Danske Hypotek AB (publ)

Full Rating Report

COVERED BOND RATING

AAA

ISSUER RATINGS

LONG-TERM RATING

A

OUTLOOK

Stable

SHORT-TERM RATING

N-1+

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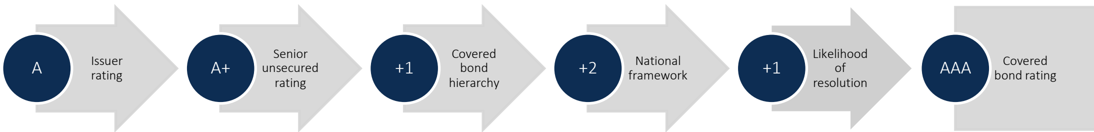
RATING RATIONALE

Our 'AAA' issue rating on covered bonds issued by Sweden-based mortgage company Danske Hypotek AB (publ) (Danske Hypotek) 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 'aaa' qualitative assessment and 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



Given the stable outlook on the issuer rating on Danske Hypotek, 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 Danske Hypotek 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. We do not anticipate that proposed changes to the Swedish Covered Bond Issuance Act, which are required to adapt to the EU's updated covered bond directive, will impact the ratings on Danske Hypotek's covered bonds.

RATING STRENGTHS:

- Issuer and group creditworthiness, reducing downgrade risk for covered bonds.
- Strong national and European protections for covered bonds.
- Danske Hypotek'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 Danske Hypotek, potentially due to deterioration in our assessment of Danske Bank.
- Reduced security in covered bond assets.

Figure 2. Danske Hypotek cover pool characteristics, Q4 2018–Q4 2020

	Q4 2018	Q2 2019	Q4 2019	Q2 2020	Q4 2020
Eligible cover pool assets (SEKm)	74.5	74.5	92.9	107.3	113.8
Outstanding covered bonds (SEKm)	47.6	63.5	73.1	89.5	90.9
Overcollateralisation (%)	56.6	17.3	27.0	19.8	25.2
Weighted-average LTV (%)	59.1	58.4	59.0	59.1	58.0
Average loan seasoning (years)	3.4	3.8	3.8	3.9	4.2
Average bond maturity (years)	4.0	3.7	3.3	3.2	2.8
Average loan size (SEKm)	1.08	1.07	1.06	1.04	1.04
Owner-occupied share (%)	95.8	95.8	96.2	96.3	96.4
Priority liens (%)	98.2	98.3	98.5	98.6	98.6
>60 day past due loans (bps)	0.00	0.00	0.00	0.00	0.00

Source: Danske Hypotek's European Covered Bond Council Harmonised Transparency Templates (ECBC). LTV–loan to value.

