FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Realkredit Danmark's CC T Covered Bonds to 'AAA', Affirms CC S Covered Bonds at 'AAA'

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Fitch Ratings - Frankfurt am Main - 08 Jan 2021: Fitch Ratings has upgraded Realkredit Danmark A/S's (Realkredit, A/Stable/F1/a) mortgage covered bonds issued out of Capital Centre (CC) T to 'AAA' from 'AA+', and affirmed those issued out of CC S at 'AAA'. The Outlooks are Stable.

The upgrade of CC T reflects the reduced credit loss in the cover pool, stemming mainly from decreased loan-to-value (LTV) ratios, which improves the recovery rates of the residential and commercial pools. The relied upon overcollateralisation (OC) of 6.5% now supports the revised 'AAA' breakeven OC of 6.0%.

Feedback

KEY RATING DRIVERS

The covered bonds' ratings for the two programmes are based on Realkredit's Long-Term Issuer Default Rating (IDR) of 'A' and the various uplifts above the IDR granted to the programmes. The covered bonds' ratings also consider OC protection for covered bond holders.

The covered bond programmes are rated five notches above the bank's IDR. This is out of a maximum achievable uplift of eight notches, consisting of a resolution uplift of zero notches, a payment continuity uplift (PCU) of six notches and a recovery uplift of two notches.

The Stable Outlook for both programmes is driven by that on Realkredit's IDR and the three-notch cushion against an IDR downgrade.

For the CC S cover pool, which consists of Danish fixed-rate residential and commercial mortgages, Fitch gives credit to 5.9% OC. This is the lowest nominal OC observed in the last 12 months and provides more protection than the 4% 'AAA' breakeven OC for the programme.

For the CC T cover pool, which consists of Danish floating-rate residential and commercial mortgages, Fitch gives credit to 6.5% OC. This is also the lowest nominal OC observed in the last 12 months and provides more protection than the 6% 'AAA' breakeven OC for the programme.

Uplifts

Fitch currently does not assign a resolution uplift to Realkredit's covered bonds, as the issuer is a specialised mortgage lender not operationally integrated into a parent bank and the bail-in tool is not applicable to specialised mortgage banks in Denmark.

The six-notch PCU for both programmes reflects the liquidity protection in place for at least 12 months. Of the outstanding bonds in CC S, 99% have a pass-through amortisation profile and all of CC T bonds have extendible maturity. The remaining bonds of CC S are hard-bullet, whose redemptions are covered by liquid assets for at least 12 months. The six notches also reflect interest payment protection of at least three months in both programmes.

Both programmes are eligible for a recovery uplift of two notches. The combination of 'AA+' timely payment rating and a one-notch recovery uplift results in the lowest breakeven OC supporting the 'AAA' ratings.

OC Protection

The Fitch-breakeven OC has slightly increased for CC S and reduced for CC T. For CC S the Fitch 'AAA' breakeven OC has increased to 4.0% from 3.5%. For CC T the Fitch 'AAA' breakeven OC has decreased to 6% from 7% over the last 12 months.

The 50bp increase in Fitch's 'AAA' breakeven OC for CC S reflects the higher default rates of the commercial pool. This is the result of loans having longer tenors and a slight increase in the pool correlation regarding industry concentration. Recovery rates have also reduced as the weighted average LTV has increased in the pool.

The 100bp reduction in Fitch's 'AAA' breakeven OC for CC T reflects the decreased weighted average LTV predominately in the residential pool but also to a lesser extent in the commercial pool, which increases recovery rates. The portfolio composition in the share of residential and commercial assets has also remained stable with good residential asset performance.

The breakeven OC for both covered bond programmes remains driven by the credit risk of each pool as Fitch does not model a sale of assets in its cash flow analysis, but considers the possibility of bond refinancing post insolvency or models the pass-through or maturity extension of bonds with these features. The credit loss component of the breakeven OC is 5.6% for CC S and 6.6% for CC T.

For the residential assets, Fitch has derived foreclosure frequency (FF) assumptions based on the analysis of vintage cumulative default data. The expected FF is 1% for the residential assets in CC S and 1.47% for CC T, to which Fitch applied high rating scenario multiples to derive FF in each rating scenarios. This is due to the mild economic environment in Denmark and low cumulative defaults. On recovery prospects, we give full credit to the automated valuation model used for regulatory purposes.

Fitch has analysed the commercial sub-portfolios under the Appendix 10 of its Covered Bonds Rating Criteria (Commercial Real Estate Loans Securing Covered Bonds Analysis), which references Fitch's SME Balance Sheet Securitisation Rating Criteria. There were no material changes in Fitch's assumptions for these assets. Fitch uses its Portfolio Credit Model to derive stressed losses for this segment. The expected average annual default rate (90 days' past due) for the performing commercial mortgage portfolio was set at 1.5%. It was set at 0.5% (floored at 0.25% for each loan) for the social and cooperative housing segment, given its good historical performance.

