Danske Hypotek AB (publ)

Full Rating Report

COVERED BOND RATING

AAA

ISSUER RATINGS

LONG-TERM RATING

A

OUTLOOK

Stable

SHORT-TERM RATING

N2

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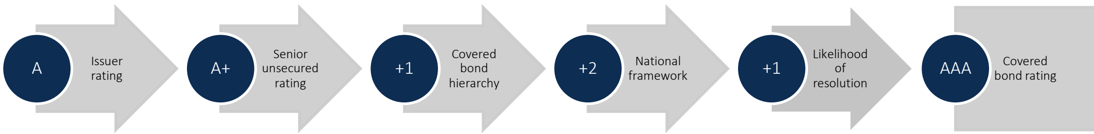
RATING RATIONALE

Our 'AAA' issue rating on covered bonds issued by Sweden-based mortgage company Danske Hypotek AB (publ) 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 our issuer rating on Danske Hypotek, we expect the covered bond ratings to remain stable. This reflects our view that Danske Hypotek and Danske Bank would maintain their status as systemically important financial institutions with a very high likelihood of resolution in the event of failure, which would exclude the bail-in of covered bonds.

RATING STRENGTHS:

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

Figure 2. Danske Hypotek cover pool characteristics, Q4 2020–Q4 2022

	Q4 2020	Q2 2021	Q4 2021	Q2 2022	Q4 2022
Eligible covered pool assets (SEKm)	113.8	115.8	121.3	129.1	129.5
Outstanding covered bonds (SEKm)	90.9	104.9	98.1	105.8	104.6
Legal overcollateralisation (%)	25.2	10.4	23.7	22.0	21.8
Weighted-average LTV (%)	58.0	56.0	54.0	53.0	59.0
Average loan seasoning (years)	4.2	4.3	4.7	4.7	4.9
Average bond maturity (years)	2.8	2.6	2.6	2.4	2.7
Average loan size (SEKm)	1.04	1.05	1.04	1.10	1.08
Owner-occupied share, residential (%)	96.4	96.0	97.0	97.0	96.0
Priority liens, residential (%)	98.6	99.0	99.0	99.0	99.0
>60 day past due loans (bps)	0.0	0.0	0.0	0.0	0.0
Share of commercial mortgages (%)	0.0	0.0	0.0	0.3	0.2

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

Figure 3. Residential loan balance by property region (SEKbn), 31 Dec. 2022

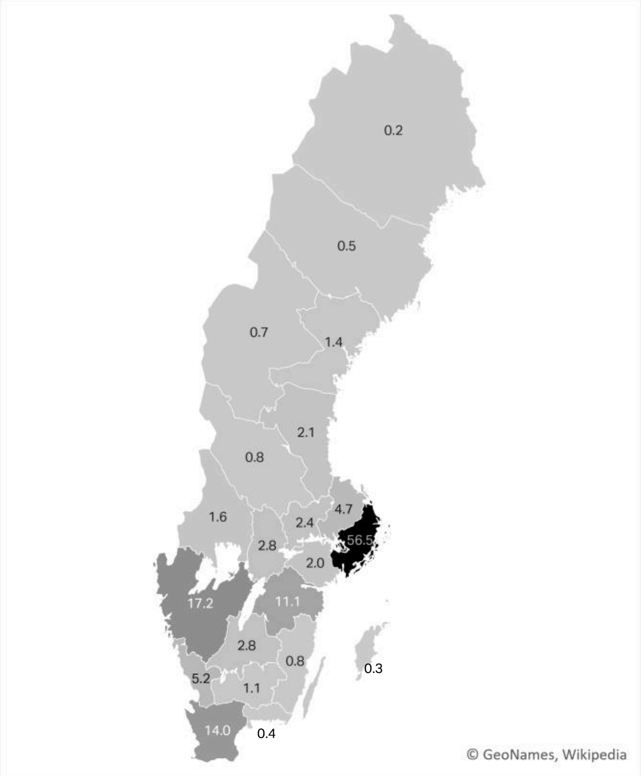


Figure 4. Weighted residential mortgage LTV by property region (%), 31 Dec. 2022

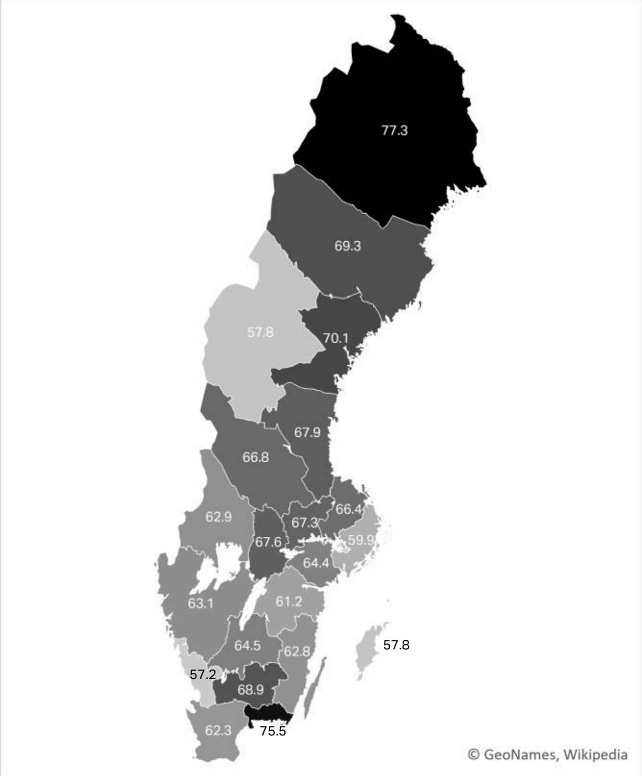


Figure 5. Commercial and multi-family mortgage loan balance by property region (SEKbn), 31 Dec. 2022