Figure 3. Loan balance by property region (SEKbn), 31 Dec. 2020

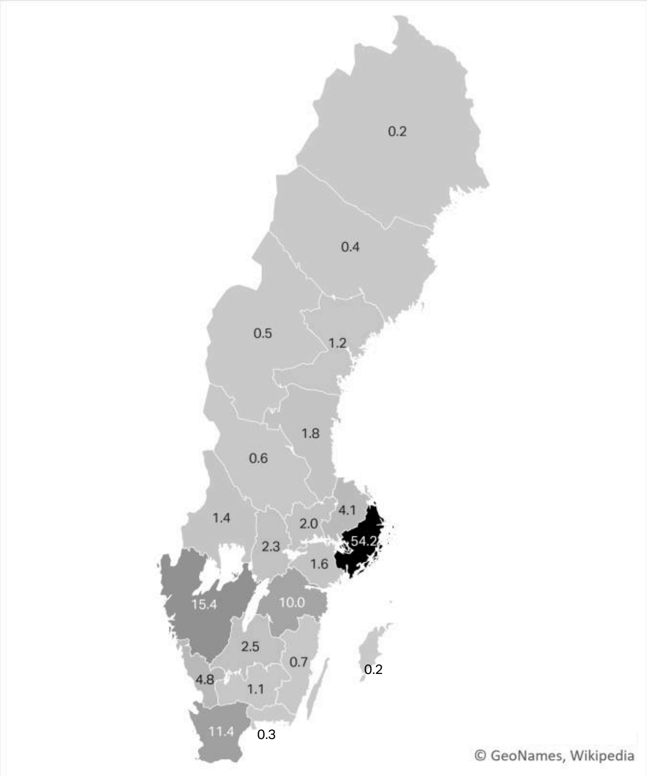


Figure 4. Weighted LTV by borrower region (%), 31 Dec. 2020

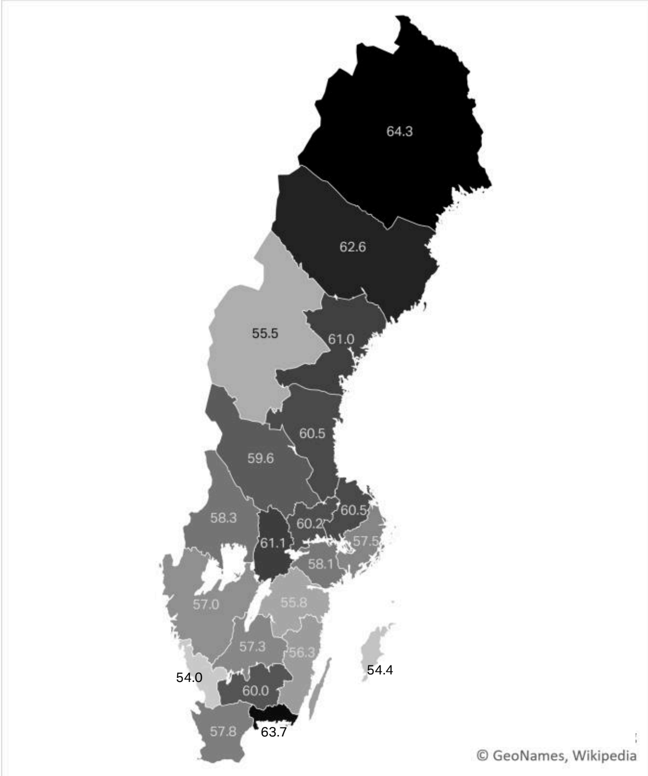


Figure 5. Average loan per property by region (SEKm), 31 Dec. 2020

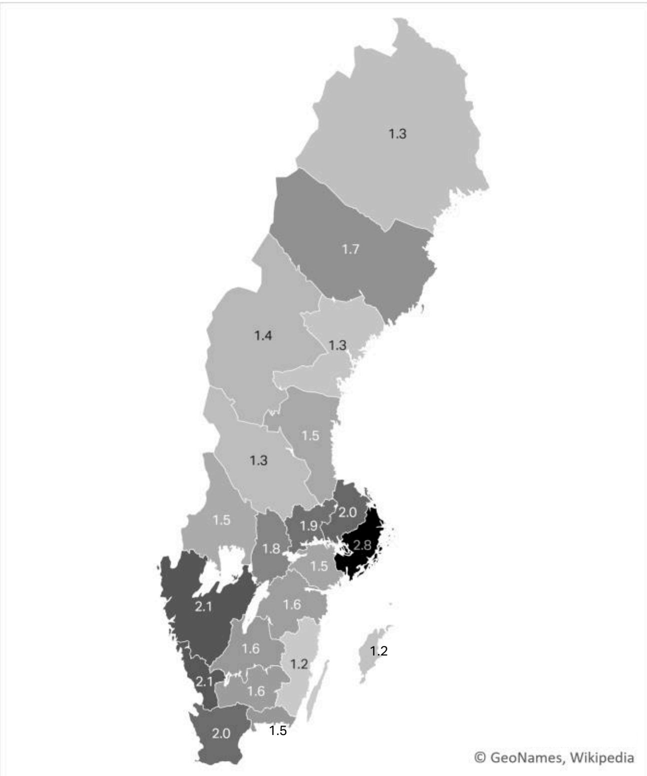
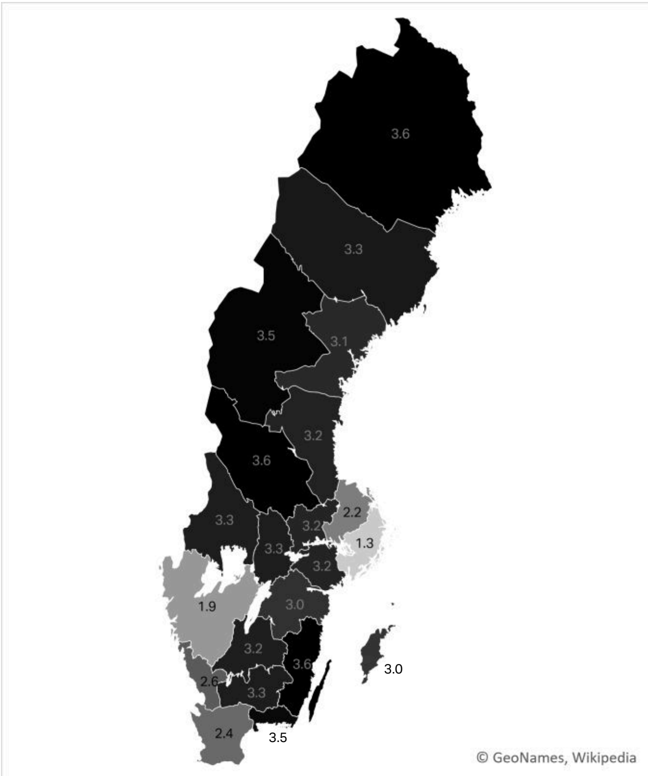


Figure 6. Average region class by property region, 31 Dec. 2020

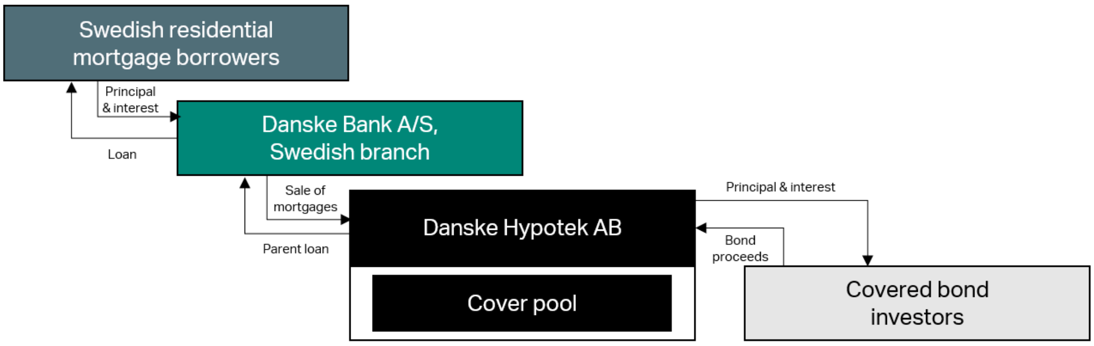


COMPANY PROFILE

Danske Hypotek 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 on the same benchmark market as its competitors. All of the loans financed by Danske Hypotek were acquired from Danske Bank's Swedish branch, as Danske Hypotek itself does not conduct any new lending business. A large share of Danske Hypotek's loan book was previously financed by Danske Bank's Danish covered bond pool.

Danske Bank originally entered the Swedish market 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, driven in part by professional trade union partnerships similar to those used by Danske Bank in other Nordic countries.

Figure 7. Danske Hypotek covered bond structure



QUALITATIVE ASSESSMENT

Our qualitative assessment of the covered bonds is 'aaa'

NCR's qualitative assessment of Danske Hypotek'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 Danske Hypotek'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 form Danske Bank or Danske Hypotek) for ensuring that bondholders receive timely coupon and principal payments.

Issuer rating

Our issuer rating on Danske Hypotek is 'A'

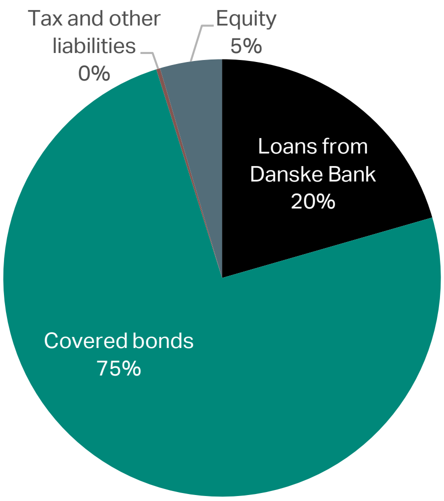
NCR believes that repayment capacity for covered bonds is linked to the credit quality of the issuer and the issuer's banking group. We have assigned Danske Hypotek an issuer rating of 'A' (see the appendix for a summary of our issuer rating on Danske Hypotek). Our rating considers the current Swedish operating environment for mortgage lenders as well as Danske Hypotek's strong risk-adjusted earnings, very low historical and projected loss performance, and low credit risk profile. We consider Danske Hypotek 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 Danske Hypotek is in line with our credit assessment of Danske Bank, we view Danske Hypotek as a core financing vehicle for the parent's Swedish mortgage operations, providing some additional support for our 'A' issuer rating on Danske Hypotek if conditions in the Swedish market were to deteriorate further. The outlook for our issuer rating on Danske Hypotek is stable.

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

Senior unsecured issue rating one notch above the issuer rating

As of year-end 2020, Danske Bank had issued DKK 104bn in senior non-preferred debt instruments. These instruments represent 13% of its risk exposure amount and a significant portion of the bank's minimum requirement for own funds and eligible liabilities (MREL) buffers and requirements. We therefore believe that the senior non-preferred 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. Danske Hypotek'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 Danske Hypotek, 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 for Danske Hypotek, which we reflect in an additional notch above the issuer rating in our senior unsecured rating of 'A+'.

Figure 8. Danske Hypotek liabilities, year-end 2020



Source: Company data.

Given the preference for covered bonds in Swedish financial institutions' debt hierarchies, NCR adds an additional notch to Danske Hypotek'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)[1]
5. Subordinated debt and capital instruments

[1] Section 18 of the Swedish Rights of Priority Act (1970:979), see also Bill 2017/18:292.

