

# Danske Hypotek AB (publ)

Initial Rating Report

## COVERED BOND RATING

**AAA**

## ISSUER RATINGS

### LONG-TERM RATING

**A**

## OUTLOOK

**Negative**

## SHORT-TERM RATING

**N-1+**

## PRIMARY ANALYST

Sean Cotten  
+46735600337  
sean.cotten@nordiccreditrating.com

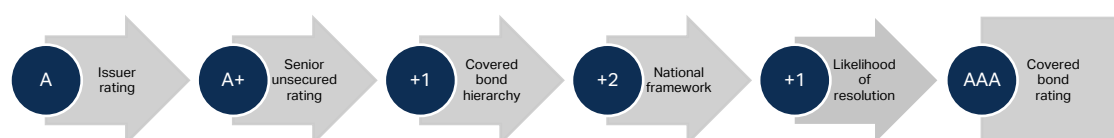
## SECONDARY ANALYST

Geir Kristiansen  
+4790784593  
geir.kristiansen@nordiccreditrating.com

## RATING RATIONALE

Our 'AAA' issue rating on covered bonds issued by Sweden-based mortgage company Danske Hypotek AB (publ) (DH) is ultimately based on our 'A' issuer rating on the company which in turn reflects its ownership by the Danske Bank A/S bank group (Danske Bank) and its vital funding role for the group's mortgage portfolio in Sweden. Our covered bond ratings are supported by our qualitative assessment of 'aaa' as well as our analysis of the support available from the cover pool, which indicates 'AAA' level support for bondholders in the unlikely event that the pool becomes a standalone entity.

Figure 1. Danske Hypotek covered bond rating components



Despite our negative outlook on the issuer rating on DH given the uncertain economic impact of the COVID-19 pandemic on Sweden and Denmark, we do not anticipate a multiple-notch downgrade of the company and expect the covered bond ratings to be stable. This reflects our view that DH and Danske Bank will maintain their status as systemically important financial institutions (SIFIs) with a very high likelihood of resolution which would be expected to exclude the bail in of covered bonds.

### RATING STRENGTHS:

- Issuer and group creditworthiness, reducing downgrade risk for covered bonds.
- Strong national and European protections for covered bonds.
- DH's maintenance of a clean loan book via transfers of non-performing loans to its parent.

### COVERED BOND RATING DRIVERS:

- Change in single point of entry resolution for Danske Bank.
- Multiple-notch reduction in NCR's issuer rating on DH, potentially due to deterioration in our assessment of Danske Bank.
- Reduced security in covered bond assets.

Figure 2. Danske Hypotek cover pool characteristics, 2017Q4-2019Q4

	2017Q4	2018Q2	2018Q4	2019Q2	2019Q4
Eligible cover pool assets (SEKm)	32.9	56.0	74.5	74.5	92.9
Outstanding covered bonds (SEKm)	19.1	38.9	47.6	63.5	73.1
Overcollateralisation (%)	72.1	44.2	56.6	17.3	27.0
Weighted-average LTV (%)	51.2	56.2	59.1	58.4	59.0
Average loan seasoning (years)	4.3	3.6	3.4	3.8	3.8
Average bond maturity (years)	4.7	4.4	4.0	3.7	3.3
Average loan size (SEKm)	1.06	1.08	1.08	1.07	1.06
Owner-occupied share (%)	94.2	95.5	95.8	95.8	96.2
Priority liens (%)	100.0	97.9	98.2	98.3	98.5
>60 day past due loans (bps)	0.0	0.0	0.0	0.0	0.0

Based on DH's European Covered Bond Council Harmonised Transparency Templates (ECBC HTT). LTV-loan to value.

