15 September 2022

Financial Institutions

Realkredit Danmark A/S
Issuer Rating Report

SCOPE

A+ NEGATIVE

Scope's credit view (summary)

The ratings of Realkredit Danmark A/S benefit from the credit strength of its parent company Danske Bank A/S. We consider Realkredit to be a fully integrated subsidiary of Danske Bank and therefore apply our top-down approach to the analysis.

When determining the reliability and stability of parent support to subsidiaries, we particularly take into account the extent to which the respective subsidiary is considered strategic for the group. We align the ratings of fully integrated subsidiaries with those of the parent based on, among other factors, jurisdiction, resolution strategy and the degree of centralisation of key corporate functions, including funding and risk management. Moreover, we take into account the parent company's record in supporting its subsidiaries.

As a specialised mortgage finance subsidiary in the group's home market of Denmark, Realkredit originates the majority of its domestic mortgage loans within Danske Bank for which the latter provides a first loss guarantee. While it has its own governance structure, it is closely integrated into the group through a uniform strategy and risk management principles. The loans are funded by covered bonds, which makes the bank a key funding vehicle for Danske Bank group.

Realkredit's standalone financial profile continues to be supported by its high asset quality, strong capitalisation and position as a major covered bond issuer in Denmark. We consider Realkredit's proven pass-through funding model as a key credit strength. Nevertheless, declining interest margins have continued to put pressure on financial performance. However, the bank was able to stop the trend of declining market shares in 2021.

Credit quality remained very robust in 2021 and at a sound level in H1 2022. This continues to be supported by low and declining loan-to-value (LTV) ratios across the portfolio. A solid risk position as Denmark's second largest mortgage lender puts Realkredit in a good position to weather the current recession, even though asset quality in commercial real estate may weaken.

Realkredit is dependent on wholesale funding. However, the Danish covered bond market is well established and liquid with a wide range of domestic and foreign investors.

Profitability has come under pressure due to falling margins, which Realkredit finds difficult to offset as the company has limited ability to increase volumes in its mature market or reduce its already very low cost base. Return on equity is still sound, but also likely remain under pressure due to rising regulatory requirements.

Outlook

The **Outlook is Negative,** reflecting concerns triggered by the alleged money laundering by clients of Danske's Estonian operations (ESG factor). Realkredit has no direct exposure to these events, but indirect effects from the reputational fallout have contributed to a fall in its Danish market share.

Rating-change drivers

- Any material change to the credit profile of Danske Bank is likely to affect the ratings of Realkredit.
- A weakening in Realkredit's position as a core subsidiary within Danske Bank Group could lead us to revisit our support assumptions.

Ratings & Outlook

Issuer rating	A+
Outlook	Negative
Short-term debt rating	S-1+
Short-term debt rating Outlook	Negative
Covered bonds ratings	AAA
Covered bonds Outlook	Stable

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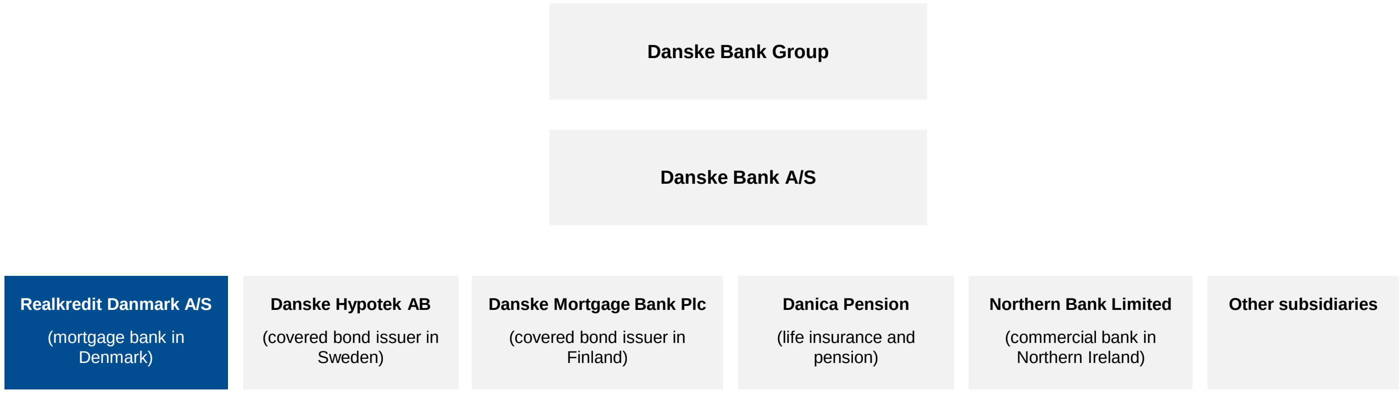
Issuer profile