National regulations are supportive of covered bonds

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

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 Danske Hypotek'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
- the 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 for cover pool assets:

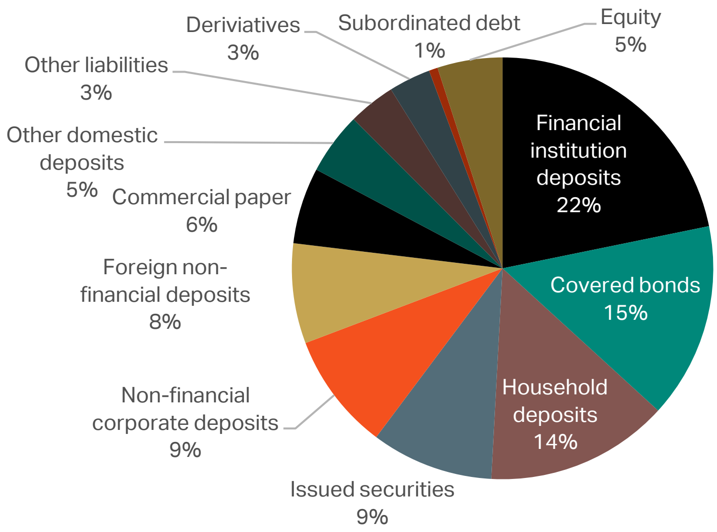
- Property exposures located in Sweden or other states of the EU;
- Maximum LTV of 75% for residential mortgages included in eligible security;
- Maximum LTV of 70% for agricultural mortgages included in eligible security;
- Maximum LTV of 60% for commercial mortgages included in eligible security;
- Maximum of 10% commercial mortgages in the cover pool;
- Maximum of 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%.

We do not anticipate that proposed changes to the Swedish Covered Bond Issuance Act, required to adapt to the EU's updated covered bond directive, will impact the ratings on Danske Hypotek's covered bonds. The final implementation will be effective from 8 July 2022, though the Swedish regulator has received many comments from issuers and investors about the November 2020 proposal. The key proposed changes for Swedish covered bonds are:

- an increase in the maximum LTV to 80% from 75% for residential mortgages included in eligible security;
- classification of agricultural mortgages as either primarily residential or commercial, which could restrict the permitted LTV where they are considered commercial;
- a greater ability to include lower-rated derivative counterparties, where necessary, to avoid counterparty concentrations;
- an increase so that the nominal value of eligible pool assets exceeds bond liabilities by 5%, i.e. an increase in overcollateralisation to 5% from 2%;
- liquidity buffer requirements covering 180 days of net outflows using initial maturity dates for extendable maturity ('soft bullet') bonds; and
- approval of a maturity extension of soft-bullet bonds by the Swedish regulator.

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 2.5 trillion in outstanding covered bonds as of February 2021. This reflects 15% of Swedish monetary financial institution liabilities and equity (down from 16.6% a year earlier due to a large increase in deposits as a result of the pandemic), making 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 1.2 trillion as of 26 Feb. 2021.

Figure 9. Swedish monetary financial institutions' liabilities and equity, Feb. 2021



Source: Sweden Financial Market Statistics, Feb 2021

High likelihood of resolution supports covered bond holders

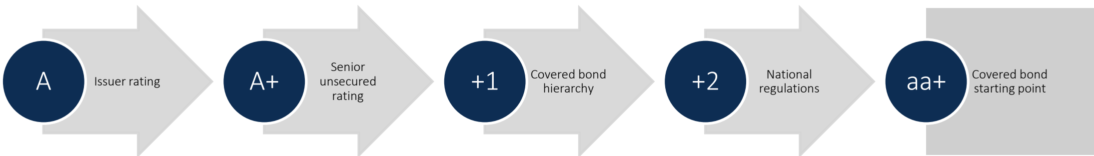
A one-notch uplift reflects the high likelihood of resolution for Danske Bank

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

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

In our view, Danske Hypotek 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 Danske Hypotek of 4.71% of total liabilities and own funds since 1 Jan. 2021. We note that the subordinated loan from Danske Bank is included in Danske Hypotek's MREL, ensuring that Danske Hypotek is well over its regulatory MREL requirement. We also believe that default by Danske Hypotek would have a significant negative impact on the Swedish covered bond market, given nearly SEK 100bn outstanding covered bonds, and believe that the company's standard residential mortgage assets would be highly likely to be part of a restructuring if resolution measures failed.

Figure 10. Danske Hypotek covered bond starting point



Our evaluation of the impact of resolution compares the implicit default frequency of the covered bond starting point with the probability of the covered bonds being protected in a resolution scenario for Danske Bank, which is 95%, the maximum level under our criteria. The resulting qualitative assessment is presented in Figure 11.

Given the covered bond starting point of 'aa+' and the 95% probability of resolution for Danske Hypotek, the qualitative assessment is 'aaa'. The figure also makes it clear that the qualitative assessment of Danske Hypotek's covered bonds is likely to remain 'aaa', even if Danske Hypotek or Danske Bank are downgraded by multiple notches or resolution assumptions change dramatically. We note that, all else being equal, the issuer rating on Danske Hypotek could fall five notches before the qualitative assessment fell below 'aaa'. If the issuer rating fell more than five notches it could still be possible for the security of the cover pool to provide additional uplift to the covered bond ratings.

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-

COVER POOL ANALYSIS AND STRESS TESTING

Stress testing indicates strong credit support from pool assets.

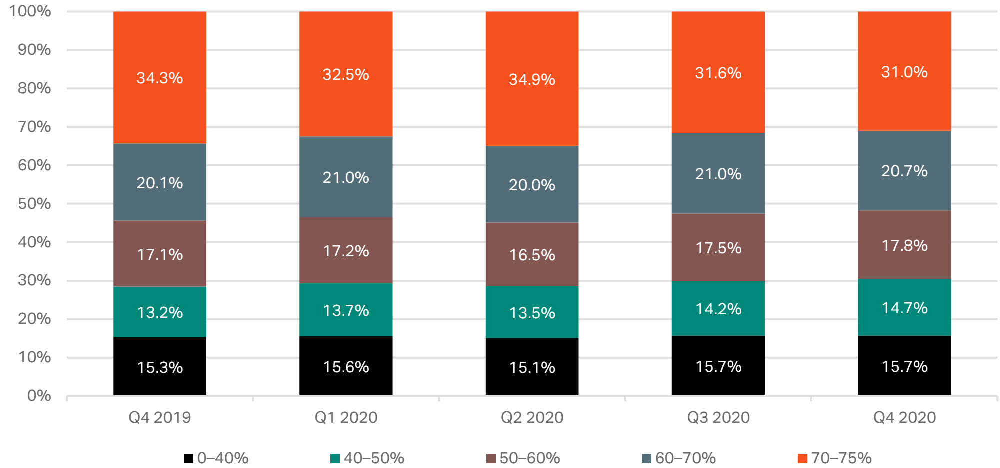
Our cover pool analysis and stress testing support the 'AAA' rating on Danske Hypotek's covered bonds. Given the qualitative assessment of 'aaa', the analysis of the cover pool is primarily to provide further information on the details and sensitivities of the cover pool. We have used loan, property and borrower level details from Danske Hypotek 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 Danske Hypotek's European Covered Bond Council Harmonised Transparency Templates (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

