Nordic Credit Rating

FINANCIAL INSTITUTION

Sweden
11 Apr. 2022

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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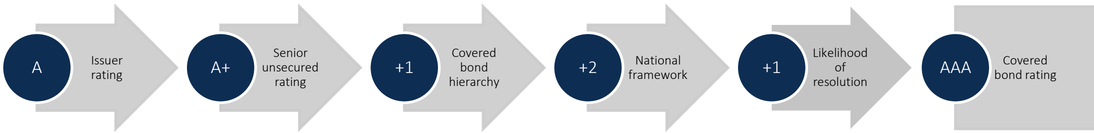
RATING RATIONALE

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 were to become 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 remain stable. This reflects our view that Danske Hypotek and Danske Bank will maintain their status as systemically important financial institutions with a very high likelihood of resolution, which would be expected to exclude the bail-in of covered bonds. Proposed changes to the Swedish Covered Bond Issuance Act, to align with the EU's latest covered bond directive, will not 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, due to deterioration in our assessment of Danske Bank.
- Reduced security in covered bond assets.

Figure 2. Danske Hypotek cover pool characteristics, Q4 2019–Q4 2021

	Q4 2019	Q2 2020	Q4 2020	Q2 2021	Q4 2021
Eligible cover pool assets (SEKm)	92.9	107.3	113.8	115.8	121.3
Outstanding covered bonds (SEKm)	73.1	89.5	90.9	104.9	98.1
Overcollateralisation (%)	27.0	19.8	25.2	10.4	23.7
Weighted-average LTV (%)	59.0	59.1	58.0	56.0	54.0
Average loan seasoning (years)	3.8	3.9	4.2	4.3	4.7
Average bond maturity (years)	3.3	3.2	2.8	2.6	2.6
Average loan size (SEKm)	1.06	1.04	1.04	1.05	1.04
Owner-occupied share (%)	96.2	96.3	96.4	96.0	97.0
Priority liens (%)	98.5	98.6	98.6	99.0	99.0
>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 HTT). LTV–loan to value.