Figure 3. Loan balance by region (SEKbn), 31 Dec. 2019

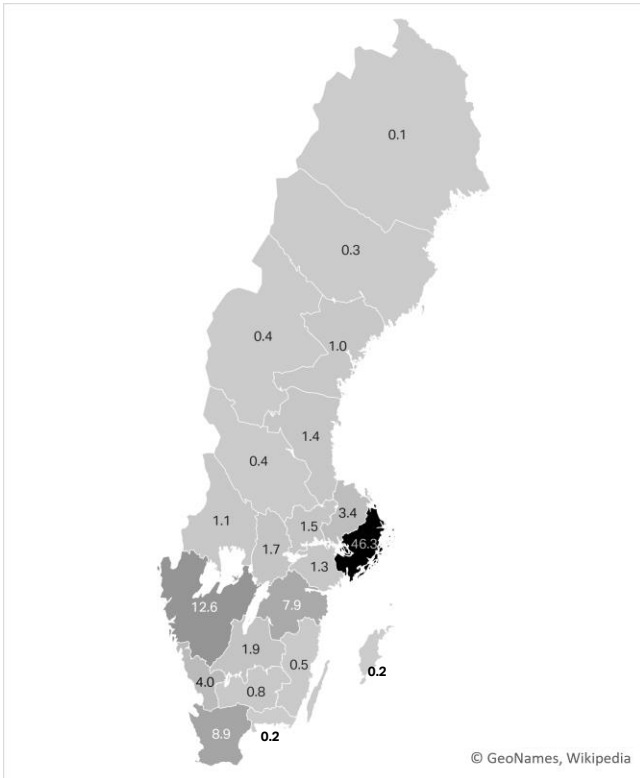


Figure 4. Weighted LTV by region (%), 31 Dec. 2019

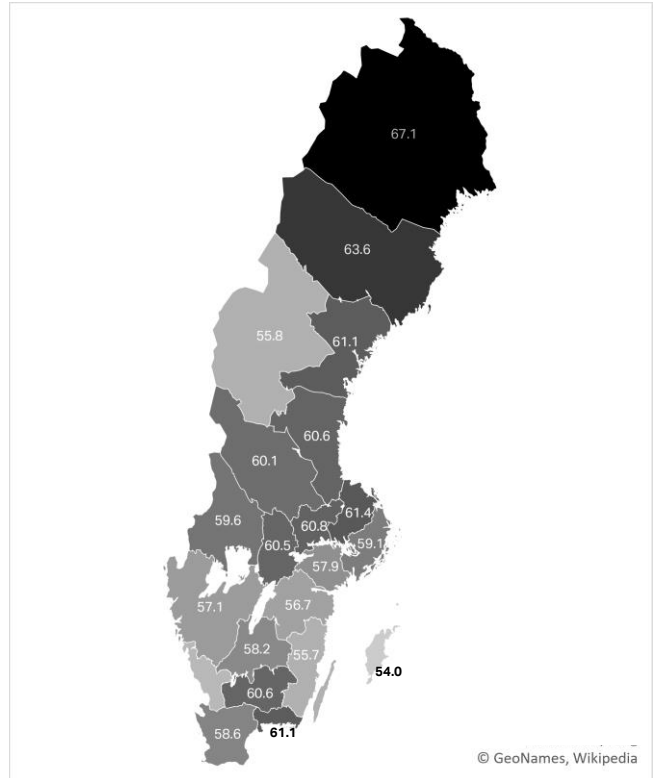


Figure 5. Average loan balance by region (SEKbn), 31 Dec. 2019

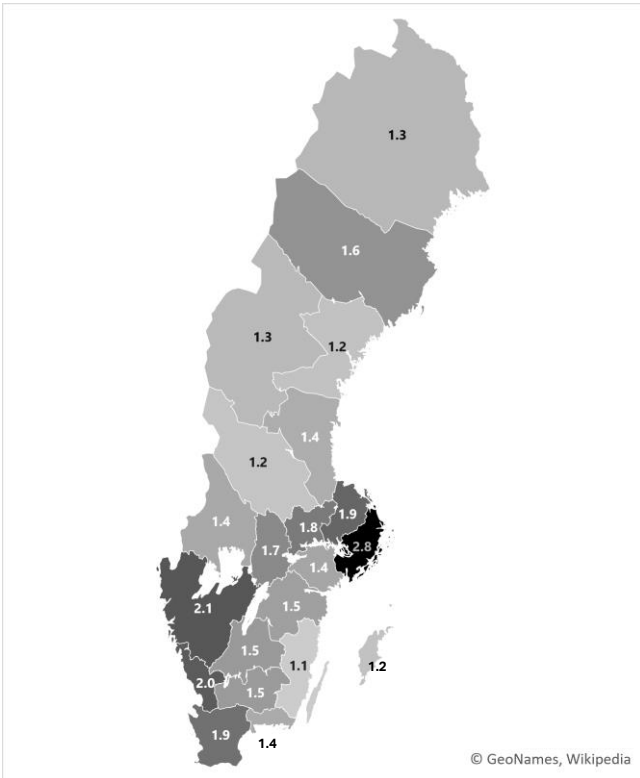
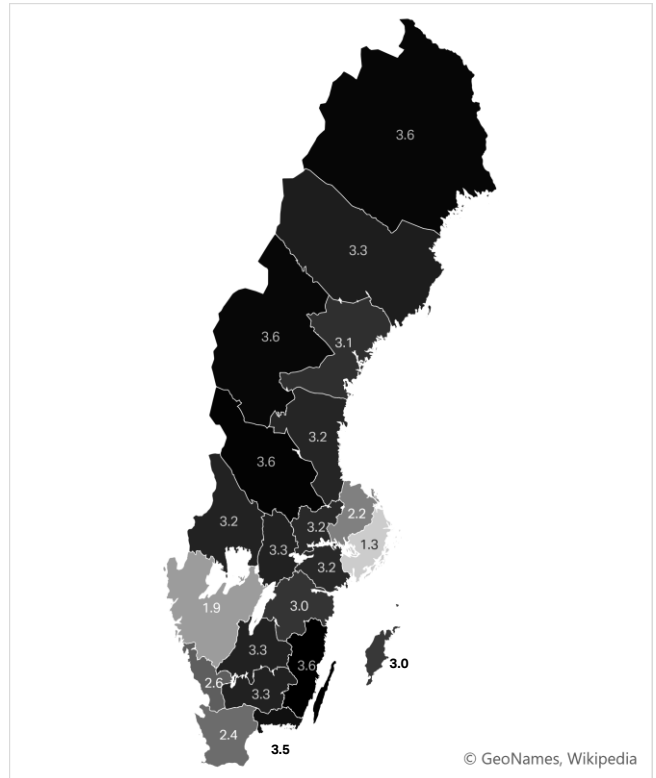


Figure 6. Average region class<sup>1</sup> under NCR methodology, 31 Dec. 2019

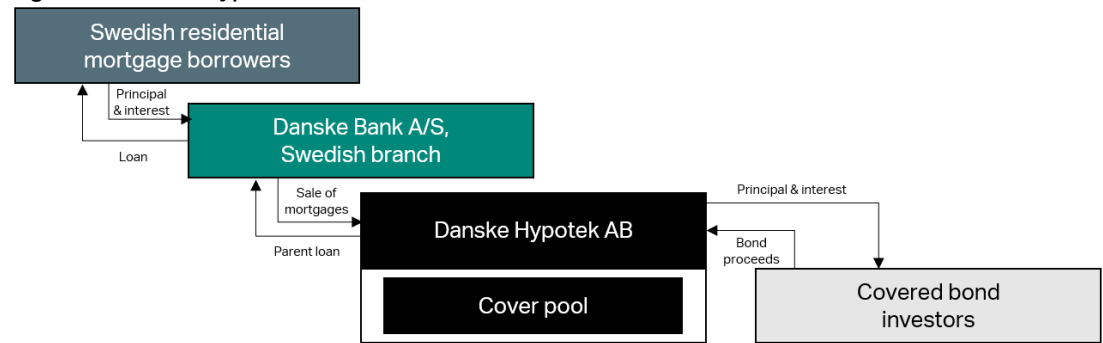


<sup>1</sup> See §65, *Covered Bond Rating Methodology*, 5 Jul. 2019. In summary, region classes are defined from 1-5. Classes 1-2 are for larger cities where price fluctuations are larger, but liquidity is higher. A class of 3 is in line with national levels and classes 4-5 reflect less liquid housing markets.

## COMPANY PROFILE

DH is a wholly owned Swedish subsidiary of Danske Bank and has been authorised to issue covered bonds in Sweden since 2017. The company was created to provide access to Sweden's covered bond market and to finance Danske Bank's Swedish mortgage loans in the same manner and benchmark market as its competitors. All of the loans financed by DH were acquired from Danske Bank's Swedish branch given that DH itself does not conduct any new lending business. A large share of DH's loan book was previously financed by Danske Bank's Danish covered bond pool.

Figure 7. Danske Hypotek covered bond structure



Source: Company

Danske Bank originally entered Sweden in 1995 and operates via a branch. It has explicit growth ambitions in the Swedish banking market and has steadily improved its mortgage market share to nearly 4% over the past two decades in part driven by similar professional trade union partnerships employed by Danske Bank in other Nordic countries.

## QUALITATIVE ASSESSMENT

NCR's qualitative assessment of DH's covered bonds is 'aaa', reflecting the 'A' issuer rating on the company and notches of support taking into account Swedish covered bond regulation and the very high likelihood of a single point of entry resolution for Danske Bank, protecting DH's covered bonds from bail in. Our qualitative assessment considers the likelihood that the cover pool will become a standalone entity, thus becoming solely responsible (without further support from Danske Bank or DH) for ensuring that bondholders receive timely coupon and principal payments.

## ISSUER RATING

NCR believes that repayment capacity for covered bonds is linked to the credit quality of the issuer and the issuer's banking group. We have assigned DH an issuer rating of 'A' (see the appendix for a summary of our issuer rating on DH). Our rating considers the current Swedish operating environment for mortgage lenders as well as DH's strong risk-adjusted earnings, very low historical and projected loss performance, and low credit risk profile. We consider DH a challenger in the Swedish mortgage market and note that the loan book is concentrated in Stockholm, but we believe that the company benefits from being selective with the loans transferred from Danske Bank. While our 'a' standalone assessment of DH is in line with our credit assessment of Danske Bank, we view DH as a core financing vehicle for the parent's Swedish mortgage operations, providing some additional support to our 'A' issuer rating on DH if conditions in the Swedish market were to deteriorate further. The outlook for our issuer rating on DH is negative, reflecting the uncertain economic impact of COVID-19 on housing prices and the potential for material further deterioration in asset quality in Danske Bank's loan book throughout the Nordic banking markets.

Our qualitative assessment of the covered bonds is 'aaa'

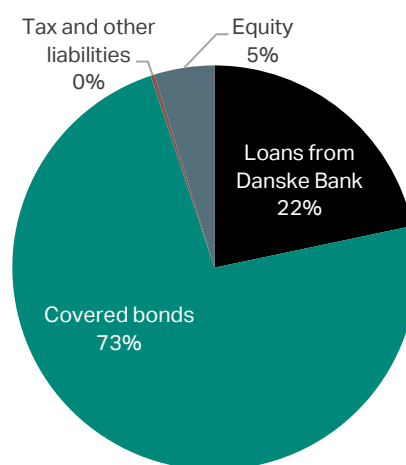
Our issuer rating on DH is 'A'

## SENIOR UNSECURED ISSUE RATING AND COVERED BOND HIERARCHY

The covered bond starting point is two notches above the issuer rating given senior non-preferred buffers

As of end-2019, Danske Bank had issued DKK 86bn in senior non-preferred debt instruments. These instruments are likely to provide a meaningful buffer for Danske Bank's senior unsecured creditors in the event of resolution and benefit all group subsidiaries. DH's liability structure consists primarily of covered bonds, which are already excluded from bail in according to the EU's Bank Recovery and Resolution Directive (BRRD), and loans directly from Danske Bank. We note that Danske Bank's senior loan is subordinated to covered bond holders, giving them priority claims on all mortgage loans transferred to DH, whether or not such loans are eligible for the cover pool. In our view, the bail in of senior non-preferred instruments in the event of a resolution of Danske Bank is likely to provide material additional support to DH which we reflect in an additional notch above the issuer rating in our senior unsecured rating of 'A+'.