Realkredit is a fully owned mortgage subsidiary of Danske Bank, Denmark's largest banking group. Realkredit accounts for about 20% of the group's assets and 40% of its loan book.

Viewed as a standalone entity, Realkredit has a 25% market share of Danish mortgage lending and is Denmark's second largest mortgage lender after Nykredit. Together, the two issuers account for two-thirds of the Danish covered bond market, as, by law, mortgages should be funded through covered bonds.

Realkredit is a fully integrated subsidiary of Danske Bank Group

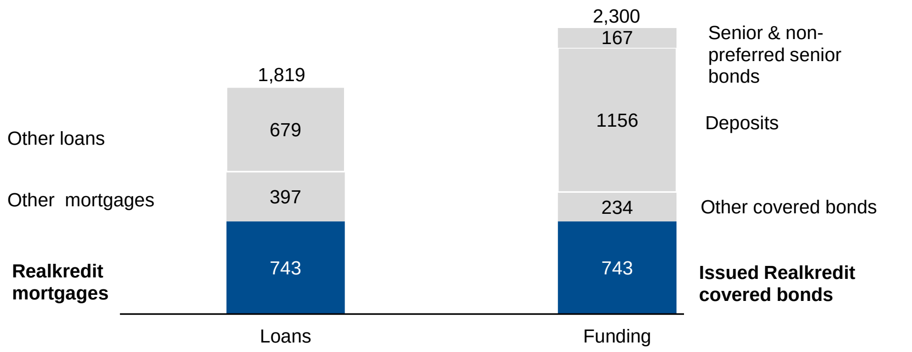
Figure 1: Danske Bank Group structure



Source: bank, Scope Ratings

As a part of its monoline business model, Realkredit funds most mortgage loans originated by Danske Bank in Denmark, though the latter also originates mortgage loans that are financed through its own mortgage pools and mortgage subsidiaries in Sweden and Finland (Figures 1 and 2).

Figure 2: Danske Bank Group's loan portfolio and funding structure (DKK bn)



Data as of H1 2022. Source: bank

Realkredit's mortgage loans are originated through the branch network and finance centres of Danske Bank, through the Corporate & Institutional Mortgage Finance unit at Realkredit and its own 'home' real-estate agency chain. While the majority of customers are served in Denmark, the large real estate division serves business customers in Norway and Sweden.

In autumn 2021, Realkredit launched a new website that helps customers find relevant services, calculate remortgaging and additional lending on all loan types and get into contact with the bank. This is an important step to increase and support customers' digital interaction with the bank.

High integration into the group through a uniform strategy and risk management

Key back office support, control functions and overall strategy are provided by Danske Bank. Realkredit also has its own governance structure, risk management and compliance function. Realkredit takes care of certain tasks on behalf of the group, such as property valuation and energy certificates. We believe Realkredit, as a core operating and fully integrated subsidiary, would be provided extraordinary support by Danske Bank if necessary.

Strict matching of assets and liabilities as the base for risk mitigation

Covered bonds as a core and strictly regulated funding source

The Danish mortgage bond market has always been based on the matching of terms and conditions for loans and corresponding covered bonds, restrictive eligibility criteria, including LTV limits and property valuation requirements. It posts additional collateral if LTVs rise above statutory limits. The effect of its balance principle is that interest rate, exchange rate and liquidity risks are largely eliminated for Realkredit and passed on to borrowers or borne by covered bond investors. Refinancing risk is mitigated by the issuance of bonds with longer maturities than the fixing periods. The maturity of covered bonds can also be extended in the event of a failure to refinance.