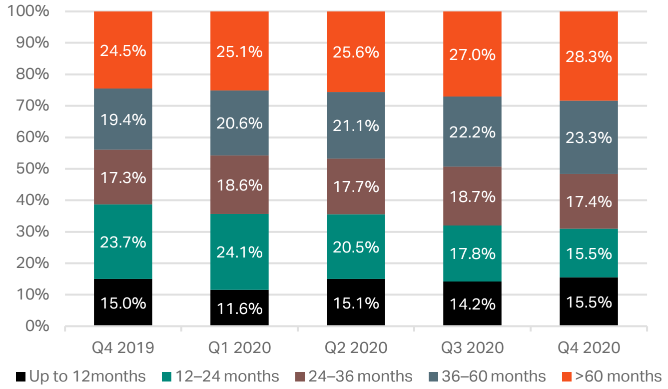
The following charts provide an overview of the characteristics of the cover pool assets. As of year-end 2020, the pool includes SEK 113.8bn in eligible residential mortgage loans, i.e. loans qualifying for overcollateralisation, LTV and loan performance requirements. In addition, Danske Hypotek had SEK 3.5bn representing ineligible portions of residential mortgage loans (i.e. above 75% LTV) at year-end 2020, 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 borrower level LTV, last five quarters



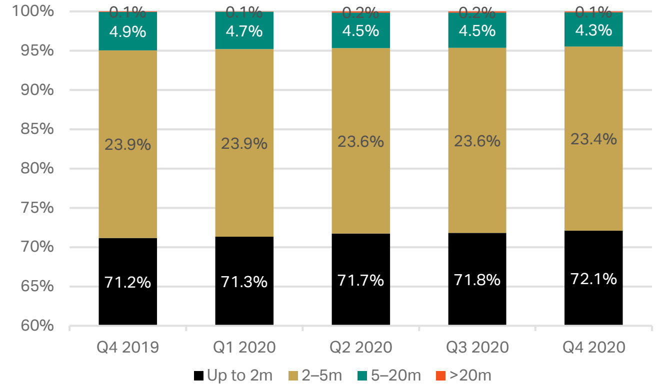
Source: Company data. Entire eligible loan amount in respective bucket based on borrowers' LTV.

Figure 13. Share of pool by loan seasoning, last five quarters



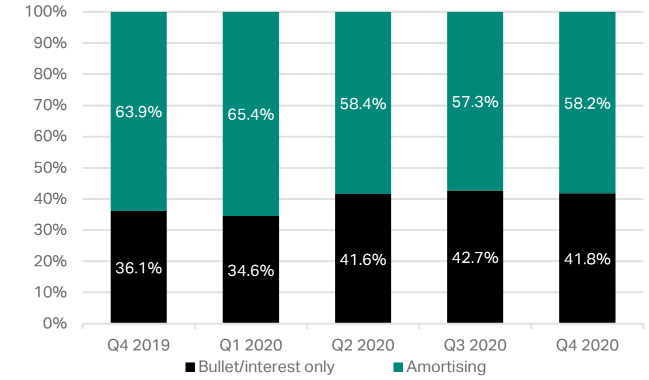
Source: Company data.

Figure 14. Share of pool by loan size (SEK), last five quarters



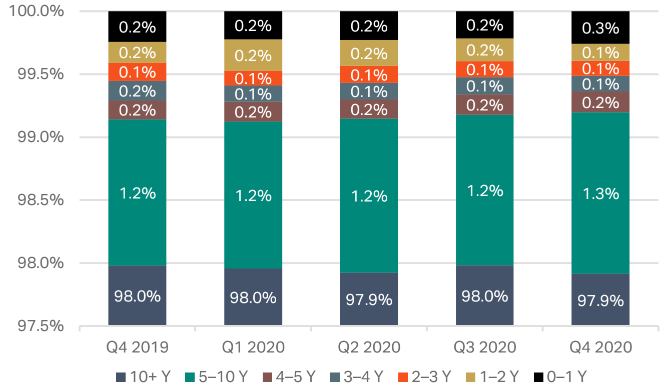
Source: Company data.

Figure 15. Share of pool by payment profile, last five quarters



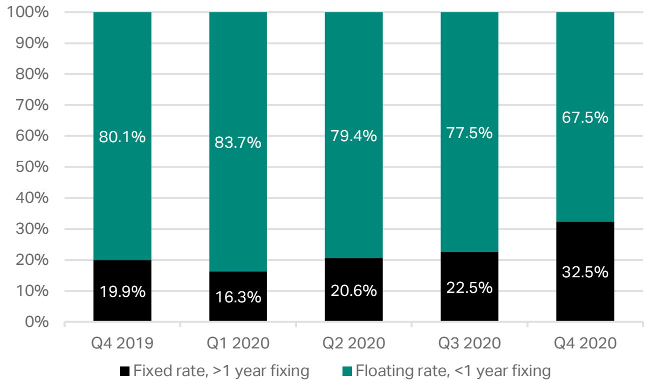
Source: ECBC HTT.

Figure 16. Share of pool by maturity, last five quarters



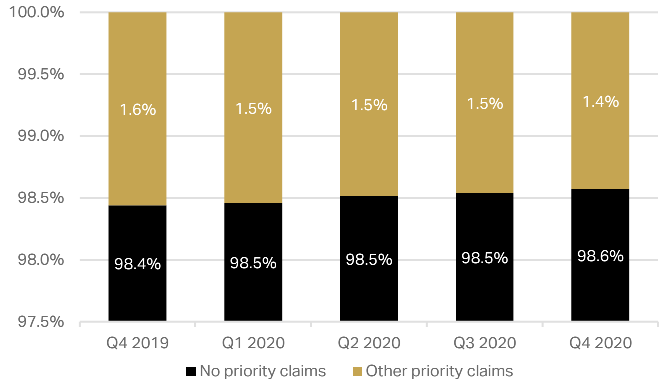
Source: Company data.

Figure 17. Share of pool by interest rate, last five quarters



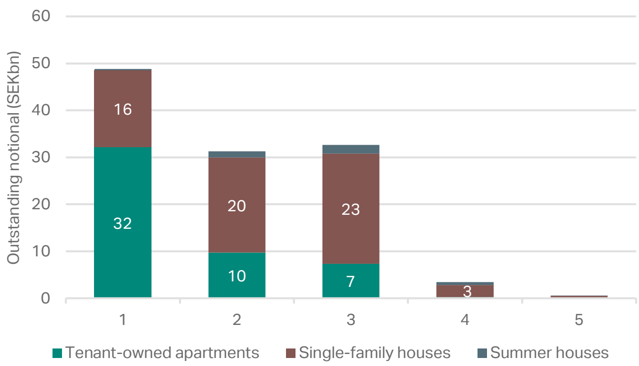
Source: Company data.