Figure 8. Danske Hypotek liabilities, end-2019



Source: company reports

Given the preference for covered bonds in Swedish financial institutions' debt hierarchies, NCR adds an additional notch to DH's covered bond ratings, i.e. one notch higher than the theoretical rating for the company's senior unsecured instruments. This reflects the implementation of the BRRD which explicitly defines covered bonds as having priority over senior unsecured debt obligations in the default hierarchy of financial institutions. The BRRD also limits the potential for bail in of covered bonds in instances in which covered bond liabilities exceed eligible cover pool assets. However, liabilities may never exceed eligible pool assets in Swedish covered bond pools.

According to the Swedish Financial Supervisory Authority (FSA), the priority structure of Swedish banks is as follows:

1. Claims with a special right of priority, e.g. covered bonds
2. Claims with a general right of priority, e.g. guaranteed deposits
3. Claims with no right of priority, non-prioritised claims, e.g. senior bonds
4. Some claims with no right of priority that are attributable to debt instruments pursuant to Chapter 21, section 15, point 3a of the Resolution Act (2015:1016)<sup>2</sup>
5. Subordinated debt and capital instruments

<sup>2</sup>Section 18 of the Swedish Rights of Priority Act (1970:979), see also Bill 2017/18:292.

A 2-notch uplift reflects the strength of covered bond regulations in Sweden

**NATIONAL REGULATIONS**

We consider the legal framework for Swedish covered bonds as supportive of the creditworthiness of covered bonds secured by standard residential and commercial mortgage loans, adding an additional two notches to the rating on DH's covered bonds.

Swedish covered bonds are governed by the Covered Bonds Issuance Act (*Lag (2003:1223) om utgivning av säkerställda obligationer*) as well as the Swedish FSA's regulations and general guidelines (FFFS 2004:11) on covered bonds.

The Swedish Covered Bonds Issuance Act ensures:

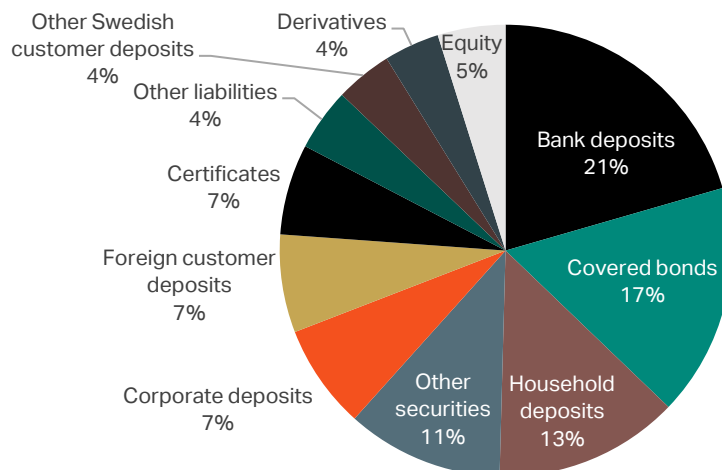
- The bankruptcy remoteness of the cover pool and the maintenance of an accurate register of pool assets, including derivative agreements;
- Covered bond investors' preferential claim to pool assets;
- Covered bond investors' pari passu claim with other senior creditors to additional assets;
- Independent monitoring of the cover pool appointed by the Swedish FSA;
- Separate bank accounts for pool-related transactions; and
- National administrator's authority to borrow and issue derivatives to maintain a balance between incoming and outgoing cash flows.

In addition, the law sets out the following requirements on cover pool assets:

- Property exposures located in Sweden or other states of the EU;
- Maximum LTV of 75% for residential mortgages included in eligible security;
- Maximum LTV of 70% for agricultural mortgages included in eligible security;
- Maximum LTV of 60% for commercial mortgages included in eligible security;
- Maximum 10% commercial mortgages in the cover pool;
- Maximum 20% of additional liquid security can be pledged in the cover pool; and
- The nominal value of eligible pool assets must exceed bond liabilities by 2%, i.e. overcollateralisation of 2%.

In addition to strong national regulations, covered bonds are a significant part of the Swedish financial fabric. They provide a material portion of Swedish bank financing with over SEK 2.6 trillion in outstanding covered bonds as of February 2020. This reflects 17% of Swedish monetary financial institution liabilities and equity and makes covered bonds one of the most important financing sources in the Swedish banking system. Not only are covered bonds a vital financing tool for Sweden's banks, they provide investors with a low-risk alternative to government bonds given that outstanding Swedish government debt was only SEK 1.1 trillion as of 31 Mar. 2020.

**Figure 9. Swedish monetary financial institutions' liabilities and equity, Feb. 2020**



Source: Sweden Financial Market Statistics, Feb 2020

A 1-notch uplift reflects the high likelihood of resolution for Danske Bank

**LIKELIHOOD OF RESOLUTION OR RESTRUCTURING SUPPORTS COVERED BOND HOLDERS**

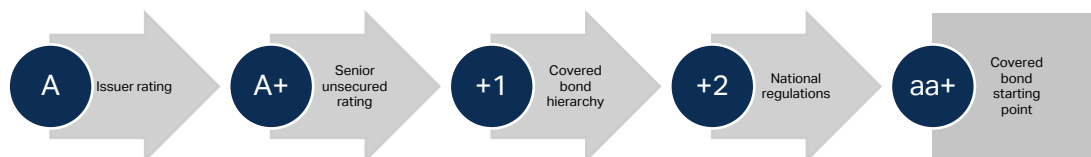
The likelihood of resolution is an important component in NCR's evaluation of the likelihood that DH's cover pool will be run down by an administrator without the support of DH or Danske Bank.

We consider a single point of entry resolution for Danske Bank a near certainty according to current European law and its explicit identification of the group as an SIFI in Denmark. We would expect that a resolution for Danske Bank would result in DH maintaining its current relationship with the parent as the originator, internal swap party, and parent loan provider.

In our view, DH would also have a very high likelihood of resolution as a standalone Swedish mortgage institution. While not explicitly identified as an SIFI in Sweden, the Swedish resolution authority, the Swedish National Debt Office, has identified a specified minimum requirement for own funds and eligible liabilities for DH of 4.9% of total liabilities and own funds since 1 Jul. 2019. However, we note that the Swedish decision was made within in the framework of Danish resolution procedures<sup>3</sup>. We also believe that default by DH would have a significant negative impact on the Swedish covered bond market given its relative size and believe that the company's standard residential mortgage assets would be highly likely to be part of a restructuring if resolution measures failed.

In our evaluation of the impact of resolution, we compare the implicit default frequency of the covered bond starting point (see Figure 10) against the probability of the covered bonds being protected in a resolution scenario for Danske Bank, which is 95%, the maximum level under our criteria.

**Figure 10. Danske Hypotek covered bond starting point**



The resulting qualitative assessment is presented in Figure 11. Given the covered bond starting point of 'aa+' and the 95% probability of resolution for DH, the qualitative assessment is 'aaa'. The figure also makes it clear that the qualitative assessment of DH's covered bonds is likely to remain 'aaa', even if DH or Danske Bank are downgraded by multiple notches or resolution assumptions change dramatically. We note that, all else being equal, the issuer rating on DH could fall five notches before affecting our covered bond ratings and even then the security of the cover pool could provide additional uplift.