Figure 3. Loan balance by property region (SEKbn), 31 Dec. 2021

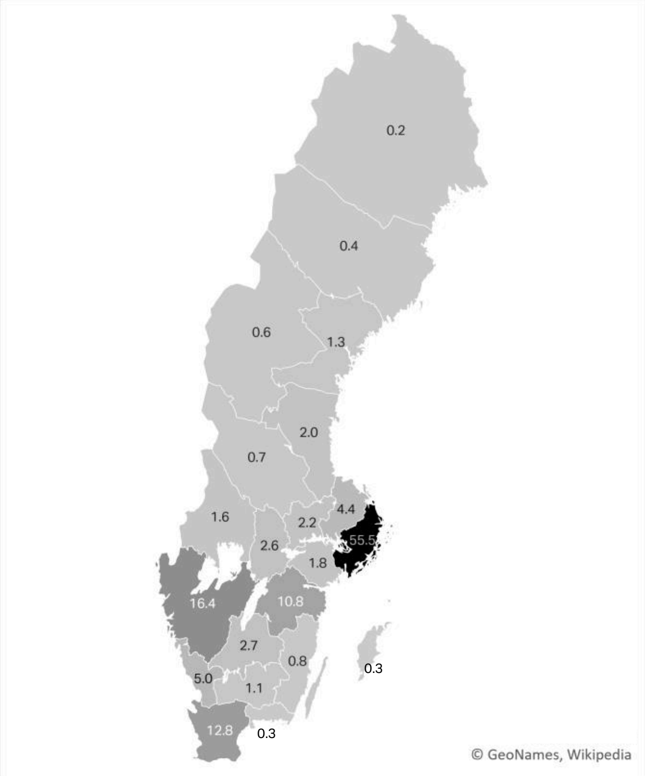


Figure 4. Weighted LTV by borrower region (%), 31 Dec. 2021

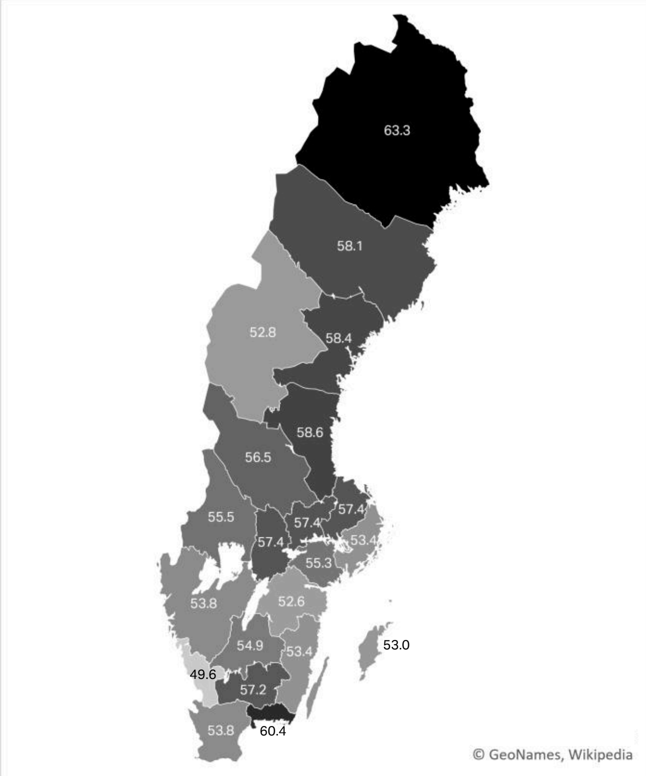


Figure 5. Average loan size per property by region (SEKm), 31 Dec. 2021

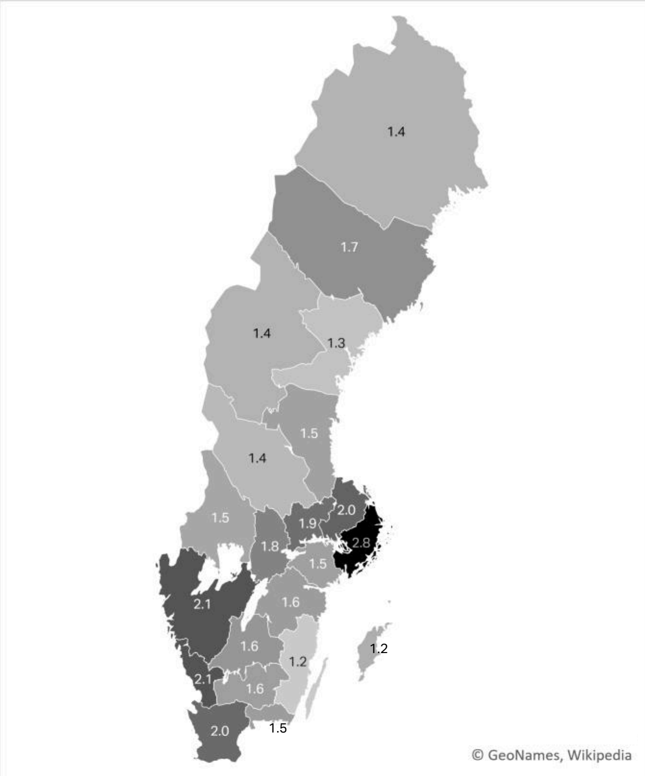
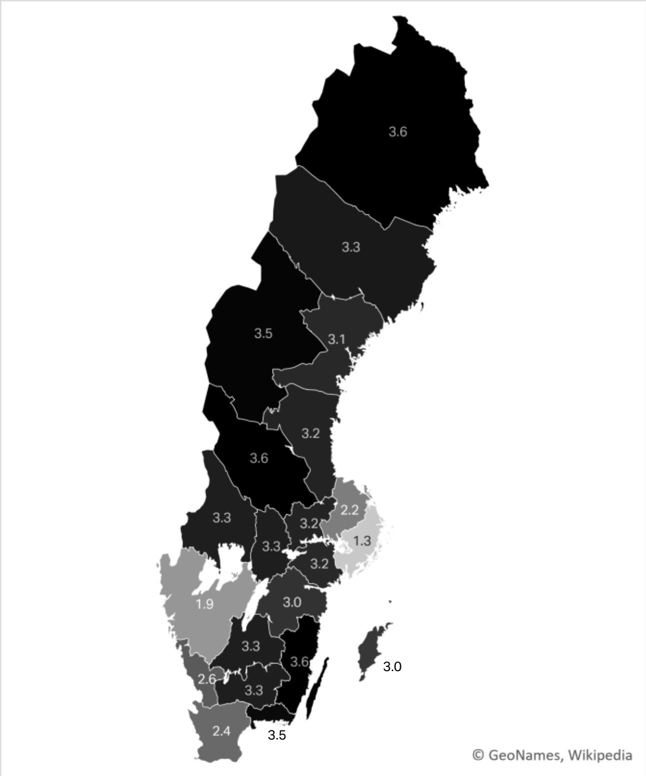


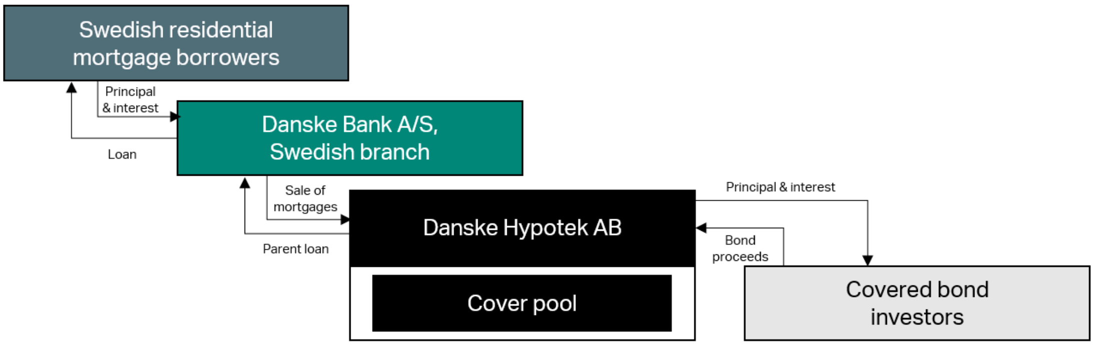
Figure 6. Average region class by property region, 31 Dec. 2021



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 benchmark market as its competitors. All of the loans financed by Danske Hypotek are acquired from Danske Bank's Swedish branch, as Danske Hypotek itself does not conduct any new lending business.

Figure 7. Danske Hypotek covered bond structure



QUALITATIVE ASSESSMENT

Qualitative assessment 'aaa'

NCR's qualitative assessment of Danske Hypotek's covered bonds is 'aaa', reflecting the issuer rating on the company and the notches of support described below. Our qualitative assessment indicates a very low likelihood that the cover pool will become a standalone entity, and a high likelihood that bondholders will receive timely coupon and principal payments.

Issuer rating of 'A'

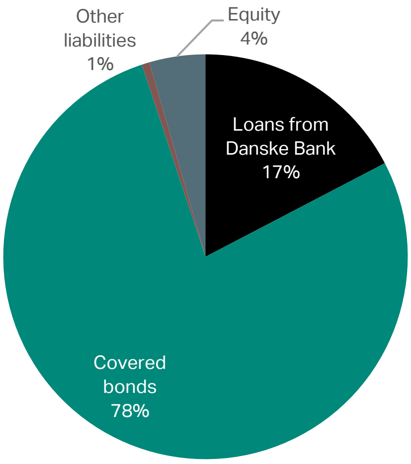
The repayment capacity for covered bonds is linked to the credit quality of the issuer and the issuer's banking group. Our 'A' issuer rating on Danske Hypotek reflects our current 'a' credit assessment of Danske Bank and the company's role as a 'vital' entity within the group structure. Our 'a' standalone assessment of Danske Hypotek is in line with our issuer rating. The outlook on our issuer rating on Danske Hypotek is stable, reflecting our credit assessment of Danske Bank and the overall Swedish mortgage market.

Senior unsecured issue rating one notch above issuer rating

As of end-2021, Danske Bank had DKK 164bn in senior non-preferred debt instruments with a maturity of over one year. These instruments represent 22.9% of the bank's risk exposure amount (REA) and a significant portion of its minimum requirement for own funds and eligible liabilities (MREL) buffers (33.9%). 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 thereby benefit all group subsidiaries.