In line with Danish mortgage banking regulations, Realkredit's assets and liabilities are assigned to two main active asset pools (Capital Centres S and T) of mortgage loans against residential and commercial property, which together make up over 90% of its balance sheet, and a small pool (Capital Centre A) for state-guaranteed social housing loans. In insolvency proceedings, the assets and liabilities of each pool would be separated.

Green bond programme: focus on energy efficiency in real estate

The green bonds are backed by loans for energy efficient commercial property, energy transmission and renewable energy projects. Launched in 2019 at a small premium relative to standard covered bonds, green bond issuance continues to grow, targeting the middle corporate segment in Denmark and Sweden. As of end-H1 2022, total green lending amounted to DKK 18bn with potential to grow. Assets that qualify for green bond issuance, i.e. properties with an Energy Performance Certificate of A or B, but that have not been funded by green bond issuances, amounted to about DKK 75.7bn at YE 2021. In the future, Realkredit intends to offer green covered bonds in Norway.

Modest but stable profitability under pressure from falling margins and macroeconomic uncertainty

As customers have increasingly been switching to long-dated, fixed-rate loans (10-30 years) to take advantage of the low interest-rate environment, Realkredit's administration margin has been falling since 2019.

The interest rate hikes in H1 2022 prompted many customers to switch to variable-rate loans and start re-mortgaging in order to reduce their outstanding debt. Moreover, given the current uncertainty in the housing market, mortgage demand is expected to drop in H2 2022, especially among first-time buyers.

Modest profitability underpinned by consistently low cost of risk and cost efficiency

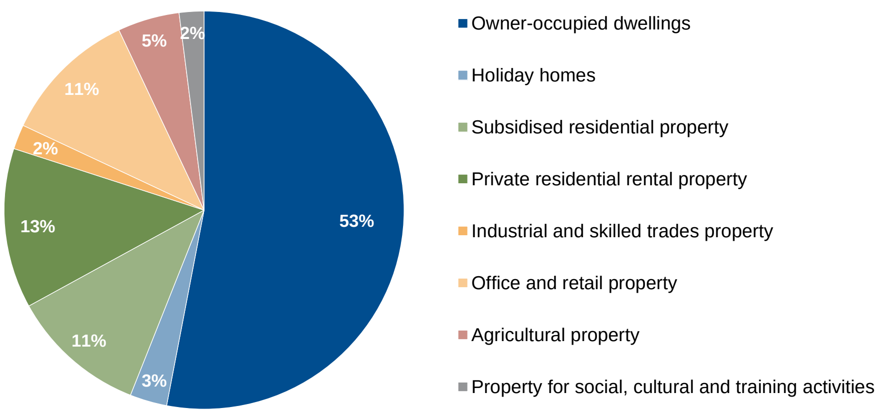
In H1 2022, Realkredit's net profit was DKK 1,9bn (2021: DKK 3,7bn) with a return on average equity of 8% (2021: 7.6%) slightly lower compared to the same period in 2021, driven by lower total income, higher costs and lower loan impairment charges. Realkredit's higher costs included the costs of ongoing compliance and digitalisation as well as the contribution to the Danish resolution fund. The cost-income ratio has thus increased from 10.9% in 2018 to a still low 17.7% in H1 2022 (2021: 16.7%).

Realkredit expects that in 2022 the Danish economy will be affected by economic and geopolitical uncertainty. The outlook is therefore subject to uncertainty. In this context, the bank expects income to be lower than in 2021 due to lower LTV for the customers. In addition, Realkredit expects expenses higher than in 2021 due to higher compliance costs and digitalisation. Loan loss provisions are expected to be similar to 2021 levels. The bank therefore expects net profit to be slightly lower than in 2021.