**Figure 11. Qualitative assessment based on the covered bond starting point and the probability of resolution or restructuring**

COVERED BOND STARTING POINT	95%	67%	33%	0%
aaa	aaa	aaa	aaa	aaa
aa+	aaa	aaa	aaa	aa+
aa	aaa	aaa	aa+	aa
aa-	aaa	aa+	aa	aa-
a+	aaa	aa	aa-	a+
a	aaa	aa	a+	a
a-	aa+	aa-	a	a-

<sup>3</sup><https://www.riksgalden.se/en/press-and-publications/press-releases-and-news/news/2019/decision-on-mrel-for-danske-hypotek-ab/>

Stress testing indicates strong credit support from pool assets.

### COVER POOL ANALYSIS AND STRESS TESTING

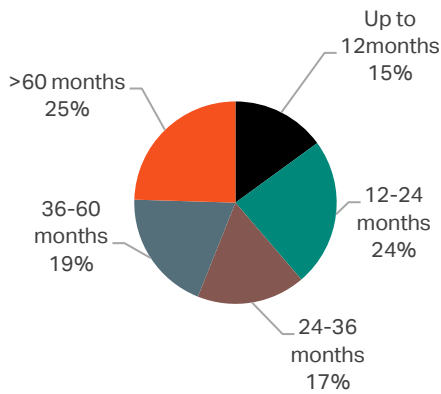
Our cover pool analysis and stress testing support the 'AAA' rating on DH's covered bonds. Given the qualitative assessment of 'aaa', the analysis of the cover pool is primarily to provide further information on the details and sensitivities of the cover pool. We have used loan, property and borrower level details from DH to analyse pool assets, and conduct sensitivity analysis and credit risk stress testing on the cover pool according to our criteria. In addition, we have complemented detailed data with data available from DH's ECBC HTT to stress cash flows according to the standard stress assumptions in our criteria.

NCR has no overcollateralisation requirement in its methodology but stresses pool assets to determine the ability to fulfil commitments as a standalone entity. Accordingly, overcollateralisation is a key component of an issuer's ability to repay bondholders in full in the event of a rundown.

### POOL CHARACTERISTICS

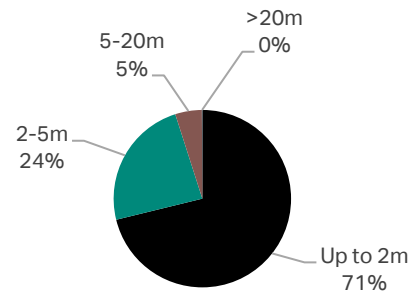
The following charts provide an overview of the characteristics of the cover pool assets. Unless otherwise specified, the figures below reflect the SEK 92.9bn in eligible pool loans, i.e. loans qualifying for overcollateralisation, LTV and loan performance requirements. In addition, DH had SEK 3.2bn in ineligible loans as at end-2019 to which covered bond holders have priority claims given that Danske Bank's senior claims are subordinated to covered bond holders.

Figure 12. Share of pool by loan seasoning, 31 Dec. 2019



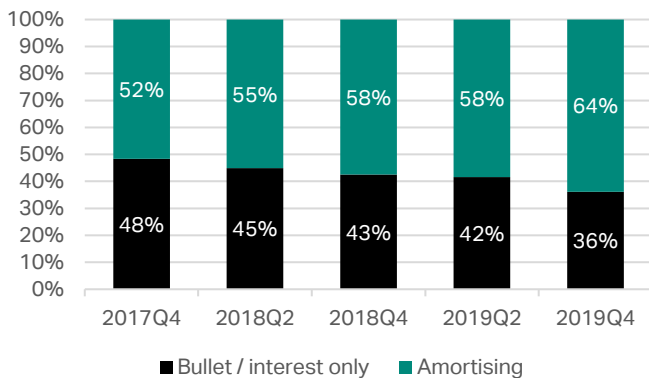
Source: Company data.

Figure 13. Share of pool by loan size (SEK), 31 Dec. 2019



Source: Company data.

Figure 14. Payment profile, 2017Q4-2019Q4



Source: ECBC HTT template

Figure 15. All mortgage loans (including ineligible loans) by region class and property type, 31 Dec. 2019



Based on company data and NCR region class

Figure 16. Share of loans by interest rate type, 31 Dec. 2019

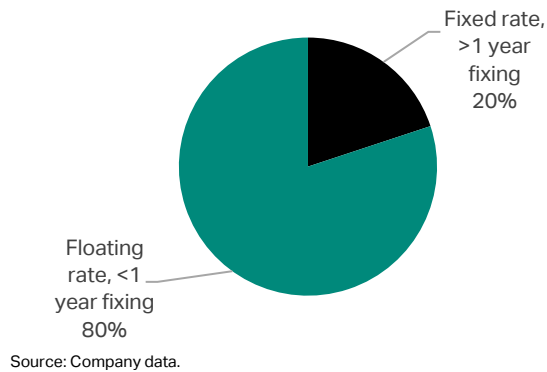


Figure 17. Share of loans by priority claims, 31 Dec. 2019

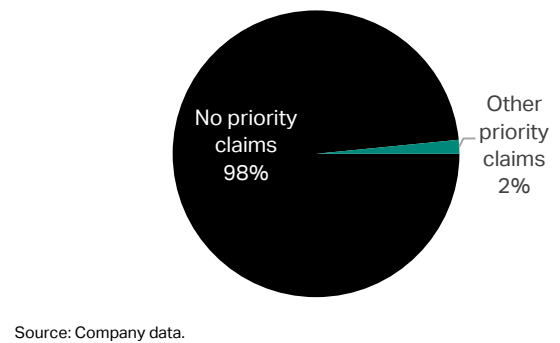


Figure 18. Cover pool by LTV, 31 Dec. 2019

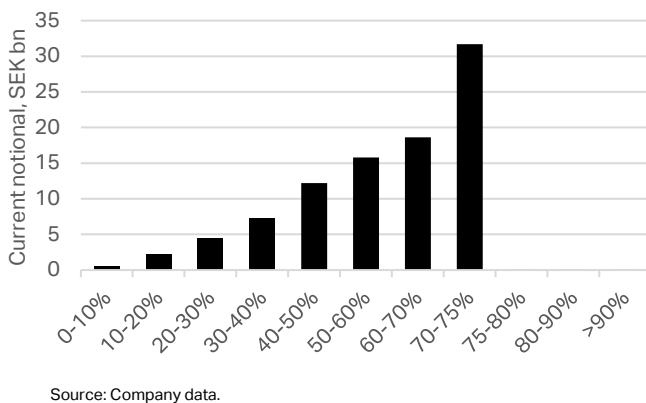
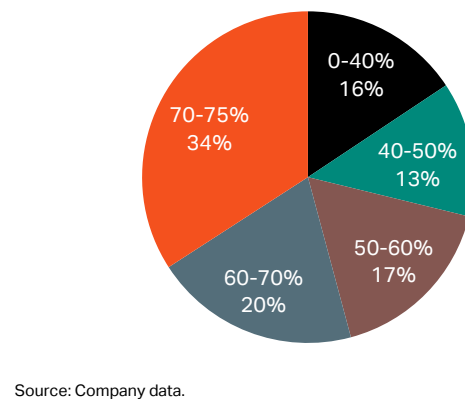


Figure 19. Cover pool LTV profile, 31 Dec. 2019



**STRESS TESTING**

NCR's standalone stress testing of the cover pool assumes that all forms of external support for the pool are exhausted and that only the underlying assets can provide enough liquidity to make coupon and principal payments. This analysis begins with the assumption that the issuer and/or banking group is being liquidated and administrators have committed to winding down the pool and selling necessary assets at a discount to ensure investors receive timely payment. For more details of the stress assumptions, see *Appendix 1: Analysing the cover pool* in our *Covered Bond Rating Methodology*, 5 Jul. 2019.