Figure 18. Share of pool by priority claims, last five quarters



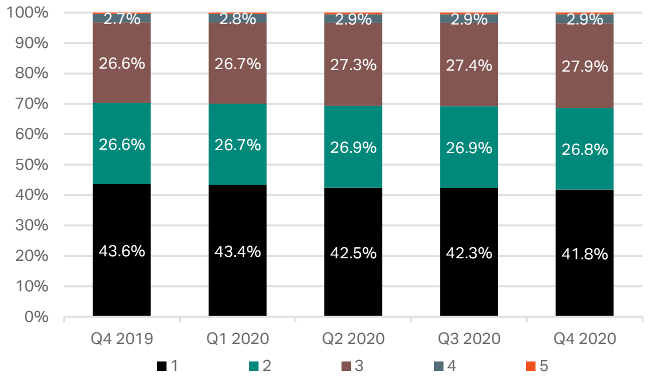
Source: Company data.

Figure 19. Region class and property type, 31 Dec. 2020



Source: Company data, including loan balances outside the cover pool, NCR region definitions.

Figure 20. Region class, last five quarters



Source: Company data, including loan balances outside the cover pool, NCR region definitions.

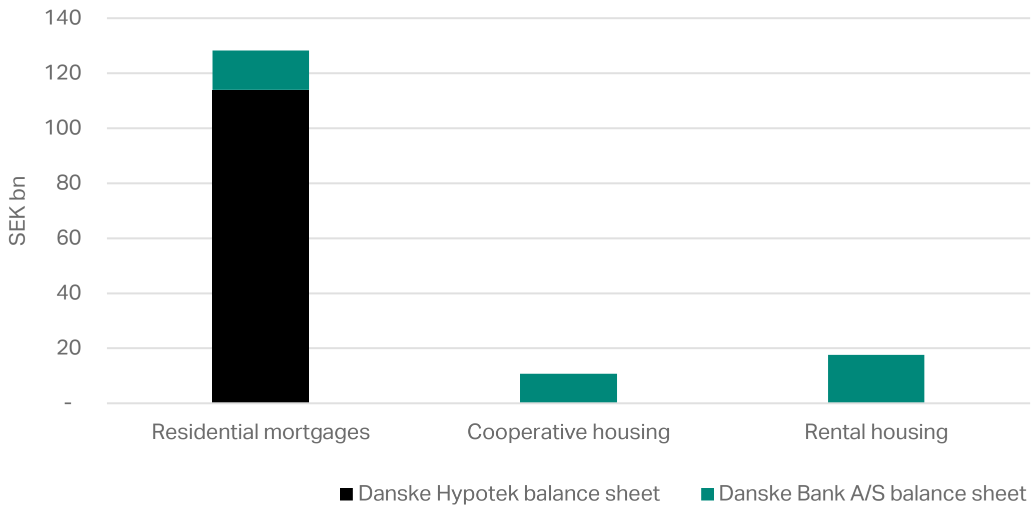
During 2021, Danske Hypotek plans to begin transferring some of the SEK 28bn in multi-family housing mortgages and cooperative housing loans from Danske Bank (currently in cover pool C) to Danske Hypotek's cover pool.

Multi-family rental housing carries the default risk of the property owner and their ability to service their bank loans. While property owners can raise rental rates, the rates in Sweden are often regulated and dependent on investments to raise the standard of the building. The ability to service the debt on multi-family housing is also dependent on maintaining low vacancies and stable rental income. The strength and available alternatives in the local rental market and attractiveness of the underlying asset therefore play a larger role in the default risk for these types of loans.

NCR views cooperative housing as carrying a similar default risk to residential mortgages, but with a higher concentration given the higher average loan sizes. Housing cooperatives in Sweden have the ability to increase fees to tenant owners and are the owners of the physical collateral. In addition, the risk of vacancy or unpaid tenant rent is minimal for cooperative housing once all tenant rights are sold. When housing cooperatives default, the building is sold to a new owner, forcing the tenant owners to become renters and lose their own ownership rights.

We note that Danske Hypotek maintains the ability to sell non-performing assets back to Danske Bank to preserve low non-performing levels in the cover pool.

Figure 21. Available cover pool assets, as of year-end 2020



Source: Company data.

Stress testing

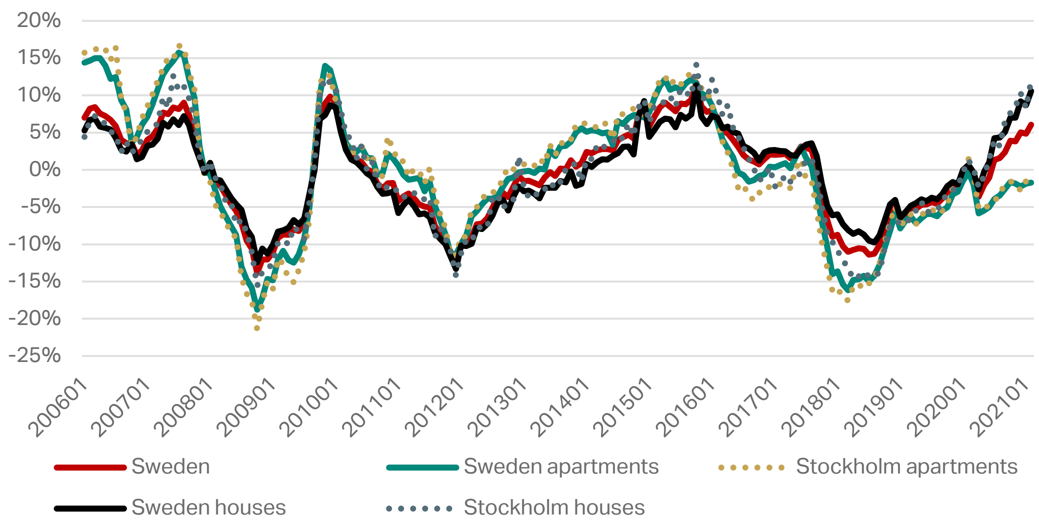
NCR's standalone stress testing of the cover pool assumes that all forms of external support for the pool are exhausted and that only the underlying assets can provide enough liquidity to make coupon and principal payments. This analysis begins with the assumption that the issuer and/or banking group 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* of 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 Danske Hypotek, with a qualitative assessment of 'aaa', our analysis demonstrates the potential for further credit support in the highly unlikely event of the cover pool becoming a standalone entity.

Credit risk stress test

Our stress scenarios assume that Swedish housing prices are 5–15% above their long-term trend levels as shown in Figure 22. This is an increase in stress from our analysis a year ago, which serves to counterbalance the increase in value of the cover pool collateral over the past year. Since 2005, average housing prices in Sweden have increased by 6.5% per annum using ValueGuard's HOX index (7.5% for flats and 6.3% for single-family homes). However, house prices in particular have risen sharply since the outbreak of the pandemic, leading the national housing price index to rise to 6% over the compound annual growth rate (CAGR).

Figure 22. 12-month housing price growth adjusted for CAGR, 2006–February 2021



Source: ValueGuard, HOX index.

Longer data series from Statistics Sweden reveal similar annual growth levels of 6.1% for Sweden and 7.0% for Stockholm since 1975. Over this 45-year sample, the beta of greater Stockholm housing prices has been 1.28 and the correlation of Stockholm to the overall market has been 92%. Using the 5–15% over CAGR assumption results in assumed property value declines of 25–45% in our five stress scenarios[2].