High asset quality supported by healthy mortgage loans

Realkredit's core loan segment is residential mortgage loans (56%), including owner-occupied housing and holiday homes (Figure 3). Realkredit also provides mortgages to the corporate sector, including commercial real estate, residential rental property and agriculture.

Figure 3: Realkredit Danmark A/S loan portfolio split by segment



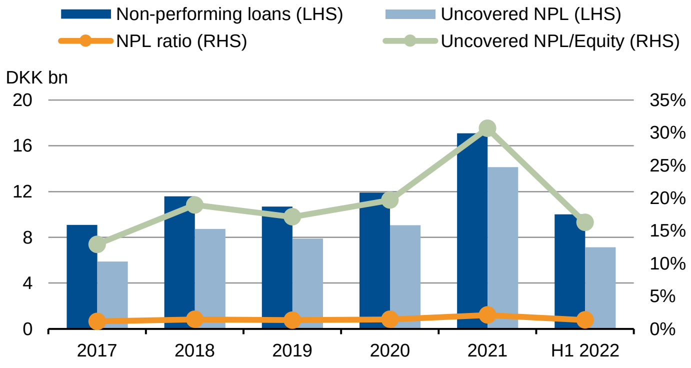
Data as of YE 2021. Source: bank

Realkredit's asset quality benefits from the strong legislative standards for mortgage loans under Denmark's Mortgage Act and Denmark's covered bond legislation. Realkredit sets LTV caps at 80% for residential mortgages, 75% for second homes (summer houses) and 60% for commercial real estate and agriculture. Higher LTV limits may apply for public housing and are also covered by the government guarantee. To cover the risk of rising LTVs, Danske Bank provides Realkredit with a first loss guarantee on the unsecured part of certain mortgages originated by Danske's network.

Since July 2022, homebuyers in rural areas have an opportunity to raise government-guaranteed loans. The government guarantee covers the part of the loan between 60% and 90% of the value of properties with a market price below DKK 10,000 per sq m or that are situated in a postal code area with an average market price below DKK 8,000 per sq m. The term of the scheme is limited to three years and can be used in situations in which loans are not available on ordinary terms and conditions.

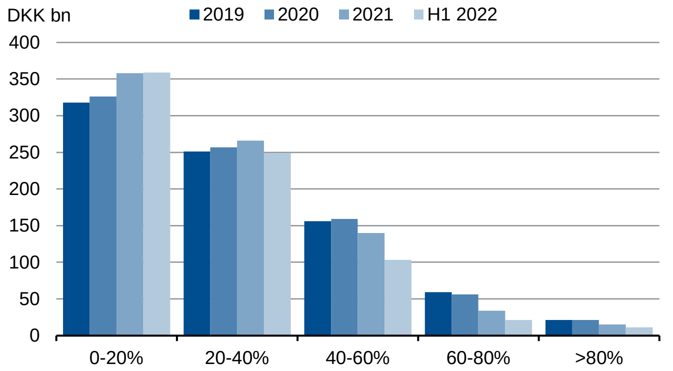
Despite the ongoing rise in interest rates, higher consumer prices and a less tense housing market, the level of impairment charges remained low in H1 2022. As of H1 2022, loan loss reversals amounted to DKK 27m, against impairment charges of DKK 269m (3 bp) in 2021. Total loan loss reserves amounted to DKK 2.9bn as of H1 2022, the same as at YE 2021.

Figure 4: Realkredit Danmark A/S non-performing loans (NPLs) vs uncovered NPLs



Source: bank, SNL, Scope Ratings

Figure 5: Realkredit Danmark A/S portfolio LTV breakdown



Source: bank, Scope Ratings

The overall quality of the portfolio remains high. As of H1 2022, Realkredit's mortgage NPLs (classified as stage 3 according to IFRS9) accounted for 1.35% of total loans (2021: 2.1%) (Figure 4).