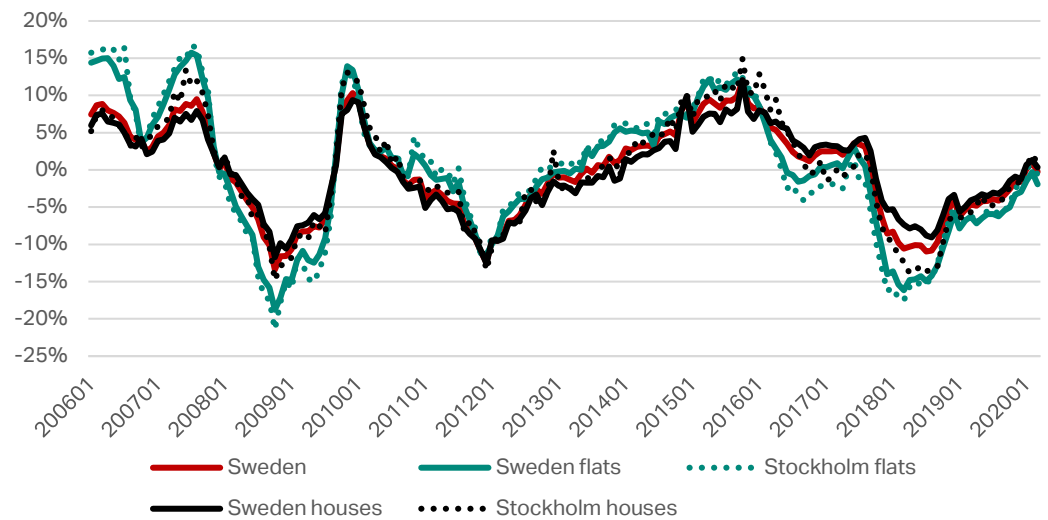
NCR conducts credit risk and cash flow stress testing on the cover pool assets with five increasingly difficult stress scenarios – Level 1 to Level 5 – with Level 5 being the most severe. Where the qualitative assessment is below 'aaa', the varying levels of stress can determine whether additional credit support is available from pool assets and reflected in additional notches in the covered bond ratings. For DH, with a qualitative assessment of 'aaa', our analysis demonstrates potential for further credit support in the highly unlikely event that the cover pool becomes a standalone entity.

**CREDIT RISK STRESS TEST**

In our stress scenarios we assume that the Swedish housing prices reflected in the initial data are +/- 5% from their long-term trend levels as shown in Figure 20. Since 2005, average housing prices in Sweden have increased by 6.1% per annum using ValueGuard's HOX index (7.5% for flats and 5.6% for single-family homes).



Figure 20. 12-month housing price growth adjusted for CAGR, 2006-March 2020



Source: ValueGuard, HOX index

Longer data series from Statistics Sweden reveal similar annual growth levels of 6.1% for Sweden and 7.1% for Stockholm since 1975. Over this 45-year sample, the beta of greater Stockholm housing prices has been 1.26 and the correlation of Stockholm to the overall market has been 90%. Using the +/- 5% assumption results in assumed property value declines of 20-40% in our five stress scenarios<sup>4</sup>.

NCR's credit risk stress testing begins with the standard assumptions in Figure 21. As defined in our criteria, we make adjustments to default assumptions based on the concentration of the portfolio and to stressed property valuations based on the region class of the specific property.

Figure 21. Standard asset quality assumptions used in credit risk stress testing, percent

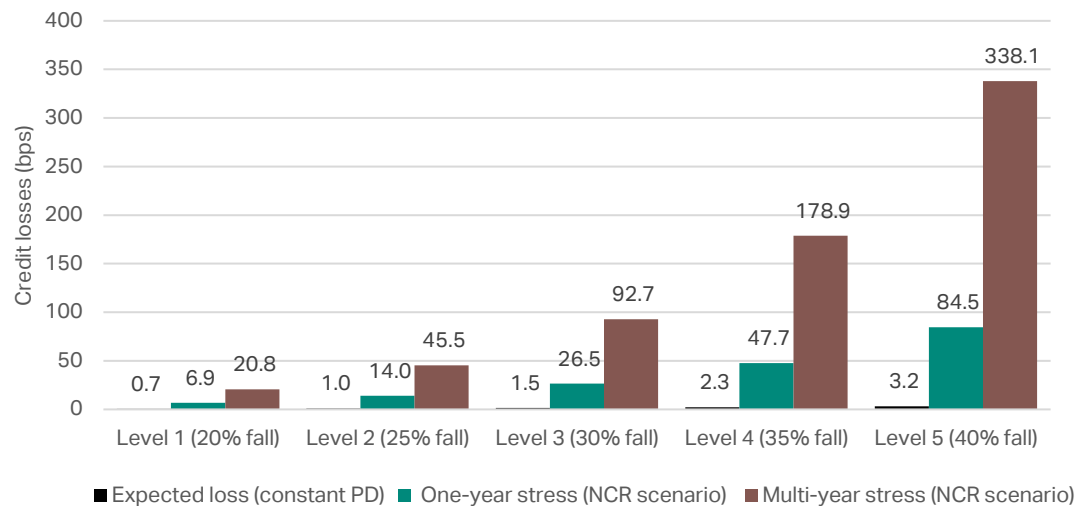
	RESIDENTIAL NON-PERFORMING LOANS	RESIDENTIAL LOANS IN DEFAULT	RESIDENTIAL FORECLOSURE REBATE*	RESIDENTIAL HOUSING PRICE FALL
Level 1	4.00	1.33	30.9	20.0
Level 2	5.24	1.75	32.7	25.0
Level 3	6.87	2.29	34.5	30.0
Level 4	9.00	3.00	36.4	35.0
Level 5	11.80	3.93	40.0	40.0

\*Half of defaults are assumed to result in an executive auction at discounted prices.

The resulting one-year and multi-year credit losses in the stress scenario are compared to the expected loss of the portfolio using DH's own default probabilities and standard price falls as shown Figure 22. The stressed credit losses include an 8% upward adjustment to the standard default rates in Figure 21 given that DH's cover pool is somewhat more concentrated than its Swedish peers'.

<sup>4</sup>For more details of our stress assumptions, see Appendix 1: Analysing the cover pool in our *Covered Bond Rating Methodology*, 5 Jul. 2019.

Figure 22. Estimated stressed credit losses for DH, bps of total pool loans as of 31 Dec. 2019

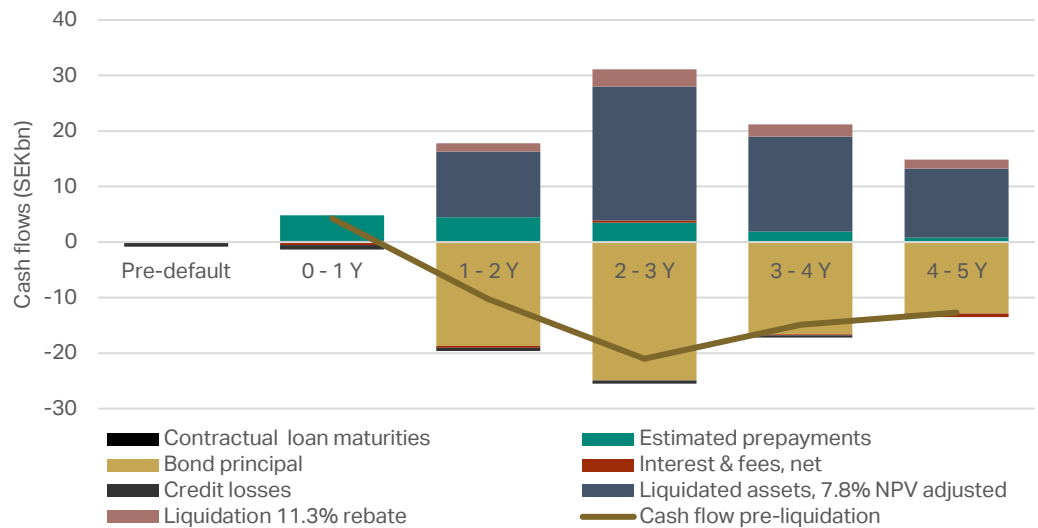


Based on NCR analysis of company data. PD-Probability of default according to DH

CASH FLOW STRESS TEST

The stressed losses and non-performing loans are input to our cash flow stress test assuming the portfolio is being run down by an administrator and outstanding bonds are repaid by selling pool assets at a discount. As described in our qualitative analysis, we do not view this scenario as likely. As shown in Figure 23, our stress scenario analysis shows no shortfall in our most extreme scenario, Level 5, where the sale of highly-discounted cover pool assets is sufficient to repay existing bond holders.