NCR's credit risk stress testing begins with the standard assumptions in Figure 23. 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 23. 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	25.0
Level 2	5.24	1.75	32.7	30.0
Level 3	6.87	2.29	34.5	35.0
Level 4	9.00	3.00	36.4	40.0
Level 5	11.80	3.93	40.0	45.0

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

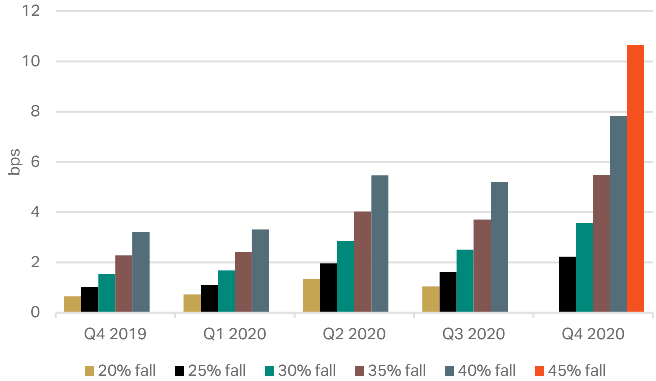
The resulting one-year and multi-year credit losses in the stress scenario are compared to the expected loss of the portfolio using Danske Hypotek's own default probabilities and standard price falls in the figures below. The stressed credit losses include a 7% upward adjustment to the standard default rates in Figure 23, given that Danske Hypotek's cover pool is somewhat more concentrated than those of its

[2] For more details of our stress assumptions, see Appendix 1: Analysing the Cover Pool in our *Covered Bond Rating Methodology* of 5 Jul. 2019.

Swedish peers. This is a decrease from 8% in our previous stress tests, reflecting a reduction in concentration compared with peers as loans have been added to the cover pool.

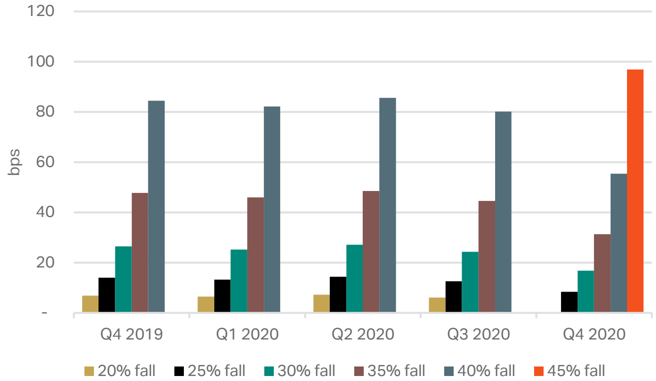
The step-wise changes from Q4 2020 in the figures below reflect the two changes described above. First, we now stress the property collateral by 25–45% in the five scenarios compared with 20–40% previously. Second, it reflects the decrease in the concentration adjustment to 7% from 8%, reducing non-performing loans and default rates in all five stressed scenarios from Q4 2020.

Figure 24. Expected loss as a share of cover pool loans, based on actual portfolio composition and NCR stress test, last five quarters



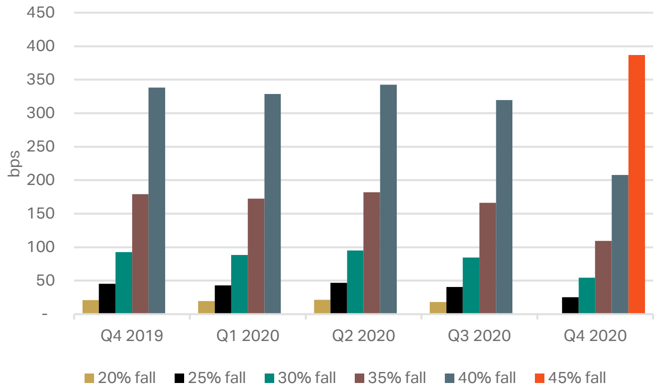
Based on NCR analysis of company data.

Figure 25. One-year credit loss as a share of cover pool loans, based on actual portfolio composition and NCR stress test, last five quarters



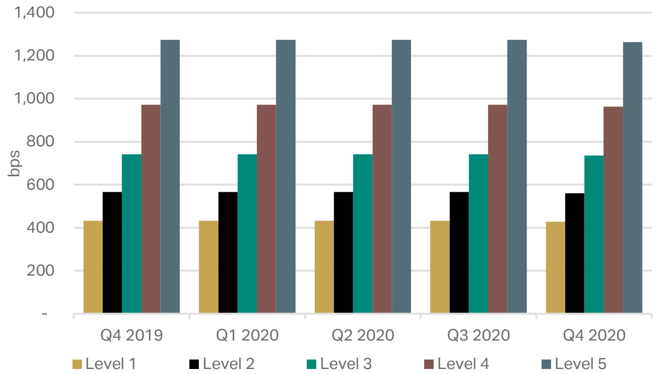
Based on NCR analysis of company data.

Figure 26. Multi-year credit loss as a share of cover pool loans, based on actual portfolio composition and NCR stress test, last five quarters



Based on NCR analysis of company data.

Figure 27. Peak non-performing loans as a share of cover pool loans, based on actual portfolio composition and NCR stress test, last five quarters



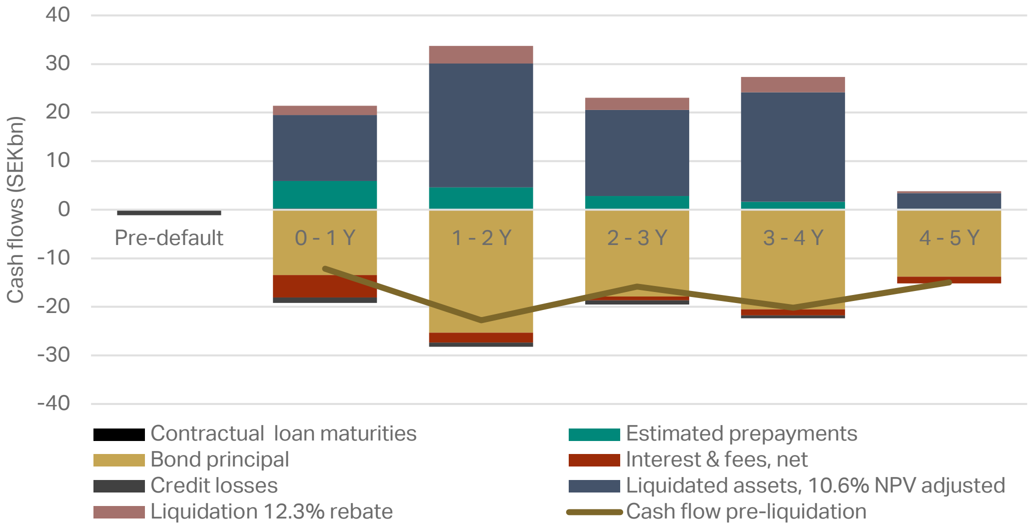
Based on NCR analysis of company data.

Cash flow stress test

The stressed losses and non-performing loans are input to our cash flow stress test based on an assumption of the portfolio being run down by an administrator and outstanding bonds being 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 28, our stress scenario analysis shows a shortfall in our most extreme scenario, Level 5, in which the sale of highly-discounted cover pool assets is not sufficient to repay existing bond holders in the fifth year of rundown. This discrepancy is largely due to the assumption that mortgage margins are reduced to 0% from the 1.4% market average provided by the regulator at end 2020. Cash flows would be sufficient if margins were to be maintained at about 1% in the level 5 scenario.