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We continue to take into account that this segment may gradually reduce over time in both capital centres. We also applied low and high stressed prepayment rates of 0% and 20%, respectively (lower than for residential loans based on historical data), cure rates of 50% in a 'B' scenario and a three-year recovery timing assumption for these loans. The 'AAA' collateral haircuts are 75% for industrial properties and 65% for the other commercial properties. For the social and cooperative housing segments, we applied the residential market value declines that are set out in the Originator-Specific Residential Mortgage Analysis Rating Criteria.

On the commercial sub-pool analysis, Fitch tested high and low prepayment assumptions in both its portfolio credit and cash-flows models. For CC S, the worst-case scenario was low prepayments while for CC T, the worst-case scenario was high prepayments. The resulting ALM loss component is -1.5% for CC S and -0.6% for CC T.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The covered bonds are rated 'AAA', which is the highest level on Fitch's scale. The ratings cannot be upgraded.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

CC S Covered Bonds

The 'AAA' rating of Realkredit's CC S mortgage covered bonds would be vulnerable to a downgrade if any of the following occurs: (i) Realkredit's Long-Term IDR was downgraded by four notches to 'BBB-' or below; or (ii) the level of OC Fitch gives credit to in its analysis falls below the 'AAA' breakeven OC of 4%. Should the relied-upon OC decrease to the legal minimum of 8% (of risk-weighted assets), the covered bonds would be downgraded to 'A+', one notch above the bank's IDR.

CC T Covered Bonds

The 'AAA' rating of Realkredit's CC T mortgage covered bonds would be vulnerable to a downgrade if any of the following occurs: (i) Realkredit's Long-Term IDR was downgraded by four notches to 'BBB-' or below; or (ii) the level of OC Fitch gives credit to in its analysis falls below the 'AAA' breakeven OC of 6%. Should the relied-upon OC decrease to the legal minimum of 8% (of risk-weighted assets), the covered bonds would be downgraded to 'A+', one notch above the bank's IDR.

Feedback

Pandemic Downside Scenario Stress Sensitivity:

Fitch expects the coronavirus containment measures to negatively impact the performance of Danish mortgage loans. However, the covered bonds' ratings benefit from a cushion between the OC that Fitch relies upon in its analysis and the OC equivalent to Fitch's 'AAA' breakeven OC. In addition, the ratings are well protected by the three-notch buffer against a downgrade of Realkredit.

When Fitch performed downside sensitivity scenario stresses to the programmes by increasing the cover pool's PD assumption and reducing the recovery rates on the mortgage loans, the current OC still provided sufficient protection for the 'AAA' rating on the programmes.

The Fitch breakeven OC for the covered bond ratings will be affected, among other factors, by the profile of the cover assets relative to outstanding covered bonds, which can change over time, even in the absence of new issuance. Therefore, the breakeven OC to maintain the covered bonds' ratings cannot be assumed to remain stable over time.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The covered bonds' ratings are driven by the credit risk of the issuing financial institution as measured by its Long-Term IDR.

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ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Realkredit's CC T covered bond programme's previous elevated governance score of '4' for transaction parties and operational risk has been reduced to '3', as the relied upon OC is no longer restricting the programme's rating.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Realkredit Danmark A/S				
• senior secured, Mortgage Covered Bonds, S	LT	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
• senior secured, Mortgage Covered Bonds, T	LT	AAA Rating Outlook Stable	Upgrade	AA+ Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Structured Finance and Covered Bonds Counterparty Rating Criteria (pub. 29 Jan 2020)

Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum (pub. 29 Jan 2020)

SME Balance Sheet Securitisation Rating Criteria (pub. 07 Feb 2020) (including rating assumption sensitivity)

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

Fitch's Foreign-Currency Stress Assumptions for Residual Foreign-Exchange Exposures in Covered Bonds and Structured Finance - Supplementary Data File (pub. 30 Jun 2020)

Structured Finance and Covered Bonds Country Risk Rating Criteria (pub. 23 Sep 2020)

Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria (pub. 13 Nov 2020)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

ABS Loss Forecaster Model, v1.1.1 (1)

Covered Bonds Cash Flow Model, v1.27.2 (1)

Portfolio Credit Model, v2.12.0 (1)

ResiGlobal Model: Europe, v1.6.4 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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Endorsement Policy

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Structured Finance: Covered Bonds Structured Finance Banks Europe Denmark

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