Figure 23. Stressed cash flows in NCR's level 5 scenario for DH as of 31 Dec. 2019



Based on NCR analysis of company data. NPV-Net present value

We note that the outcome of this analysis is highly theoretical given the assumption that the stress is immediate and based on current assets and outstanding bonds. The stress scenario is also dependent on NCR's assumptions with respect to the severity of discount rates and liquidation rebates for sold assets as principal payments are made by selling pool assets. Interest and fees have a modest impact on our analysis of DH's stressed cash flows. Interest rate risk is mitigated by the relatively short-term nature of interest rate fixing in their mortgage book, though we assume that all lending margins are zero in our Level 5 stress scenario.

## **ADDITIONAL FACTORS**

### **COUNTERPARTY RISK**

DH's primary interest rate swap counterparty is Danske Bank, which fulfils our criteria in terms of the creditworthiness of swap counterparties. We note that Danske Bank is obligated to find a replacement counterparty at its own expense if its applicable public counterparty rating falls below 'BBB+'. We also consider that Danske Bank and DH are likely to be part of the same resolution process, which is likely to prioritize the continuity of the derivatives within the cover pool. In view of this, we do not adjust the rating on the covered bonds despite the concentration in DH's swap partners.

### **SWAPS IN THE COVER POOL**

The swaps in the cover pool serve to reduce the interest rate risk between the pool and the outstanding bonds by swapping all bond interest payments to the 3-month Stockholm Interbank Offered Rate. The maturities of the swap agreements are matched to the outstanding maturities of the bonds.

## DANSKE HYPOTEK ISSUER RATING

Our 'A' long-term issuer rating on Danske Hypotek AB (publ) reflects the current Swedish operating environment for mortgage lenders as well as DH's strong risk-adjusted earnings, very low historical and projected loss performance and low credit risk profile. It also considers DH's importance to Danske Bank's long-term strategy in its core Swedish market. We have also assigned 'N-1+' short-term issuer credit ratings to DH.

### OUTLOOK

The negative outlook reflects our view that DH faces an uncertain economic impact from COVID-19 which could primarily affect our view of the company's operating environment, earnings, and collateral coverage. In addition, a material deterioration for Danske Bank, which is more exposed to at-risk corporate segments than DH, could affect our credit assessment of the parent and limit our rating on the mortgage company. The outlook could be revised to stable if there are clear signs of an economic recovery.

#### POSITIVE RATING DRIVERS:

- An upgrade is unlikely at this time given the current state of the Nordic economies and uncertain timeline for returning to normal operating conditions.

#### NEGATIVE RATING DRIVERS:

- Deterioration in NCR's view of Danske Bank group's creditworthiness.
- Long-term economic recession, affecting economic activity and employment.
- Lower capital ratios or increased margin compression for Swedish residential mortgages.

Figure 24. Danske Hypotek key credit metrics

	2017	2018	2019	2020e	2021e
Net interest margin (%)	1.25	1.42	1.15	1.10	1.05
Loan losses/net loans (%)	0.00	0.00	(0.05)	0.05	0.02
Pre-provision income/REA (%)	3.8	5.5	3.8	3.6	3.5
Return on ordinary equity (%)	13.1	21.2	22.0	14.8	14.3
Loan growth (%)	-	132.5	25.3	15.0	15.0
CET1 ratio (%)	42.0	16.1	16.7	16.9	17.0

Based on company and NCR data. All metrics adjusted according to NCR methodology. CET1- common equity Tier 1.

### RATING RATIONALE

NCR recently reduced its assessment of the Swedish banking market due to the economic effects of the COVID-19 pandemic. We also revised down our assessments for output growth, unemployment, and the international cycle. However, we believe that Sweden's government support for individuals will benefit mortgage lenders in two ways. First, it will maintain income levels above 92.5% for most individuals who have been temporarily furloughed. Additionally, the ability for borrowers to temporarily reduce amortisation will reduce the likelihood of default, with the positive side effect that a larger share of performing loans will stay on the balance sheet rather than being amortised, thereby supporting earnings.

DH's environmental, social and governance (ESG) ambitions are largely dictated by group-wide investments and commitments to sustainability. In 2020, Danske Bank outlined seven key ESG goals to be achieved by 2023 which reflect measurable targets for sustainable finance, sustainable operations, and impact initiatives. These initiatives cover all of the group's business areas, including green investments by Danica Pension, sustainable loan financing targeting corporate clients, internal

Operating environment for Sweden is 'bbb+'

The ESG assessment is favourable, but neutral for the issuer rating

diversity, governance training, and environmental goals. We view the specificity of the targets as a positive example of turning qualitative ambition into measurable objectives.

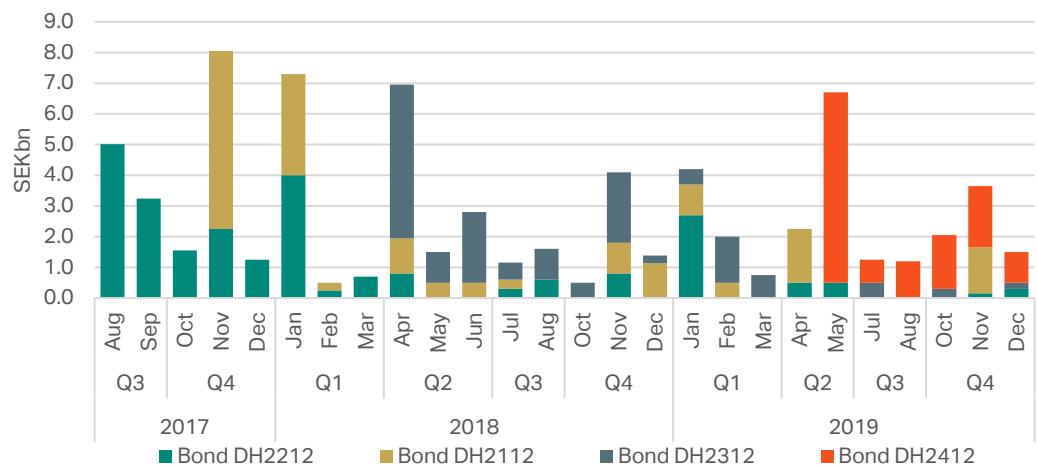
DH's role in the group's environmental strategy is not yet precisely defined, but could eventually lead to an increased focus on the environmental impact of its loan book. Although the current focus is on building a benchmark covered bond curve, DH could eventually become an issuer of green bonds. DH's role in the Danske Bank's societal endeavors are conducted within Sweden by the group's Swedish branch. This is reflected in part by the gender equality of senior leadership and community partnerships.

In our view, recent money laundering issues at Danske Bank's Estonian branch do not reflect DH's risk governance. In fact, the group's response in terms of increasing compliance and oversight has contributed to improvements in this respect. DH's largest expense costs reflect administrative services provided by the group via various service level agreements, which serve as a core of DH's own governance model. DH also maintains dedicated full-time resources in key functions such as credit risk, financial accounting, operations, and treasury. Risk oversight and internal audit processes are conducted by Danske Bank.