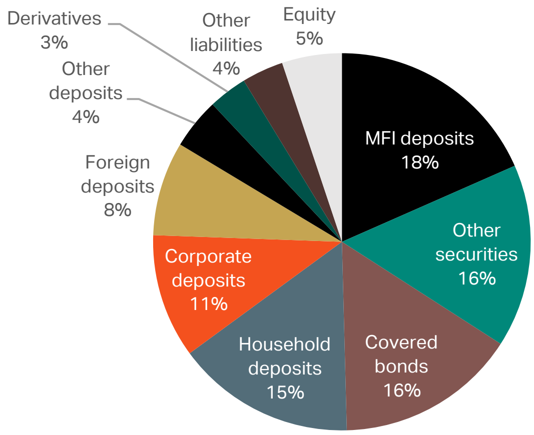
Danske Hypotek's liability structure consists primarily of covered bonds, which are already excluded from bail-in according to the EU's Bank Recovery and Resolution Directive, and loans directly from Danske Bank. We note that Danske Bank's senior loan is subordinated to covered bond holders, giving them 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 'A+' senior unsecured rating.

Figure 8. Danske Hypotek liabilities, end-2021



Based on company data.

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



Source: Sweden Financial Market Statistics, Feb 2022.

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 on the company's senior unsecured instruments. This reflects our view that the EU directive explicitly defines covered bonds as having priority over senior unsecured debt obligations in the default hierarchy of financial institutions. The directive also limits the potential for bail-in of covered bonds in instances in which covered bond liabilities exceed eligible cover pool assets. However, liabilities can never exceed eligible pool assets in Swedish covered bond pools.

According to the Swedish Financial Supervisory Authority, 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

National regulations provide two-notch uplift to covered bond ratings

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 Financial Supervisory Authority'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 Financial Supervisory Authority;
- separate bank accounts for pool-related transactions; and

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

- 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%.

The proposed changes to the Swedish Covered Bond Issuance Act, required to adapt to the EU's updated covered bond directive, will not impact the ratings on Danske Hypotek's covered bonds. The final implementation will be effective from 8 July 2022, pending legal approval in Sweden scheduled for May 2022. There will also be transitional rules to manage tap issuance and LTV limits. The key changes affecting Swedish covered bonds are:

- an increase in 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 maximum LTV for commercial and commercial agriculture loans of 60%, which can be increased to 70% if the overcollateralisation in the cover pool exceeds 10%;
- a greater ability to include lower-rated derivative counterparties, where necessary, to avoid counterparty concentrations;
- liquidity buffer requirements covering 180 days of net outflows using extended maturity dates for extendable maturity ('soft bullet') bonds; and
- approval of soft bullet bonds which are only extended if approved by the Swedish regulator to avoid insolvency.

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 December 2021. This reflects 15.5% of Swedish monetary financial institution liabilities and equity, making covered bonds one of the most important financing sources in the country's banking system.

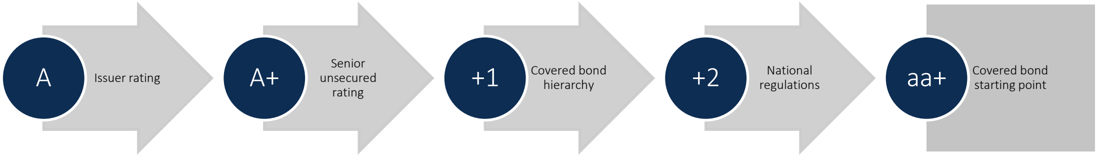
High likelihood of resolution supports 'aaa' qualitative assessment

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 a systemically important financial institution 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 a systemically important financial institution 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 4.6% of total liabilities and own funds since 1 Jan. 2022. We note that the 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 over 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 were to fail.

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 ('aa+') and the 95% probability of resolution for Danske Hypotek, the qualitative assessment is 'aaa'. It is also clear that the qualitative assessment of Danske Hypotek's covered bonds is likely to remain 'aaa', even if Danske Hypotek or Danske Bank were to be downgraded by multiple notches or if 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 were to fall 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

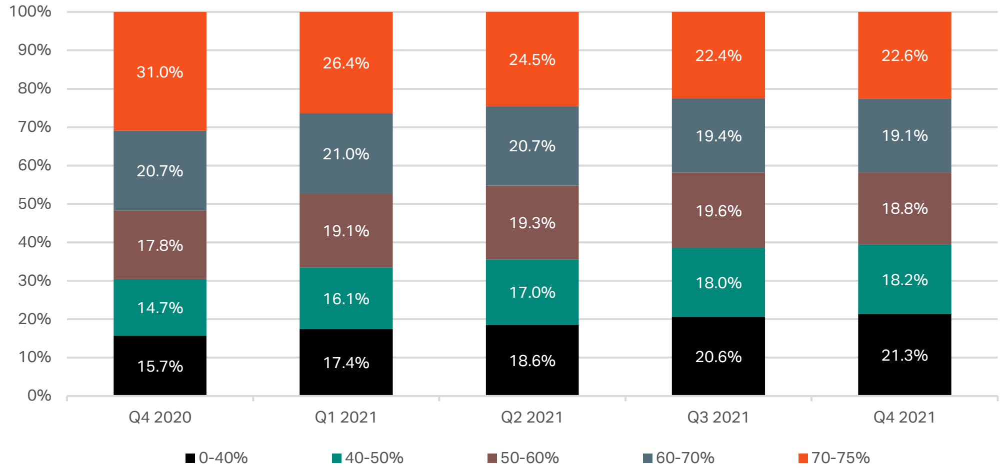
Our cover pool analysis and stress testing support the 'AAA' rating on Danske Hypotek's covered bonds. Given the qualitative assessment of 'aaa', the analysis of the cover pool is primarily to provide further information on the details and sensitivities of the cover pool. We have used loan, property 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 specified 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.

LTV levels improved due to housing price increases

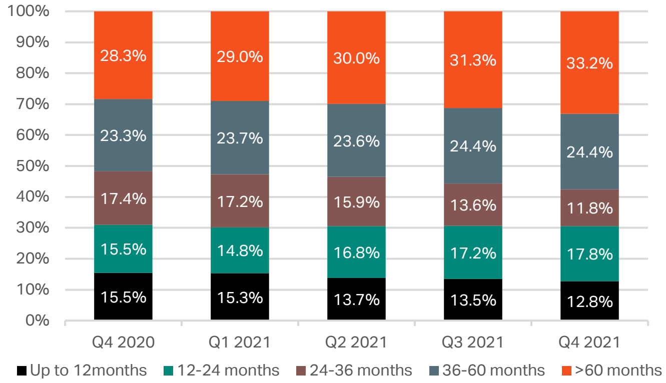
The following charts provide an overview of the characteristics of the cover pool assets. As of end-2021, the pool included SEK 121.0bn in eligible residential mortgage loans, i.e. loans qualifying for overcollateralisation, LTV and loan performance requirements. In addition, at end-2021, Danske Hypotek had SEK 3.5bn representing ineligible portions of residential mortgage loans (i.e. above 75% LTV or non-performing loans), 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



