average LTV ratio	57.35

Table 6

Loan Seasoning Distribution*	
As of June 30, 2019	
Months	Percentage of portfolio
0-60	73.55
60-72	4.64
72-84	4.08
84-96	4.12
96-108	3.48
108-120	2.04
More than 120	8.01
Weighted-average loan seasoning (years)	3.93

*Seasoning refers to the elapsed loan term.

Table 7

Geographic Distribution Of Loan Assets	
As of June 30, 2019	
Region	Percentage of portfolio
Smaland and the islands	3.63
South Sweden	9.28
Stockholm	48.83
Upper Norrland	0.42
Middle Norrland	1.42
West Sweden	17.40
East Middle Sweden	16.13
North Middle Sweden	2.88
Total	100

Table 8

Collateral Uplift Metrics	
As of June 30, 2019	
Asset WAM (years)	13.18
Liability WAM (years)	3.67
Available credit enhancement (%)	21.49
Required credit enhancement for first notch of collateral uplift (%)	13.09
Required credit enhancement for second notch of collateral uplift (%)	17.53
Required credit enhancement for third notch of collateral uplift (%)	21.97
Target credit enhancement for maximum uplift (%)	26.41
Potential collateral-based uplift (notches)	2
Adjustment for liquidity (Y/N)	N
Adjustment for committed overcollateralization (Y/N)	N
Collateral support uplift (notches)	2

WAM--Weighted-average maturity.

Counterparty risk

Counterparty risks are either structurally addressed or mitigated by the inclusion of replacement language in line with our current counterparty criteria. As a result, we believe that counterparty risks do not constrain the program rating (see "Counterparty Risk Framework: Methodology And Assumptions," published on March 8, 2019).

Bank account provider and commingling risk

Mortgage borrowers pay into their respective account number with Danske Bank. Upon the sale and inclusion of a mortgage loan in Danske Hypotek's cover pool, borrowers are informed of the sale and their registration number within their account number changes. At that point, Danske Hypotek becomes the account provider and Danske Bank the loan servicer. We consider commingling risk to be mitigated by the Swedish covered bond law, as long as the funds belonging to the cover pool are identifiable at all times, which is the case in this structure in our view.

Swaps

The issuer has entered into a swap agreement with Danske Bank.

On the asset side, the issuer swaps the loans' base rate into three-months Stockholm Interbank Offered Rate (STIBOR). Under the swap the issuer pays to the swap counterparty each month the base rate on the mortgage loans and receives on a quarterly basis three-months STIBOR.

On the liability side, the issuer pays three-month STIBOR and receives the corresponding fixed interest rate.

The reset dates on the assets and the covered bonds are the same, thus mitigating basis risk.

Danske Bank is a related counterparty to the issuer and it is entitled to termination payments that rank pari passu with payments on the covered bonds. According to the swap documentation, Danske Bank is committed to replace itself, at its own cost and within 60 days, if its rating falls below 'BBB+'. If it fails to meet this commitment, an additional termination event would allow the issuer to terminate the derivative agreement. Furthermore, if its rating is lowered below 'A', the swap counterparty is committed to post collateral sufficient to cover the issuer's exposure to the counterparty plus certain volatility risk in the swap value. We categorize the current counterparty's collateral-posting framework in the derivative contract as adequate according to our counterparty criteria.

Our counterparty criteria combine the collateral framework assessment with the replacement trigger and the issuer's RRL to derive the maximum potential covered bond rating. While the replacement trigger according to the swap documentation is the 'BBB+' rating on the long-term, unsecured and unsubordinated debt obligations of Danske Bank, our counterparty criteria state that RRL is the applicable counterparty rating when the counterparty is related to the covered bond issuer. We have therefore derived the applicable replacement trigger from the rating type shown in the documentation.

When the swap documentation does not explicitly refer to a rating type, as is the case in this program (which refers to rating triggers on the long-term, unsecured and unsubordinated debt obligations of the bank) we generally consider this to be our RCR.

A replacement trigger of 'BBB+' on the RCR equates to a replacement trigger of 'BBB' on the long-term ICR, because there is currently one notch difference between the RCR and ICR on Danske Bank. This, in turn, equates to a

replacement trigger of 'a-' on the RRL (given the very strong systemic importance of mortgage covered bonds).

The adequate collateral framework assessment, combined with the current RRL on the issuer ('aa-') and the replacement trigger at 'a-', supports a maximum potential rating of 'AAA' under our counterparty risk assessment.

Country risk

We assess country risk by applying our RAS criteria (see "Incorporating Sovereign Risk In Rating Structured Finance Securities: Methodology And Assumptions," published Jan. 30, 2019). Given that all assets are located in Sweden (AAA/Stable/A-1+), country risk does not constrain our ratings on the covered bonds.

Related Criteria

- Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- Incorporating Sovereign Risk In Rating Structured Finance Securities: Methodology And Assumptions, Jan. 30, 2019
- Criteria - Structured Finance - General: Methodology And Assumptions: Assessing Pools Of European Residential Loans, Aug. 4, 2017
- Legal Criteria: Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Criteria - Structured Finance - Covered Bonds: Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bonds Criteria, Dec. 9, 2014
- Criteria - Structured Finance - General: Global Derivative Agreement Criteria, June 24, 2013
- General Criteria: Methodology: Credit Stability Criteria, May 3, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Global Covered Bond Insights Q2 2019, June 27, 2019
- Global Covered Bond Characteristics And Rating Summary Q2 2019, June 27, 2019
- S&P Global Ratings' Covered Bonds Primer, June 20, 2019
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Oct. 16, 2018
- Assessments For Target Asset Spreads According To Our Covered Bonds Criteria, Oct. 16, 2018
- Glossary Of Covered Bond Terms, April 27, 2018

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