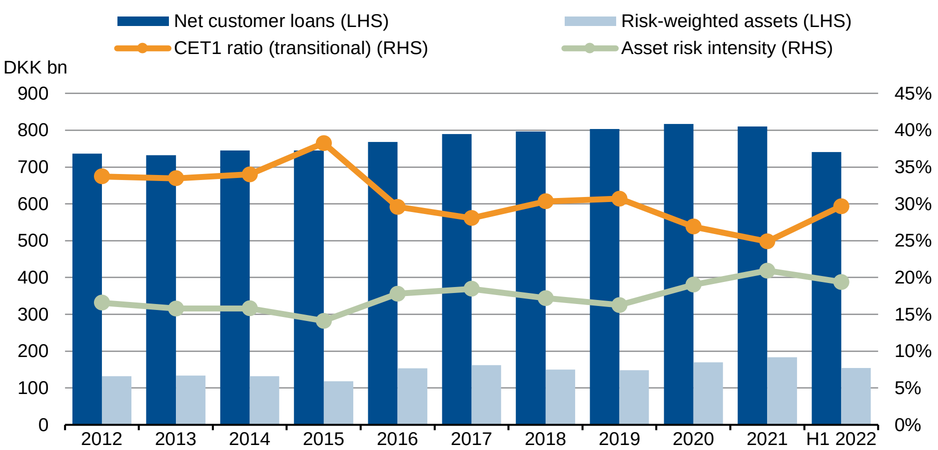
High asset quality supported by low LTVs

Based on increasing house prices and an increasing portion of amortising loans in combination with accelerating repayments, LTVs have been trending down (Figure 5). At end-H1 2022, the average LTV of the mortgage portfolio was 48% (46% for retail, 51% for commercial) (YE 2021: 54%) and only a small portion of loans, mainly related to public housing with municipal and government guarantees, had LTVs above 100% (DKK 6bn, including DKK 4bn covered by a public guarantee).

Strong capitalisation under pressure from rising regulatory requirements

Realkredit's prudential capital metrics are currently strong, underpinned by increasing interest rates reducing risk-weighted assets due to the lower market value of its loan book (Figure 6). However, we expect capital ratios to decline materially over the coming years due to regulatory changes of risk-weighting floors as a result of EBA guidelines and Basel IV. We also expect the capital buffer to continue to compare favourably to European peers.

Figure 6: Realkredit Danmark A/S solvency ratios



Source: SNL, Scope Ratings

At the end of H1 2022, the CET1 ratio was high at 29.7%, almost 14 pp above Realkredit's minimum capital requirement. The latter includes a systemic risk buffer of 3% and a Pillar 2 requirement of 2.5%. The countercyclical capital buffer was lowered to zero by Danish authorities in March 2020 in response to the Covid-19 crisis. In June 2021, the Danish Minister for Industry, Business and Financial Affairs reactivated the countercyclical capital buffer at 1.0%, effective from 30 September 2022 and subsequently announced in December 2021 that the countercyclical capital buffer will be further increased to 2.0% effective from 31 December 2022.

Realkredit's minimum leverage ratio requirement of 3% was implemented in the second quarter of 2021 with the adoption of CRR II. At end-2021, the group's leverage ratio stood at 5.1%, well above requirement.

Liquidity risk: new regulatory regime without significant changes

Minimum requirements for own funds and eligible liabilities: potential funding needs ahead

The Danish regulator requires Realkredit's buffer of liquid assets to constitute at least 2.5% of its total mortgage lending, which corresponds to DKK 18.6bn as at end-June 2022. Realkredit had unencumbered liquid assets of DKK 38.8bn after haircuts, which means an adequate buffer of DKK 20.2bn. However, given the anticipated increase in risk-weighted assets and the expected decline in the capital buffer, Realkredit may need additional bail-in-able loans from Danske bank, which we consider as manageable for the parent.