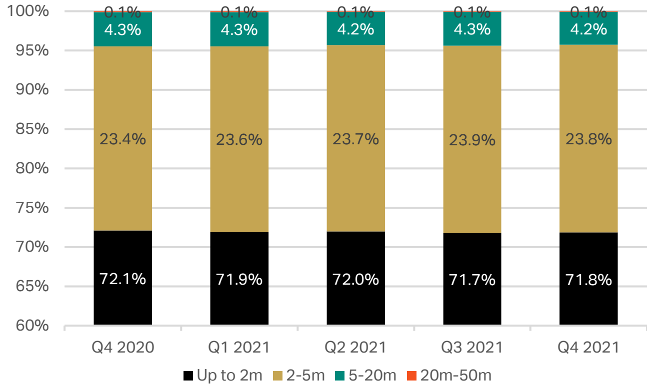
Source: company. Entire eligible loan amount in respective bucket based on borrowers' LTV.

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



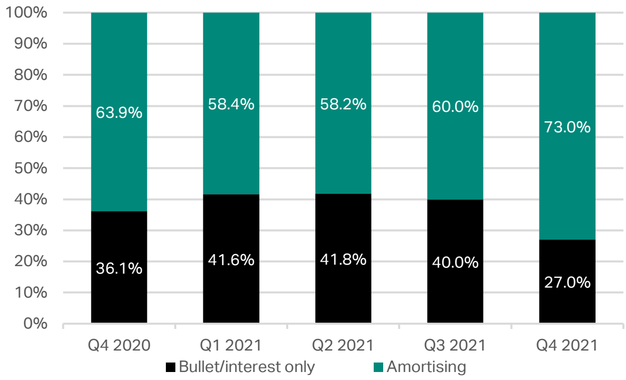
Source: company.

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



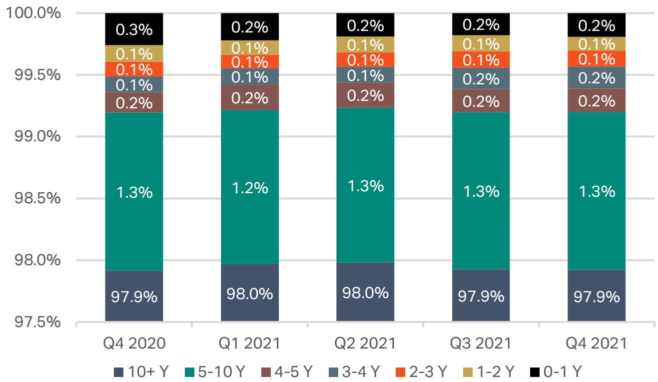
Source: company.

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



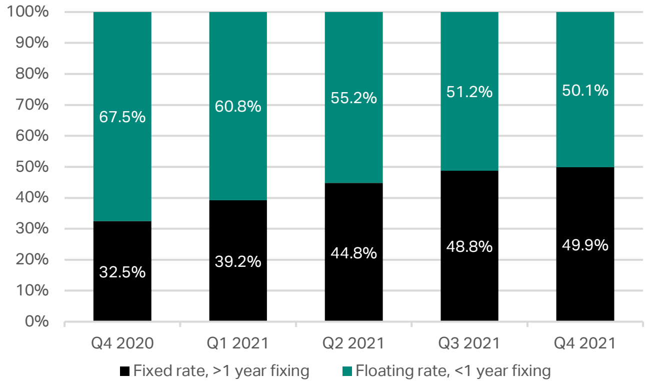
Source: ECBC HTT.

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



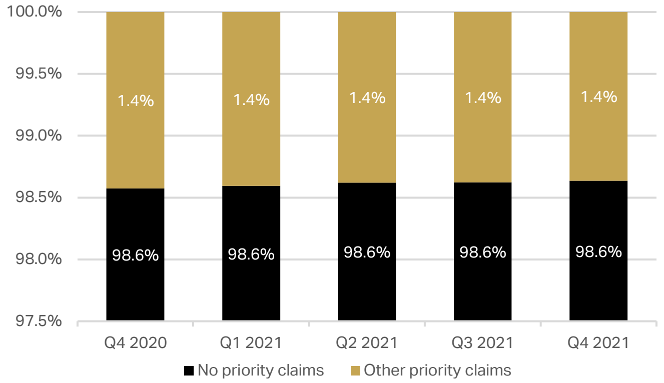
Source: company.

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



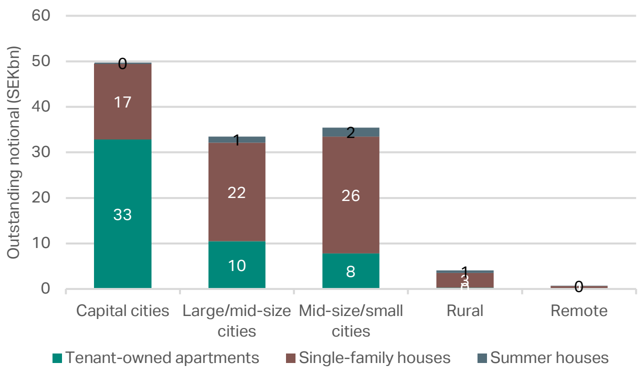
Source: company.

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



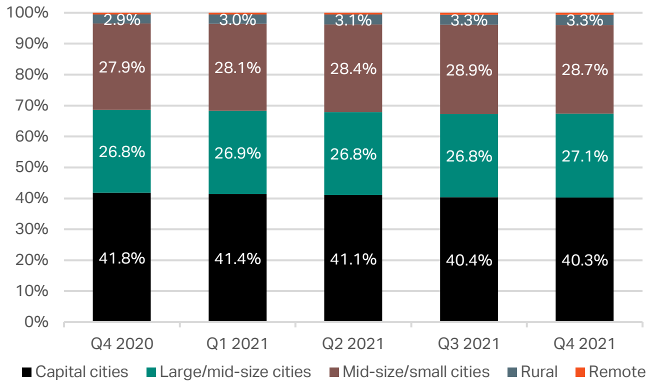
Source: company.

Figure 19. Region class and property type, 31 Dec. 2021



Based on company data, NCR region definitions.