We note 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 regarding the severity of discount rates and liquidation rebates for assets sold as principal payments are made by selling pool assets. Interest and fees have a modest impact on our analysis of Danske Hypotek's stressed cash flows. Interest rate risk is mitigated by the relatively short-term nature of interest rate fixing in its mortgage book, though we assume that all lending margins are zero in our Level 5 stress scenario.

Figure 28. Stressed cash flows in NCR's level 5 scenario for Danske Hypotek as of 31 Dec. 2020



Source: NCR analysis of company data

ADDITIONAL FACTORS

Counterparty risk

Danske Hypotek'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 obliged to find a replacement counterparty at its own expense if its applicable public counterparty rating falls below 'A-'. We also consider that Danske Bank and Danske Hypotek 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 Danske Hypotek's swap partners.

We note that the proposed changes to the Swedish covered bond act would allow Danske Hypotek to use bank counterparties at credit quality step 3, approximately public credit ratings at the 'BBB' level. According to our criteria, we could adjust covered bond ratings to reflect the risk of overreliance on derivative counterparties with public credit ratings of 'BBB+' or lower (or equivalent NCR credit assessments) outside an issue's banking or ownership group.

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 three-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 operating environment for Swedish mortgage lenders, as well as Danske Hypotek's strong risk-adjusted earnings, very low historical and projected loss performance, and low credit risk profile. It also reflects Danske Hypotek's importance to Danske Bank's long-term strategy in its core Swedish market.

STABLE OUTLOOK

The stable outlook reflects our credit assessment of Danske Bank and the overall Swedish mortgage market. Upside to Danske Hypotek's issuer rating remains constrained by our 'a' credit assessment of Danske Bank. Danske Bank's 2020 net profit exceeded its previous guidance of DKK 4–4.5bn, in part due to lower than anticipated credit loss provisioning, despite conservative loss provisions. Danske Bank maintains a robust capital position with a fully phased-in CET1 ratio of 18.0%, well above the regulatory minimum requirement of 13.2%. We could revise our rating on Danske Hypotek due to changes in our view of Danske Bank, which we currently see as unlikely.

POSITIVE RATING DRIVERS:

- Improvement in NCR's view of Danske Bank group's creditworthiness.

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 29. Danske Hypotek key credit metrics, 2018–2023e.

%	2018	2019	2020	2021e	2022e	2023e
Net interest margin	1.4	1.2	1.1	1.0	1.0	1.0
Loan losses/net loans	0.00	-0.05	-0.03	0.02	0.02	0.02
Pre-provision income/REA	5.5	3.8	3.4	3.4	3.4	3.4
Return on ordinary equity	21.2	22.0	15.1	14.5	13.8	13.3
Loan growth	132.5	25.3	21.0	12.0	15.0	10.0
CET1 ratio	16.1	16.7	17.5	18.1	18.9	19.7

Based on company and NCR data. All metrics adjusted according to NCR methodology. CET1–common equity Tier 1. REA–risk exposure amount.

RATING RATIONALE

Operating environment for Sweden is 'bbb+'

The Swedish banking sector continues to see economic effects on domestic and international output growth and unemployment as a result of the COVID-19 pandemic. However, we view the outlook for Swedish banks as stable in the current environment. Swedish banks have outperformed our expectations for earnings and asset quality and have remained well capitalised due to dividend restrictions, which has supported credit growth. Residential property prices have increased and commercial property values remain stable, which supports the valuation of collateral behind much of Sweden's credit risk. Monetary policy remains expansionary and conducive to low credit losses. For the most part, Sweden's banks have increased loss reserves in view of the potential impact of higher unemployment rather than actual defaults.

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

Danske Hypotek'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, reflecting measurable targets for sustainable finance, sustainable operations, and impact initiatives. The bank has made good progress on its stated goals, already achieving its sustainable finance investment targets by the end of 2020.

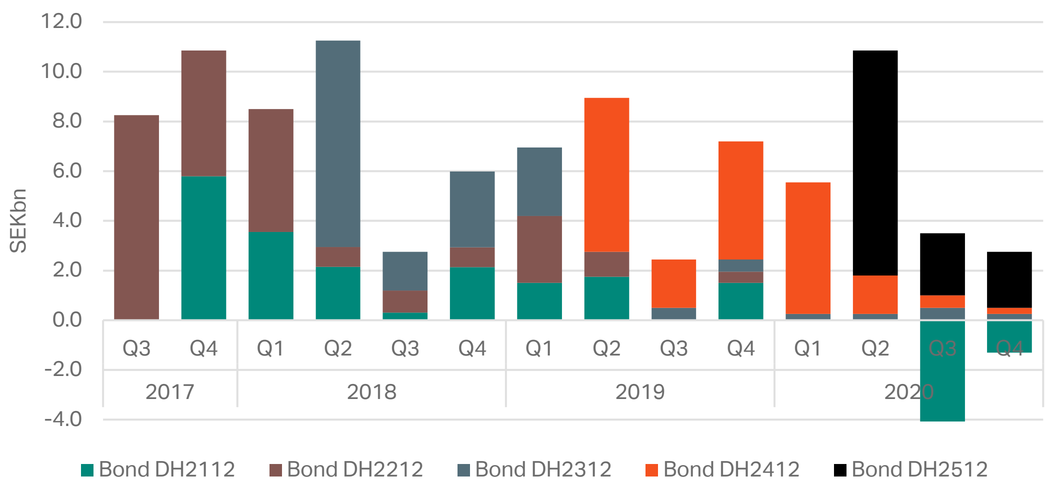
Danske Hypotek's role in the group's ESG strategy is not yet precisely defined, but Danske Hypotek could eventually become an issuer of green bonds once it establishes itself as a benchmark covered bond issuer. Danske Hypotek's role in Danske Bank's social responsibility work is conducted in Sweden by the group's Swedish branch. This is reflected in part by the gender equality of senior leadership and community partnerships.

In our view, the group's response to money laundering issues at Danske Bank's Estonian branch in terms of increasing compliance and oversight has repositioned Danske Bank as a leader in this respect. Danske Hypotek's largest costs reflect administrative services provided by the group via various service level agreements, which form the core of Danske Hypotek's own governance model. Danske Hypotek 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.

Risk appetite assessment of 'a'

Danske Hypotek's capital position is strong, and its access to additional capital from the group when necessary provides additional flexibility. Danske Hypotek's CET1 ratio of 17.5% as of year-end 2020 is an improvement, despite a 21% increase in loans during the year. At this time, we do not expect Danske Hypotek to pay dividends and we therefore project continued improvements given current capital generation and growth expectations, including the addition of multi-family housing loans with higher risk weights. The Swedish FSA's decision to remove the countercyclical buffer in March 2020 reduced Danske Hypotek's regulatory capital requirement to 11.5% as of year-end 2020.

Figure 30. Danske Hypotek covered bond tap issuance and buy-back activity, through end-2020



Source: Coumpany data.