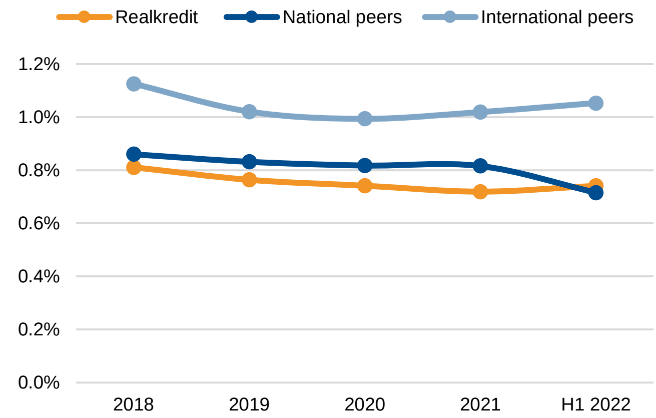
The new EU directive on covered bonds entered into force on 8 July 2022 and didn't significantly change Realkredit's total requirement for liquid assets. This includes a requirement for a cover pool liquidity buffer and stipulates eligible cover pool assets. It also introduced a new requirement on a minimum level of cover pool over-collateralisation.

Danish mortgage bank regulatory diamond: well within parameters

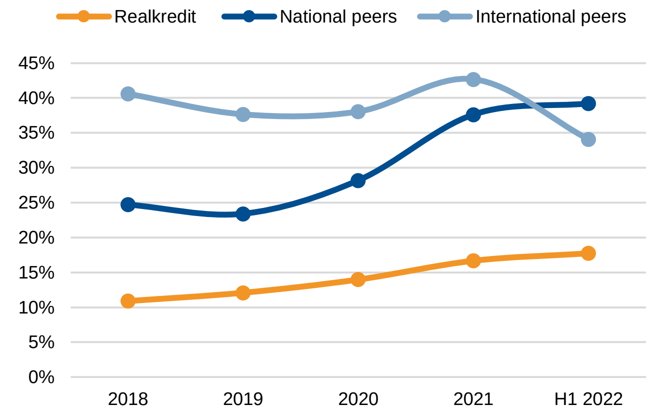
Realkredit and other Danish mortgage lenders are subject to a dedicated regulatory 'diamond' that sets five thresholds on: annual lending growth (max 15%) and certain product types such as interest only loans, short-term resets, re-mortgaging (maximum 25% per year) as well as large exposures in commercial real estate (top 20 exposures under 100% of CET1). Realkredit has been operating well within these limits in recent years.

Appendix: Peer comparison

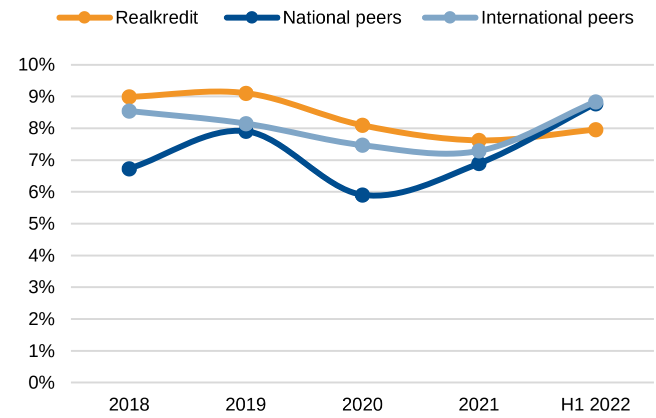
Net interest margin (%)



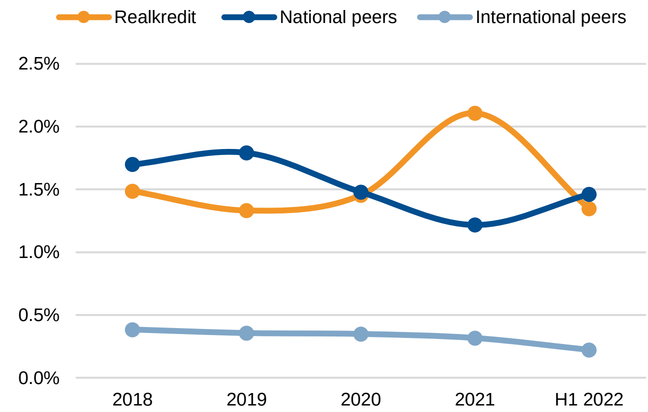
Cost/income ratio (%)