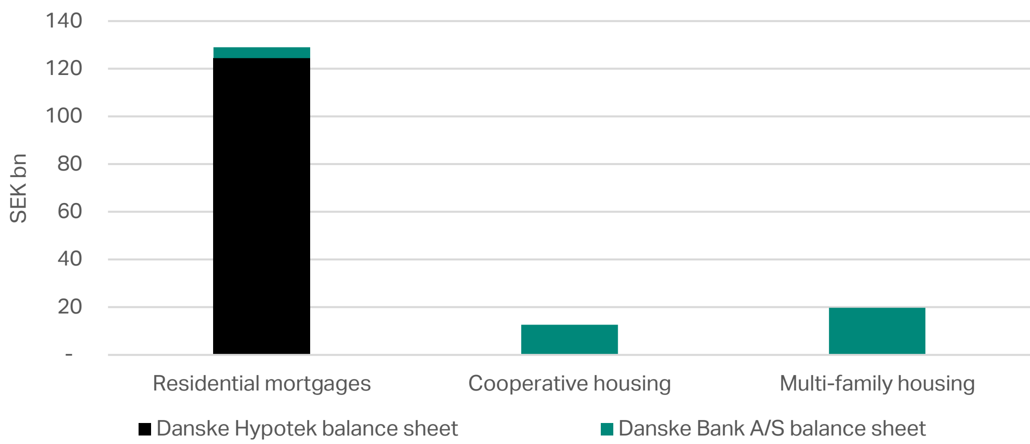
Figure 20. Region class, last five quarters



Based on company data, NCR region definitions.

In early 2022, Danske Hypotek began transferring some of the SEK 32.5bn in multi-family housing mortgages and cooperative housing loans from Danske Bank to its own cover pool. We expect most of these loans to be transferred by end-2023, starting with rental housing loans.

Figure 21. Available cover pool assets, as of end-2021



Source: company.

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 asset levels in the cover pool.

Stress testing

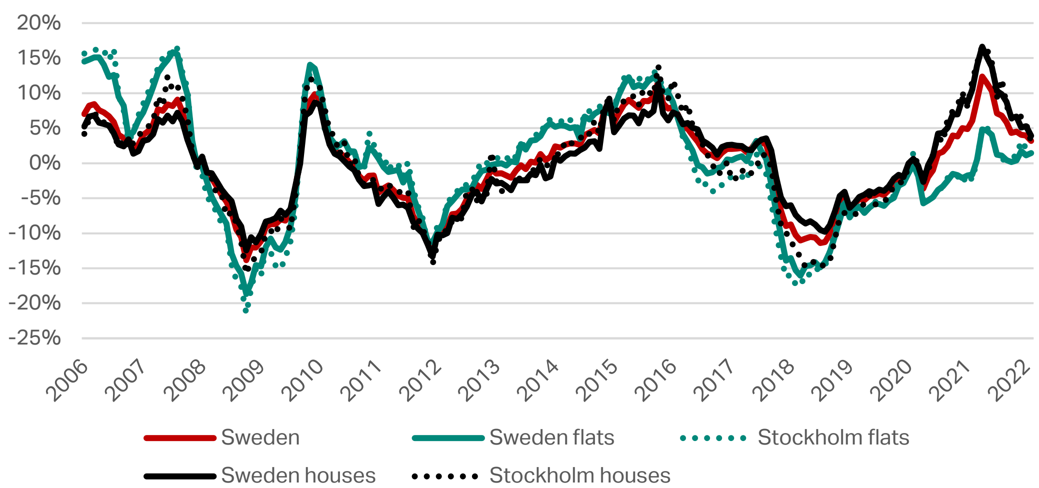
NCR's standalone stress testing of the cover pool assumes that all forms of external support for the pool are exhausted and that only the underlying assets can provide enough liquidity to make coupon and principal payments. This analysis begins with the assumption that the issuer and/or banking group 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 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 tests show lower projected losses in all scenarios

Our stress scenarios assume that Swedish housing prices are 5–15% above their long-term trend levels which has supported improving LTV levels in the cover pool (see Figure 12). Since 2005, average domestic housing prices have increased by 6.5% annually according to ValueGuard's HOX index (7.4% for flats and 6.3% for single-family homes), a trend that included a sharp increase following the outbreak of the COVID-19 pandemic. In our view, housing prices remain inflated despite peaking in the first half of 2021 (see Figure 22). We expect them to grow at rates closer to the long-term compound annual growth rate (CAGR) given the currently increased likelihood of rising interest rates and the subsequent impact on affordability.

Figure 22. Sweden 12-month housing price growth adjusted for CAGR, Jan. 2006–Feb. 2022



Source: ValueGuard, HOX index

NCR's credit risk stress testing begins with standard assumptions (see Figure 23). In line with 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, %

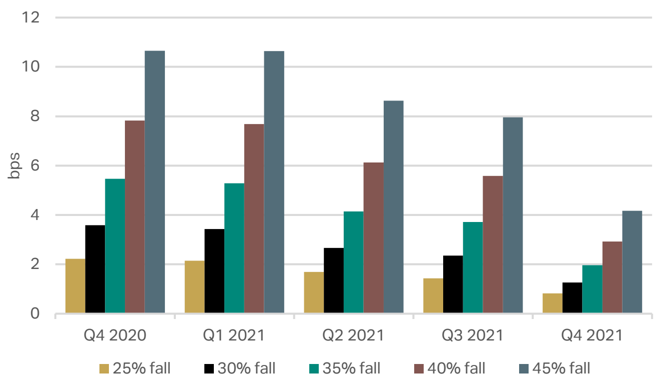
	RESIDENTIAL NON-PERFORMING LOANS	RESIDENTIAL LOANS IN DEFAULT	RESIDENTIAL FORECLOSURE REBATE*	RESIDENTIAL HOUSING PRICE FALL
Level 1	4.00	1.33	30.9	25.0
Level 2	5.24	1.75	32.7	30.0
Level 3	6.87	2.29	34.5	35.0
Level 4	9.00	3.00	36.4	40.0
Level 5	11.80	3.93	40.0	45.0

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

In our five stressed scenarios, we assume property value declines of 25–45% (5-15pp above CAGR). Recent increases in housing prices have reduced the overall loan-to-value in Danske Hypotek's portfolio, which has contributed to a reduction in stressed losses since end-2020 (see Figure 25 and Figure 26).