DH's capital position is strong, and its access to additional capital from the group when necessary provides additional flexibility. DH's CET1 ratio of 16.7% as of end-2019 was strong and we expect it to remain stable given current capital generation and growth expectations. We do not envisage any further capital injections from the group during our forecast period, but rather expect excess capital generation to provide headroom for additional new lending and further transfer of loans from Danske Bank's Swedish branch during 2020 and 2021. The Swedish FSA's recent decision to remove the countercyclical buffer to support banks' lending capacity reduced DH's regulatory capital requirement to 11.8% as of end-2019.

Risk appetite assessment of 'a'

Figure 25. Danske Hypotek covered bond tap issuance, through end-2019



Source: Company data

We view covered bonds as a stable funding source, despite a relative concentration in outstanding benchmark issues. We believe the tap issuance system used in Sweden and the country's history of supporting liquidity in the covered bond market mitigate the maturity mismatch in assets and liability. We view DH's loans from the group as a flexible and accessible secondary financing source ensuring the fulfilment of regulatory liquidity and funding levels. All outstanding bonds are denominated in Swedish krona, matching the assets.

DH's credit risk profile is well captured by the 25% regulatory risk weight floors used to calculate the company's regulatory capital measures. While there are concentrations in the mortgage book,

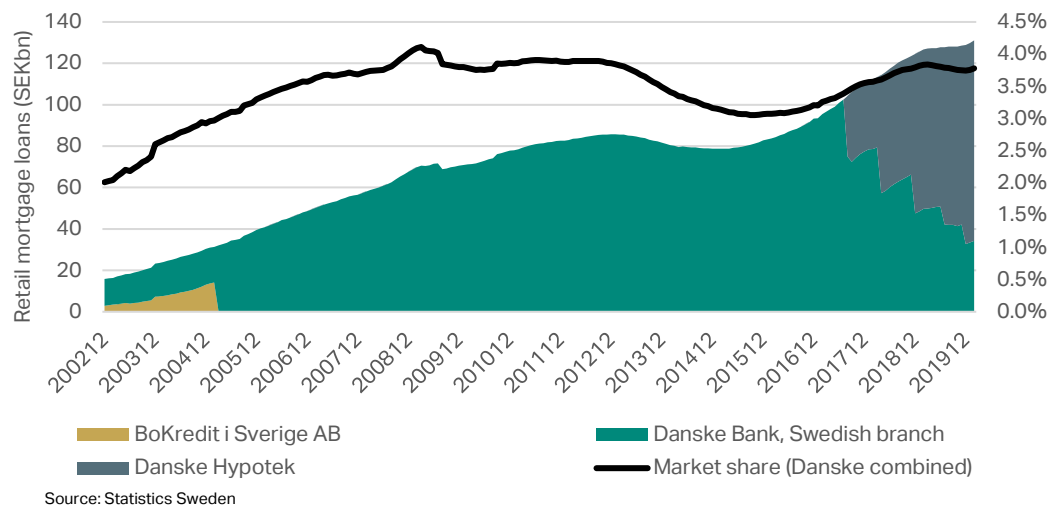
respective loans are to borrowers based in Sweden's major cities and centres of economic activity. This supports the relative liquidity of the collateral even if price volatility tends to be higher in the country's metropolitan areas. The concentration in larger cities also contributes to DH's weighted LTV based on indexed property values of 59% (HTT reported value), which is higher than that of the cover pools of its larger peers – Swedbank, Handelsbanken, SEB, Nordea – which averaged 52% as of end-2019 according to ECBC HTT reports.

Loans are originated through various channels within Danske Bank's Swedish branch, with a large majority of applications receiving automated approval based on referral to Sweden's national debt registry, Upplysningscentralen. Mortgage loans, however, are only disbursed following the registration of mortgage certificates and proper valuation of the property.

We consider DH a challenger in the Swedish mortgage market and despite a national presence is somewhat concentrated in Stockholm. Combined with the remaining loans at Danske Bank's Swedish branch, the group had a market share of 3.8% in February 2020, nearly double its 2002 levels. Danske Bank is firmly placed as the seventh largest retail mortgage lender in Sweden with nearly twice the market share of Skandiabanken, but well behind the four largest banks, SBAB and Länsförsäkringar Bank (see [The Swedish mortgage market](#) on NCR's website). During 2019, Danske Bank announced that it had piloted Danish-style 30-year mortgages in the Swedish market. Such loans could prove an attractive alternative for borrowers seeking long-term certainty in borrowing costs. However, they are unlikely to be included in DH's cover pool in the near term.

Competitive position scored as 'bbb+'

Figure 26. Danske Bank Swedish retail mortgage market share, 2002-February 2020



Source: Statistics Sweden

We view DH's earnings and loss performance metrics as very strong. DH maintains a small and flexible cost base, resulting in outstanding cost efficiency and risk-adjusted earnings. While there is pressure on mortgage margins in Sweden, the combination of regulatory capital floors for residential mortgages and relatively high return on equity requirements for most lenders supports risk-adjusted earnings for the segment. Loss performance for DH is supported by a propensity among Swedish borrowers to make payments on their mortgages at all costs given strong creditor rights. In addition, DH is expected to sell non-performing loans back to Danske Bank before they become ineligible for the pool (90 days past due) to maintain a clean pool mortgage book.

While our standalone credit assessment on DH of 'a' is in line with our credit assessment of Danske Bank, we view DH as a core financing vehicle for the group's Swedish mortgage operations, providing some additional support to our 'A' rating on DH if conditions in the Swedish market were to deteriorate further.

Performance indicators scored 'aa-'

**Figure 27. Danske Hypotek key credit metrics and financials**

Key credit metrics (%)	2017	2018	2019
<b>Income composition</b>			
Net interest income/op. revenue	118.4	105.8	103.1
Net fee income/op. revenue	(6.1)	(3.7)	(1.9)
Net trading income/op. revenue	(12.3)	(2.1)	(1.2)
Net other income/op. revenue	-	-	-
<b>Earnings</b>			
Net interest margin	1.2	1.4	1.2
Pre-provision income/REA	3.8	5.5	3.8
Return on ordinary equity	13.1	21.2	22.0
Return on assets	0.7	1.0	0.8
Cost-to-income ratio	14.4	7.8	9.9
Cost-to-income ratio, ex. trading	12.8	7.6	9.8
<b>Capital</b>			
CET1 ratio	42.0	16.1	16.7
Tier 1 ratio	42.0	16.1	16.7
Capital ratio	42.0	16.2	16.7
REA/assets	12.0	27.1	26.3
Dividend payout ratio	-	-	-
Leverage ratio	5,048.0	4,346.9	4,364.4
<b>Growth</b>			
Asset growth	69,685.4	124.9	25.4
Loan growth	-	132.5	25.3
Deposit growth	-	-	-
<b>Loss performance</b>			
Credit provisions to net loans	0.00	0.00	(0.05)
Impaired loans to gross loans	0.09	0.09	0.07
Net impaired loans to gross loans	0.09	(0.00)	(0.01)
Net problem loans to equity	1.47	(0.06)	(0.20)
NPL coverage ratio	1.4	103.2	114.8
Stage 3 loans/gross loans	-	0.09	0.07
Net stage 3 loans/gross loans	-	0.09	0.06
<b>Funding &amp; liquidity</b>			
Loan/ deposit ratio	-	-	-
Loan/ (deposit + covered bond)	172.4	160.4	130.7
Net stable funding ratio	-	-	-
Liquidity coverage ratio	6,503.0	2,929.0	1,822.0

Key financials (SEKm)	2017	2018	2019
<b>Balance sheet</b>			
Total assets	35,922	80,803	101,348
Total tangible assets	-	-	-
Total financial assets	35,880	80,758	101,060
Net loans and advances to customers	33,302	77,429	97,023
Total securities	1,755	2,465	3,379
Customer deposits	-	-	-
Issued securities	19,317	48,264	74,221
of which covered bonds	19,317	48,264	74,221
of which other senior	19,317	48,264	74,221
of which subordinated	-	-	-
Total equity	1,967	4,107	4,866
Total ordinary equity	-	-	-
<b>Capital</b>			
Common equity tier 1	1,815	3,535	4,454
Tier 1	1,815	3,535	4,454
Total capital	1,815	3,554	4,454
REA	4,317	21,929	26,682
<b>Income statement</b>			
Operating revenues	189	780	1,018
Pre-provision operating profit	162	719	918
Impairments	0	2	(48)
Net income	124	561	759

Based on NCR estimates and company data. REA – risk exposure amount. CET1 – common equity Tier 1. NPL – non-performing loans. All metrics are adjusted in line with NCR methodology.