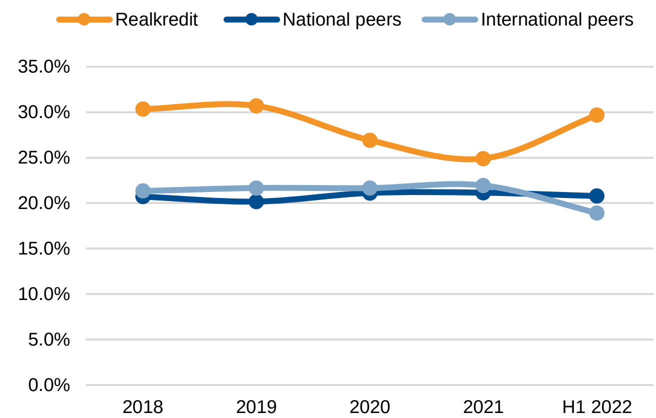
Return on average equity (%)



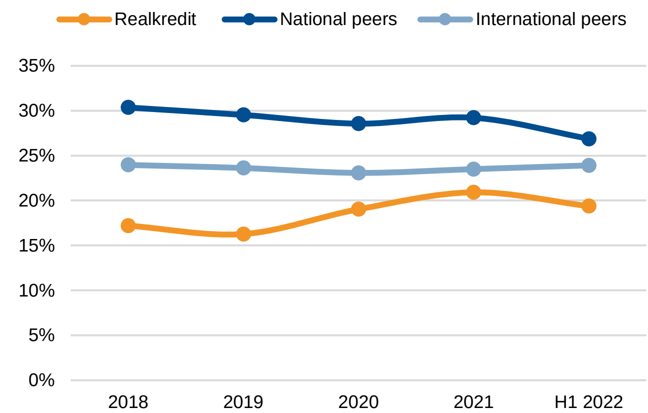
Problem loans/gross customer loans (%)



Common equity tier 1 ratio (%, transitional)



Asset risk intensity (RWA/ total assets, %)



*National peers: Nykredit Realkredit, Nordea Kredit Realkredit, Jyske Realkredit, DLR Kredit. International peers: Nordea Hypotek, DNB Boligkreditt, Swedbank Hypotek, Stadshypotek, Länsförsäkringar Hypotek, SpareBank 1 Boligkreditt, PKO Bank Hipoteczny, Bausparkasse Schwäbisch Hall, Achmea Bank, Münchener Hypothekenbank, Nationwide Building Society. Source: SNL

Appendix: Selected financial information – Realkredit Danmark A/S

	2018	2019	2020	2021	H1 2022
Balance sheet summary (DKK m)					
Assets					
Cash and interbank assets	21,446	53,826	25,045	18,643	5,515
Total securities	51,224	52,491	47,226	46,475	46,259
of which, derivatives	66	128	39	40	80
Net loans to customers	796,594	803,122	817,026	810,547	740,378
Other assets	1,953	3,109	1,971	1,334	1,411
Total assets	**871,217**	**912,548**	**891,268**	**876,999**	**793,563**
Liabilities					
Interbank liabilities	778	4,003	2,000	2,000	2,000
Senior debt	815,043	853,579	835,284	820,983	NA
Derivatives	68	5	17	16	70
Deposits from customers	0	0	0	0	0
Subordinated debt	0	0	0	0	0
Other liabilities	5,413	4,968	4,377	4,528	NA
Total liabilities	**821,302**	**862,555**	**841,678**	**827,527**	**745,810**
Ordinary equity	49,915	49,993	49,590	49,472	47,753
Equity hybrids	0	0	0	0	0
Minority interests	0	0	0	0	0
Total liabilities and equity	**871,217**	**912,548**	**891,268**	**876,999**	**793,563**
Core tier 1/ common equity tier 1 capital	*45,448*	*45,538*	*45,632*	*45,658*	*45,633*
Income statement summary (DKK m)					
Net interest income	7,008	6,905	6,496	6,285	3,088
Net fee & commission income	-617	-528	-21	-127	28
Net trading income	-67	219	-410	-327	-223
Other income	125	117	114	136	50
Operating income	**6,449**	**6,713**	**6,179**	**5,967**	**2,943**
Operating expenses	703	812	864	995	522
Pre-provision income	**5,746**	**5,901**	**5,315**	**4,972**	**2,421**
Credit and other financial impairments	196	265	335	269	-27
Other impairments	NA	NA	NA	NA	NA
Non-recurring income	0	0	0	0	0
Non-recurring expense	0	0	0	0	0
Pre-tax profit	**5,550**	**5,636**	**4,980**	**4,703**	**2,448**
Income from discontinued operations	0	0	0	0	0
Income tax expense	1,213	1,240	1,097	1,034	549
Other after-tax Items	0	0	0	0	0
Net profit attributable to minority interests	0	0	0	0	0
Net profit attributable to parent	**4,337**	**4,396**	**3,883**	**3,669**	**1,899**