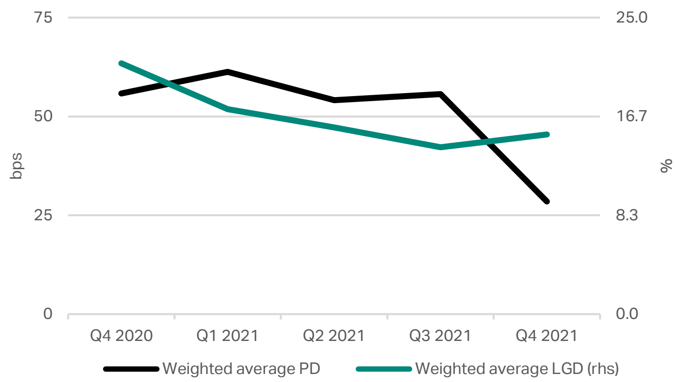
Since the beginning of the fourth quarter of 2021 we have decreased our concentration adjustment to 6% from 7% previously, reflecting a reduction in the relative geographic concentration of Danske Hypotek's loan assets compared with larger Swedish peers' cover pools.

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



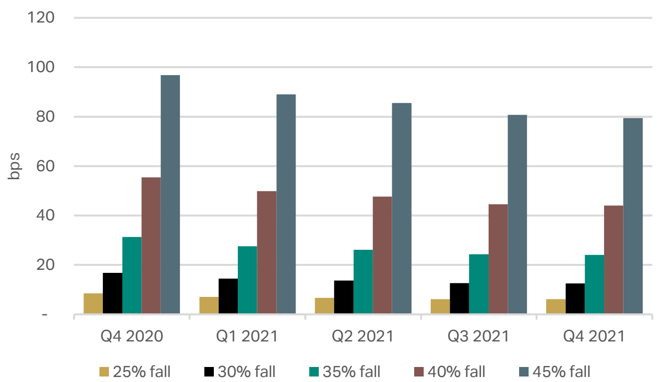
Based on NCR analysis of company data.

Figure 25. Weighted-average probability of default (PD) and loss given default (LGD) of cover pool, last five quarters



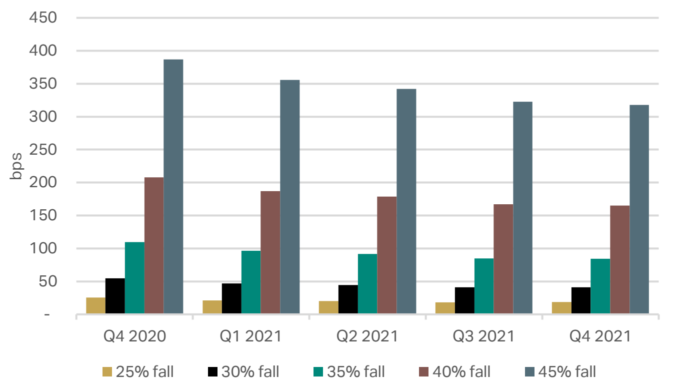
Based on NCR analysis of company data.

Figure 26. 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 27. Multi-year credit loss as a share of cover pool loans, based on actual portfolio composition and NCR stress test, last five quarters



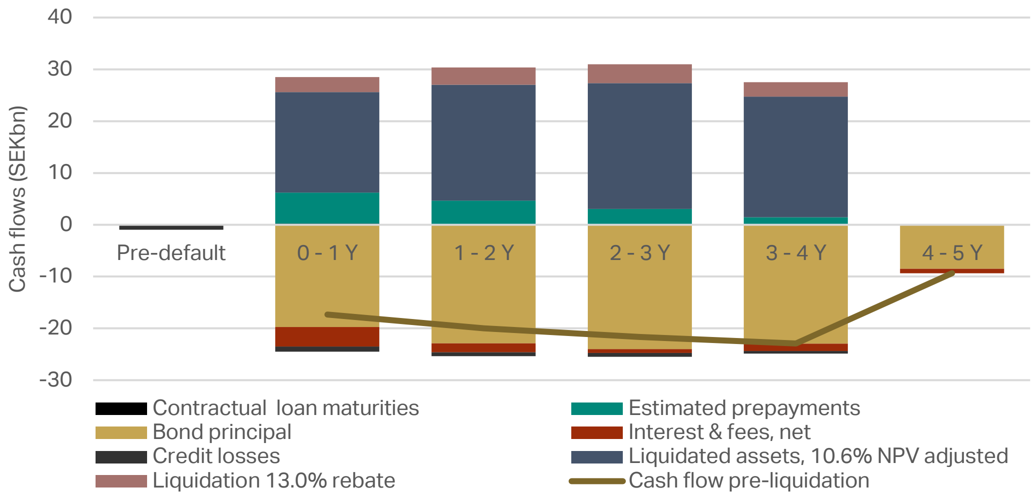
Based on NCR analysis of company data.

Cash flow stress test shows shortage in year five of rundown

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. Our stress 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 bondholders in the fifth year of rundown (see Figure 28). This discrepancy is largely due to the net present value (NPV) assumptions for liquidated assets in the cash flow analysis. Cash flows would be sufficient if mortgage margins were maintained above 1% in the Level 5 scenario, even with the 10% discount rate.

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 about the severity of discount rates and the liquidation rebates on assets sold (principal payments are made by selling pool assets). Interest and fees have only 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 the mortgage book and the company's policy of swapping all covered bond interest at floating rates.

Figure 28. Stressed cash flows in NCR's level 5 scenario for Danske Hypotek as of 31 Dec. 2021



Based on NCR analysis of company data.

ADDITIONAL FACTORS

Counterparty risk from group-internal interest rate swaps

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'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 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 prioritise 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 ranked at the EU's Credit Quality Step 3 (broadly similar to a public credit rating 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 the issuer's banking or ownership group.

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 role as a 'vital' subsidiary within the Danske Bank group and a permanent part of Danske Bank's long-term strategy in its core Swedish market.

STABLE OUTLOOK

The outlook is stable, reflecting our credit assessment of Danske Bank and the overall Swedish mortgage market. Upside to the issuer rating on Danske Hypotek remains constrained by our 'a' credit assessment of Danske Bank. Given our view of Danske Hypotek as 'vital' to Danske Bank, we could revise our rating on the company due to changes in our credit assessment of the parent, which we currently regard as stable.

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.