**Figure 28. Scoring summary sheet**

Subfactors	Impact	Score
National factors	20.0%	bbb+
Regional, cross border, sector	-	-
Operating environment	20.0%	bbb+
Capital	17.5%	a-
Funding and liquidity	15.0%	a+
Risk governance	5.0%	a
Credit risk	10.0%	a
Market risk	-	-
Other risks	2.5%	a
Risk appetite	50.0%	a
Market position	15.0%	bbb+
Earnings	7.5%	aa-
Loss performance	7.5%	aa-
Performance indicators	15.0%	aa-
<b>Indicative credit assessment</b>		<b>a</b>
Peer comparisons		Neutral
Transitions		Neutral
Borderline assessments		Neutral
<b>Stand-alone credit assessment</b>		<b>a</b>
Support analysis		Neutral
Material credit enhancement		Neutral
Rating caps		Neutral
<b>Issuer rating</b>		<b>A</b>
Outlook		Negative
<b>Short-term rating</b>		<b>N-1+</b>

**Figure 29: Capital structure ratings**

Seniority	Rating
Covered bond	AAA
Senior unsecured	A+

Type of credit rating:	Long-term issuer credit rating Short-term issuer credit rating Issue credit rating
Publication date:	The rating was first published on 30 Apr. 2020.
Office responsible for the credit rating:	Nordic Credit Rating AS (NCR), Oslo, Norway. NCR is a registered credit rating agency under Regulation (EC) No 1060/2009.
Primary analyst:	Sean Cotten, +46735600337, <a href="mailto:sean.cotten@nordiccreditrating.com">sean.cotten@nordiccreditrating.com</a>
Rating committee chairperson responsible for approval of the credit rating:	Mille O. Fjeldstad, +4799038916, <a href="mailto:mille.fjeldstad@nordiccreditrating.com">mille.fjeldstad@nordiccreditrating.com</a>
Methodology used when determining the credit rating:	<a href="#">NCR's Financial Institutions Rating Methodology published on 14 Aug. 2018</a> <a href="#">NCR's Rating Principles published on 16 Sep. 2019</a> <a href="#">NCR's Covered Bond Rating Methodology published on 5 Jul. 2019</a> The methodology and principles documents provide analytical guidance to NCR's rating activities including but not limited to, assumptions, parameters, cash flow analysis, and stress-testing. NCR's methodologies and principles can be found on our website <a href="http://nordiccreditrating.com/governance/policies">nordiccreditrating.com/governance/policies</a> . The historical default rates of entities and securities rated by NCR will be viewed on <a href="#">the central platform (CEREP) of the European Securities and Markets Authority (ESMA)</a> .
Materials used when determining the credit rating:	Annual- and quarterly reports of the rated entity, Bond prospectuses, Company presentations, Data provided by external data providers, External market reports, Meetings with management of the rated entity, Non-public information, Press reports/public information, Website of rated entity.
Potential conflicts of interest:	The rating is NCR's independent opinion of the rated entity's relative creditworthiness. The rating is solicited, i.e. it is prepared for a fee paid by the rated entity. At the time of analysis and publication neither NCR nor any of the analysts or persons involved in the rating process held any interest, ownership interest or securities in the rated entity. NCR does not have any direct or indirect shareholder with a holding of more than 5% of NCR's shares and votes. For further information, please refer to NCR's conflict of interest policy which is available on: <a href="https://nordiccreditrating.com/governance/policies">https://nordiccreditrating.com/governance/policies</a>
Additional information:	Prior to publication, the rating was disclosed to the rated entity. The issuer was given 24 hours (of which 8 business hours) to remark on factual errors and/or the inadvertent inclusion of confidential information, if applicable. The rating was not amended after the review by the issuer. No stress test or cash flow forecasting was performed. NCR's rating is an opinion regarding the relative creditworthiness of an entity or an instrument. It is not a prediction, guarantee or recommendation to buy, hold or sell securities. NCR assigns outlooks to issuer ratings to indicate where they could move in the near term, normally 12–18 months. Further information on the rating process, rating definitions and limitations is available on our website: <a href="http://nordiccreditrating.com/governance/policies">nordiccreditrating.com/governance/policies</a> .
Ancillary services provided:	No ancillary services were provided.
Regulations:	This rating was issued and disclosed under Regulation (EC) No 1060/2009.
Legal exemption from liability:	Disclaimer © 2020 Nordic Credit Rating AS (NCR, the agency). All rights reserved. All information and data used by NCR in its analytical activities come from sources the agency considers accurate and reliable. All material relating to NCR's analytical activities is provided on an "as is" basis. The agency does not conduct audits or similar warranty validations of any information used in its analytical activities and related material. NCR advises all users of its services to carry out individual assessments for their own specific use or purpose when using any information or material provided by the agency. Analytical material provided by NCR constitutes only an opinion on relative credit risk and does not address other forms of risk such as volatility or market risk and should not be considered to contain facts of any kind for the purpose of assessing an issuer's or an issue's historical, current or future performance. Analytical material provided by NCR may include certain forward-looking statements relating to the business, financial performance and results of an entity and/or the industry in which it operates. Forward-looking statements concern future circumstances and results and other statements that are not historical facts, sometimes identified by the words "believes", "expects", "predicts", "intends", "projects", "plans", "estimates", "aims", "foresees", "anticipates", "targets", and similar expressions. Forward-looking statements contained in any analytical material provided by NCR, including assumptions, opinions and views either of the agency or cited from third-party sources are solely opinions and forecasts which are subject to risk, uncertainty and other factors that could cause actual events to differ materially from anticipated events. NCR and its personnel and any related third parties provide no assurance that the assumptions underlying any statements in analytical material provided by the agency are free from error, nor are they liable to any party, either directly or indirectly, for any damages, losses or similar, arising from use of NCR's analytical material or the agency's analytical activities. No representation or warranty (express or implied) is made as to, and no reliance should be placed upon, any information, including projections, estimates, targets and opinions, contained in any analytical material provided by NCR, and no liability whatsoever is accepted as to any errors, omissions or misstatements contained in any analytical material provided by the agency. Users of analytical material provided by NCR are solely responsible for making their own assessment of the market and the market position of any relevant entity, conducting their own investigations and analysis, and forming their own view of the future performance of any relevant entity's business and current and future financial situation. NCR is independent of any third party, and any information and/or material resulting from the agency's analytical activities should not be considered as marketing or a recommendation to buy, sell, or hold any financial instruments or similar. Relating to NCR's analytical activities, historical development and past performance does not safeguard or guarantee any future results or outcome. All information herein is the sole property of NCR and is protected by copyright and applicable laws. The information herein, and any other information provided by NCR, may not be reproduced, copied, stored, sold, or distributed without NCR's written permission.

## NORDIC CREDIT RATING AS

[nordiccreditrating.com](http://nordiccreditrating.com)

### OSLO

Biskop Gunnerus' gate 14A  
0185 Oslo  
Norway

### STOCKHOLM

Engelbrektsgatan 9-11  
114 32, Stockholm  
Sweden