Source: SNL

Appendix: Selected financial information – Realkredit Danmark A/S

	2018	2019	2020	2021	H1 2022
Funding and liquidity					
Net loans/ deposits (%)	NA	NA	NA	NA	NA
Liquidity coverage ratio (%)	NA	NA	NA	NA	NA
Net stable funding ratio (%)	NA	NA	NA	214%	NA
Asset mix, quality and growth					
Net loans/ assets (%)	91.4%	88.0%	91.7%	92.4%	93.3%
Problem loans/ gross customer loans (%)	1.5%	1.3%	1.5%	2.1%	1.3%
Loan loss reserves/ problem loans (%)	24.1%	26.1%	23.9%	17.3%	28.8%
Net loan growth (%)	0.9%	0.8%	1.7%	-0.8%	-17.3%
Problem loans/ tangible equity & reserves (%)	22.5%	20.3%	22.7%	32.7%	19.8%
Asset growth (%)	-0.6%	4.7%	-2.3%	-1.6%	-19.0%
Earnings and profitability					
Net interest margin (%)	0.8%	0.8%	0.7%	0.7%	0.7%
Net interest income/ average RWAs (%)	4.5%	4.5%	3.9%	3.7%	3.7%
Net interest income/ operating income (%)	108.7%	102.9%	105.1%	105.3%	104.9%
Net fees & commissions/ operating income (%)	-9.6%	-7.9%	-0.3%	-2.1%	1.0%
Cost/ income ratio (%)	10.9%	12.1%	14.0%	16.7%	17.7%
Operating expenses/ average RWAs (%)	0.4%	0.5%	0.5%	0.6%	0.6%
Pre-impairment operating profit/ average RWAs (%)	3.7%	3.9%	3.2%	2.9%	2.9%
Impairment on financial assets / pre-impairment income (%)	3.4%	4.5%	6.3%	5.4%	-1.1%
Loan loss provision/ average gross loans (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Pre-tax profit/ average RWAs (%)	3.5%	3.7%	3.0%	2.8%	2.9%
Return on average assets (%)	0.5%	0.5%	0.4%	0.4%	0.5%
Return on average RWAs (%)	2.8%	2.9%	2.4%	2.2%	2.3%
Return on average equity (%)	9.0%	9.1%	8.1%	7.6%	8.0%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	30.3%	30.7%	26.9%	24.9%	29.7%
Tier 1 capital ratio (%, transitional)	30.3%	30.7%	26.9%	24.9%	29.7%
Total capital ratio (%, transitional)	30.6%	31.1%	27.4%	25.3%	30.1%
Leverage ratio (%)	5.1%	4.9%	5.0%	5.1%	NA
Asset risk intensity (RWAs/ total assets, %)	17.2%	16.3%	19.0%	20.9%	19.4%
Market indicators					
Price/ book (x)	NA	NA	NA	NA	NA
Price/ tangible book (x)	NA	NA	NA	NA	NA
Dividend payout ratio (%)	NA	NA	NA	NA	NA

Source: SNL

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