We view covered bonds as a stable funding source, despite a relative concentration in outstanding benchmark issues. We believe the tap issuance and early buyback 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 Danske Hypotek'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 kronor, matching the assets.

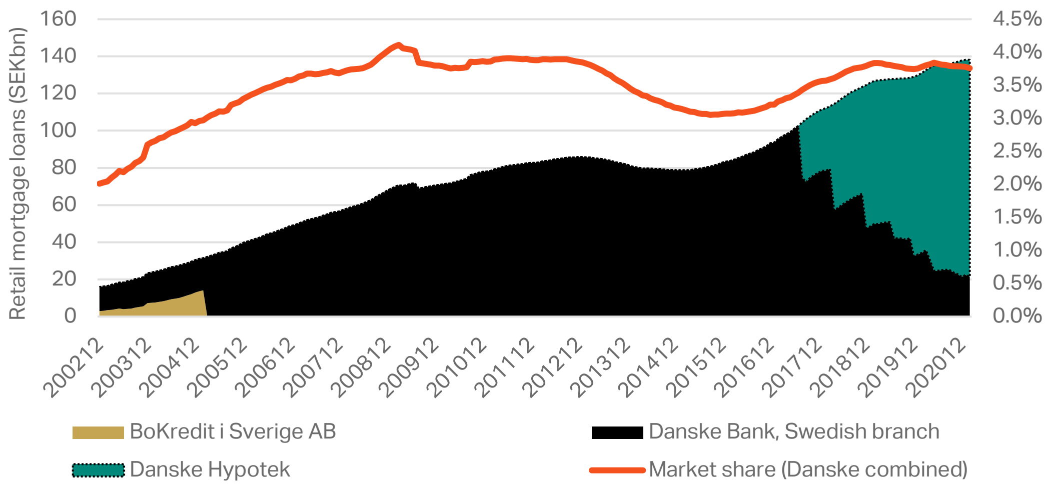
Danske Hypotek's credit risk profile is well captured by the 25% regulatory risk weight floors used to calculate the company's regulatory capital measures. While there are concentrations in the mortgage book, respective loans are to borrowers based in Sweden's major cities and centres of economic activity. This supports the relative liquidity of the collateral, although price volatility tends to be higher in the country's metropolitan areas. The concentration in larger cities also contributes to Danske Hypotek's weighted LTV based on indexed property values of 58% (HTT reported value), which is higher than that of the cover pools of its larger peers – Swedbank, Handelsbanken, SEB, Nordea – which averaged 51% as of year-end 2020 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.

Competitive position scored as 'bbb+'

We consider Danske Hypotek a challenger in the Swedish mortgage market, and, despite a national presence, it is somewhat concentrated in Stockholm. Combined with the remaining loans at Danske Bank's Swedish branch, the group's market share was 3.8% in February 2021 and has been relatively stable over the past three years. 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).

Figure 31. Danske Bank Swedish retail mortgage market share, 2002–February 2021



Source: Statistics Sweden.

Performance indicators scored 'aa-'

We view Danske Hypotek's earnings and loss performance metrics as very strong. Danske Hypotek 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 Danske Hypotek is supported by a propensity among Swedish borrowers to make payments on their mortgages at all costs given strong creditor rights. In addition, Danske Hypotek is expected to sell non-performing loans back to Danske Bank before they become ineligible for the pool (60 days past due) to maintain a clean pool mortgage book.

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

Figure 32. Danske Hypotek key financial data, 2017–2020

Key credit metrics (%)	FY 2017	FY 2018	FY 2019	FY 2020
INCOME COMPOSITION				
Net interest income/op. revenue	118.4	105.8	103.1	106.4
Net fee income/op. revenue	-6.1	-3.7	-1.9	-2.1
Net trading income/op. revenue	-12.3	-2.1	-1.2	-4.4
Net other income/op. revenue	0.0	0.0		-0.0
EARNINGS				
Net interest margin	1.2	1.4	1.2	
Pre-provision income/REA		5.5	3.8	3.4
Return on ordinary equity		18.5	16.9	15.1
Return on assets		1.0	0.8	0.7
Cost-to-income ratio	14.4	7.8	9.9	12.0
Cost-to-income ratio, ex. trading	12.8	7.6	9.8	11.5
CAPITAL				
CET1 ratio	42.0	16.1	16.7	17.5
Tier 1 ratio	42.0	16.1	16.7	17.5
Capital ratio	42.0	16.2	16.7	17.5
REA/assets	12.0	27.1	26.3	25.6
Dividend payout ratio				
Leverage ratio	0.0	0.0	0.0	0.0
GROWTH				
Asset growth		124.9	25.4	22.0
Loan growth		132.5	25.3	21.0
Deposit growth				
LOSS PERFORMANCE				
Credit provisions to net loans	0.00	0.00	-0.05	0.00
Impaired loans to gross loans	0.09	0.09	0.07	0.23
Net impaired loans to gross loans	0.09	-0.00	-0.01	
Net problem loans to equity	1.47	-0.06	-0.20	3.42
Non-performing loan coverage ratio	1.44	103.18	114.79	26.77
Stage 3 loans/gross loans		0.09	0.07	0.23
Net stage 3 loans/gross loans		0.09	0.06	0.22
FUNDING & LIQUIDITY				
Loan/deposit ratio				
Net stable funding ratio	0.0	0.0	0.0	0.0
Liquidity coverage ratio	6503.0	2929.0	1822.0	1192.0

Key financials (SEKm)	FY 2017	FY 2018	FY 2019	FY 2020
BALANCE SHEET				
Total assets	35,922	80,803	101,348	123,647
Total tangible assets	35,922	80,803	101,348	123,647
Total financial assets	35,880	80,758	101,060	123,628
Net loans and advances to customers	33,302	77,429	97,023	117,365
Total securities	1,755	2,465	3,379	4,800
Customer deposits				
Issued securities		48,264	74,221	92,232
of which covered bonds				
of which other senior debt		48,264	74,221	92,232
of which subordinated debt				
Total equity	1,967	4,107	4,866	5,661
Total ordinary equity	1,967	4,107	4,866	5,661
CAPITAL				
Common equity tier 1	1,815	3,535	4,454	5,543
Tier 1	1,815	3,535	4,454	5,543
Total capital	1,815	3,554	4,454	5,543
REA	4,317	21,929	26,682	31,641
INCOME STATEMENT				
Operating revenues	189	780	1,018	1,119
Pre-provision operating profit	162	719	918	984
Impairments	0	2	-48	-27
Net Income	124	561	759	795

Source: company. FY–full year. YTD–year to date.

Figure 33. Danske Hypotek rating scorecard

Subfactors	Impact	Score
National factors	20.0%	bbb+
Regional, cross border, sector	No impact%	n/a
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-
Indicative credit assessment		**a**
Transitions		Neutral
Borderline assessments		Neutral
Peer comparisons		Neutral
Stand-alone credit assessment		**a**
Material credit enhancement		Neutral
Rating caps		Neutral
Support analysis		Neutral
Issuer rating		**A**
Outlook		Stable
Short-term rating		**N-1+**

Figure 34. Capital structure ratings

Seniority	Rating
Covered bond	AAA
Senior unsecured	A+

DISCLAIMER

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