Figure 29. Danske Hypotek key credit metrics, 2018–2024e

%	2018	2019	2020	2021	2022e	2023e	2024e
Net interest margin	1.4	1.2	1.1	1.0	1.1	1.1	1.1
Loan losses/net loans	0.00	-0.05	-0.03	0.01	0.01	0.01	0.02
Pre-provision income/REA	5.5	3.8	3.4	3.3	3.3	3.4	3.4
Return on ordinary equity	18.5	16.9	15.1	14.3	14.7	15.0	14.3
Loan growth	132.5	25.3	21.0	6.0	20.0	8.0	8.0
CET1 ratio	16.1	16.7	17.5	18.3	17.1	18.0	18.9

Based on NCR estimates and company data. e–estimate. All metrics adjusted in line with NCR methodology. CET1–common equity Tier 1.

RATING RATIONALE

Operating environment for Sweden 'a-'

Our assessment of the Swedish banking market reflects our expectations of continued recovery in cyclical production segments and service industries as the COVID-19 pandemic recedes (as we anticipate). In addition, Sweden's strong public finances and lower-than-projected budget deficit, together with expansionary monetary policies, provide buffers against threats to economic recovery from the ongoing conflict in Ukraine. Residential property prices have increased and residential rental property values are strong, which supports the valuation of the collateral underlying much of Danske Hypotek's loan book. Monetary policy remains expansionary and conducive to low credit losses, though increasing interest rates could increase mortgage costs over the next few years.

ESG assessment neutral

Danske Hypotek's environmental, social and governance (ESG) efforts are largely dictated by group-wide investments and commitments to sustainability. Danske Bank has established seven key ESG goals to be achieved by 2023, reflecting measurable targets for sustainable finance, sustainable operations, and impact initiatives. The bank had made good progress on its stated goals as of end-2021 and has added targets for investing in sustainable funds as well as reducing emissions in its shipping, utility, and oil and gas exposures by 2030.

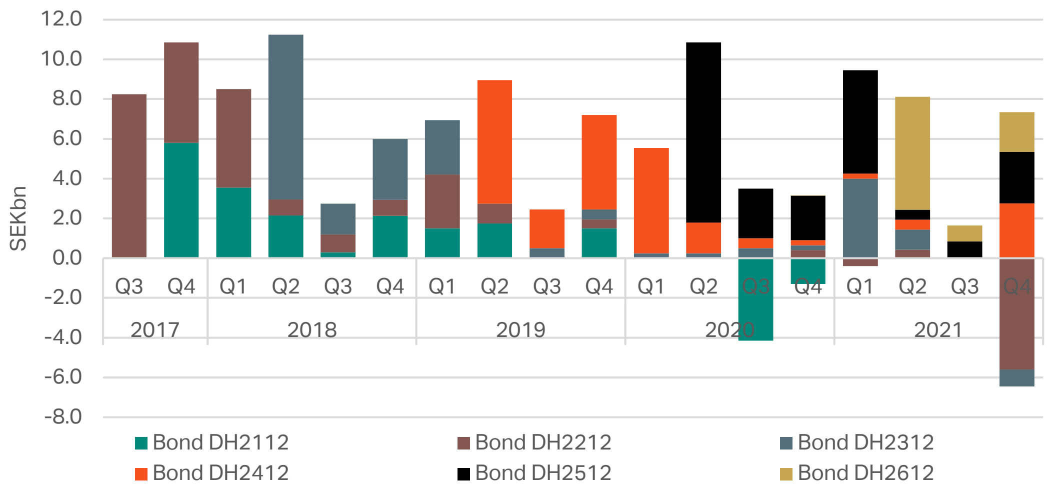
Danske Hypotek's role in the group's ESG strategy has not yet been precisely defined, but the company aims to become an issuer of green bonds now that it has established itself as a benchmark covered bond issuer. Danske Hypotek's role in Danske Bank's social responsibility efforts is conducted in Sweden by the group's Swedish branch. This is partly reflected by gender equality in senior leadership roles and community partnerships.

Danske Hypotek has benefited from recent group investments in compliance and risk governance which have repositioned Danske Bank as a leader in this respect. Danske Hypotek's pays for administrative services provided by the group via various service level agreements, which form the core of Danske Hypotek's own governance model, including risk oversight and internal audit processes. Danske Hypotek also maintains dedicated full-time resources in key functions such as credit risk, financial accounting, operations, and treasury.

Risk appetite assessment 'a'

Danske Hypotek's capital position is strong; the company had a CET1 ratio of 18.3% at end-2021. We project the ratio will fall over the next two years as it adds multi-family housing loans with higher risk weights and cooperative housing loans to the cover pool. Capital generation remains strong, however, and we do not expect Danske Hypotek to pay dividends. The company's regulatory capital requirement was 11.6% as of end-2021 but excludes a 1% countercyclical buffer which will take effect from September 2022. Danske Hypotek maintains access to additional capital from the group when necessary and can sell loans back to Danske Bank to reduce its capital requirements, which provides additional flexibility.

Figure 30. Danske Hypotek covered bond tap issuance and buy-back activity, through end-2021



Based on company 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.

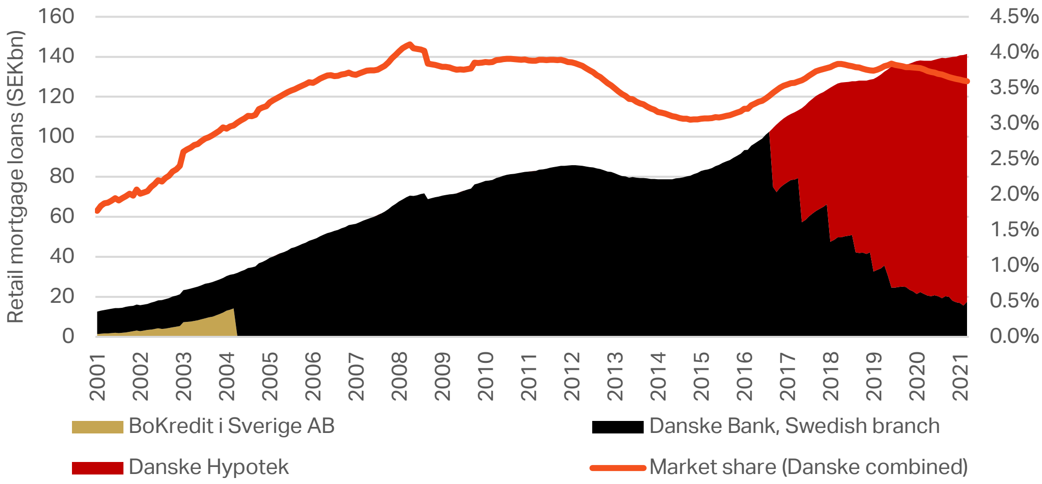
Danske Hypotek's credit risk profile is well captured by the 25% regulatory risk weight floors used to calculate the company's regulatory capital measures. While there are some concentrations in the mortgage book, the respective loans are to borrowers based in Sweden's major cities and centres of economic 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 54% (HTT reported value), which is higher than that of the cover pools of its larger peers – Swedbank, Handelsbanken, SEB and Nordea – which averaged 47% as of end-2021 according to ECBC HTT reports.

Competitive position scores 'bbb+'

Danske Bank originally entered the Swedish market as a branch operation in 1995. We consider Danske Hypotek to be a challenger in the Swedish residential mortgage market, and, despite its national presence, we note that it is relatively concentrated in Stockholm (see Figure 3). Combined with the remaining loans at Danske Bank's Swedish branch, the group's market share was 3.6% in January 2022 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 mentioned above, as well as SBAB and Länsförsäkringar Bank (see *The Swedish mortgage market* on NCR's website).

In addition to residential mortgage lending, Danske Hypotek has started to finance residential rental properties and we expect it to finance most of Danske Bank's Swedish residential rental and cooperative housing loans by end-2023.

Figure 31. Danske Bank Swedish retail mortgage market share, Dec. 2001–Feb. 2022



Source: Statistics Sweden

Performance indicators score 'aa-'

We view Danske Hypotek's earnings and loss performance metrics as very strong. The company maintains a small and flexible cost base, resulting in outstanding cost efficiency and risk-adjusted earnings. While mortgage margins in Sweden are under pressure, the combination of regulatory capital floors for residential mortgages and relatively high return on equity requirements for most lenders supports risk-adjusted earnings in the sector. Danske Hypotek's loss performance is supported by a propensity among Swedish borrowers to make payments on their mortgages at all costs given strong creditor rights.

We expect Danske Hypotek 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. As of end 2021, the bank reported elevated levels of Stage 3 non-performing loans, reflecting borrowers' use of a pandemic-related relaxation of amortisation payments on mortgage loans. We understand that the increase is temporary and does not reflect any changes in credit risk or increasing forbearance. For this reason, we anticipate that Stage 3 loans will return to pre-pandemic levels by end-2022.

Ownership support neutral

We view Danske Hypotek as a 'vital' entity within the Danske Bank group. However, we currently assess Danske Bank at 'a', which is already in line with our standalone credit assessment of Danske Hypotek.

Danske Hypotek is partly financed by Danske Bank and is highly integrated within the group's Swedish operations. In addition, we expect any financial resolution (as defined by the EU's Bank Recovery and Resolution Directive) involving Danske Bank to result in the Swedish subsidiary maintaining its current relationship with the parent. For this reason, Danske Hypotek is not eligible to be rated above the level of our credit assessment of the parent.

Figure 32. Danske Hypotek key financial data, 2017–2021

Key credit metrics (%)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
INCOME COMPOSITION					
Net interest income/op. revenue	118.4	105.8	103.1	106.4	108.1
Net fee income/op. revenue	-6.1	-3.7	-1.9	-2.1	-1.9
Net trading income/op. revenue	-12.3	-2.1	-1.2	-4.4	-6.2
Net other income/op. revenue		0.0	0.0		
EARNINGS					
Net interest margin		1.4	1.2	1.1	1.0
Pre-provision income/REA		5.5	3.8	3.4	3.3
Return on ordinary equity					14.3
Return on assets		1.0	0.8	0.7	0.7
Cost-to-income ratio	14.4	7.8	9.9	12.0	7.2
Cost-to-income ratio, ex. trading	12.8	7.6	9.8	11.5	6.8
CAPITAL					
CET1 ratio	42.0	16.1	16.7	17.5	18.3
Tier 1 ratio	42.0	16.1	16.7	17.5	18.3
Capital ratio	42.0	16.2	16.7	17.5	18.3
REA/assets	12.0	27.1	26.3	25.6	27.1
Dividend payout ratio					
Leverage ratio	0.0	0.0	0.0	0.0	0.0
GROWTH					
Asset growth		124.9	25.4	22.0	6.1
Loan growth		132.5	25.3	21.0	6.0
Deposit growth					
LOSS PERFORMANCE					
Credit provisions to net loans		0.00	-0.05	-0.03	0.01
Impaired loans to gross loans	0.09	0.09	0.07	0.23	0.72
Net impaired loans to gross loans	0.09	0.00	-0.01	0.16	0.65
Net problem loans to equity	1.47	-0.06	-0.20	3.42	12.29
Non-performing loan coverage ratio	1.44	103.18	114.79	26.77	10.49
Stage 3 loans/gross loans		0.09	0.07	0.23	0.72
Net stage 3 loans/net loans		0.09	0.06	0.22	0.69
FUNDING & LIQUIDITY					
Loan/deposit ratio					
Net stable funding ratio	0.0	0.0	0.0	0.0	0.0
Liquidity coverage ratio	6503.0	2929.0	1822.0	1192.0	0.0

Key financials (SEKm)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
BALANCE SHEET					
Total assets	35,922	80,803	101,348	123,647	131,229
Total tangible assets	35,922	80,803	101,348	123,647	131,229
Total financial assets	35,880	80,758	101,060	123,628	131,209
Net loans and advances to customers	33,302	77,429	97,023	117,365	124,444
Total securities	1,755	2,465	3,379	4,800	4,657
Customer deposits					
Issued securities	19,317	48,264	74,221	92,232	97,309
of which covered bonds					
of which other senior debt	19,317	48,264	74,221	92,232	97,309
of which subordinated debt					
Total equity	1,967	4,107	4,866	5,661	6,536
Total ordinary equity				5,661	6,536
CAPITAL					
Common equity tier 1	1,815	3,535	4,454	5,543	6,520
Tier 1	1,815	3,535	4,454	5,543	6,520
Total capital	1,815	3,554	4,454	5,543	6,520
REA	4,317	21,929	26,682	31,641	35,608
INCOME STATEMENT					
Operating revenues	189	780	1,018	1,119	1,204
Pre-provision operating profit	162	719	918	984	1,117
Impairments	0	2	-48	-27	15
Net Income	124	561	759	795	875

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

Figure 33. Danske Hypotek rating scorecard

Subfactors	Impact	Score
National factors	20.0%	a-
Regional, cross border, sector	-	-
Operating environment	20.0%	a-
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+

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