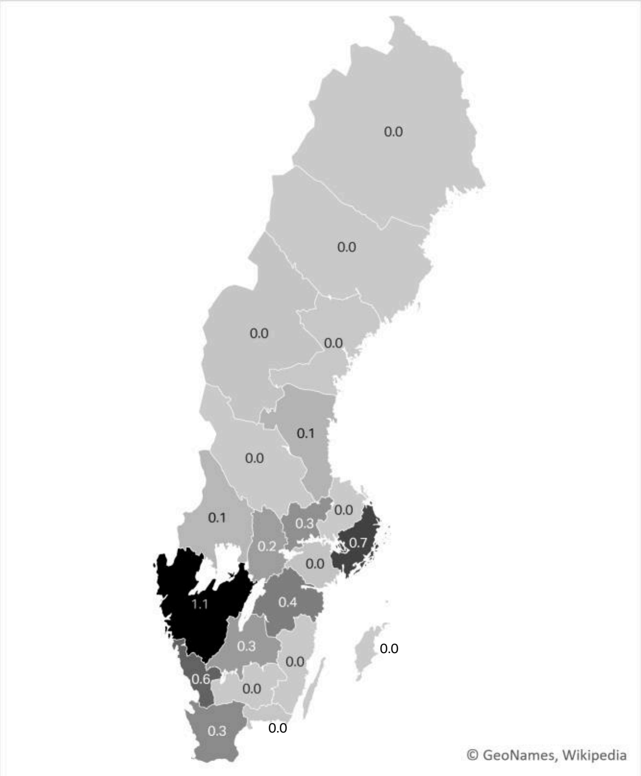
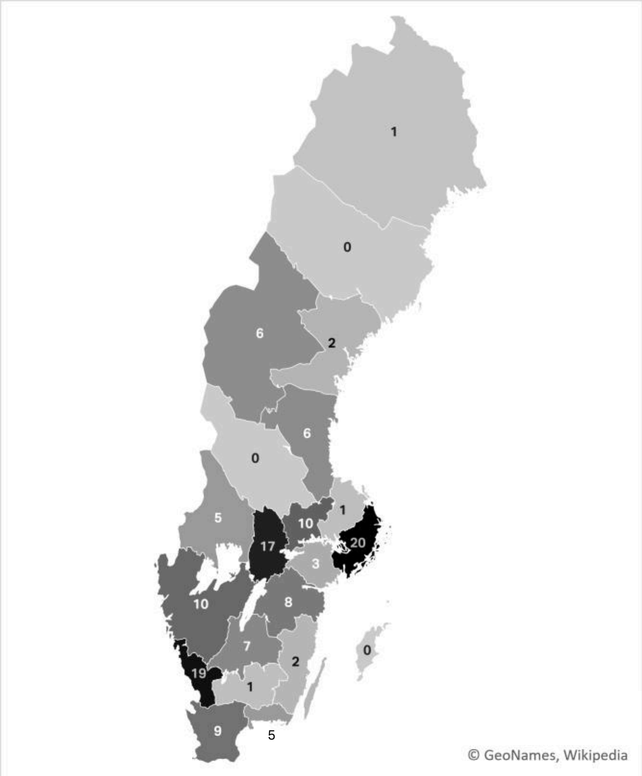


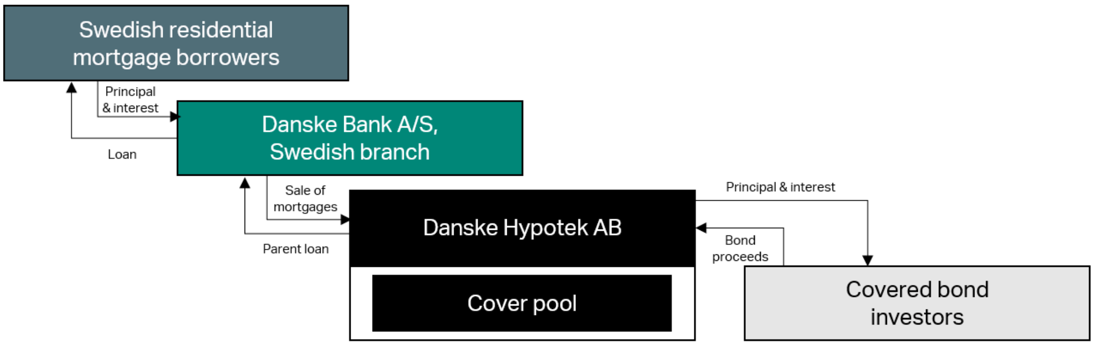
Figure 6. Average commercial and multi-family mortgage loan per property by region (SEKm), 31 Dec. 2022



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.

Senior unsecured issue rating one notch above issuer rating

As of year-end 2022, Danske Bank had DKK 77bn in senior non-preferred debt instruments with a maturity of over one year. These instruments represent 9.2% of the group's risk exposure amount (REA) and a significant portion of its minimum requirement for own funds and eligible liabilities (MREL) buffers (36.5%). 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 loans to Danske Hypotek are 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.

We consider senior unsecured bondholders as structurally subordinated to covered bond holders, given the preferential claim of the cover pool over a majority of the company's loan assets in the event of default. As a result, NCR adds an additional notch of uplift to Danske Hypotek's covered bond ratings compared with our issue rating on the company's senior unsecured debt, even if there are no instruments outstanding. This reflects the BRRD's explicit definition of covered bonds as having priority claim 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. The Swedish regulator uses independent oversight of the cover pool register to ensure that liabilities never exceed the value of pool assets.

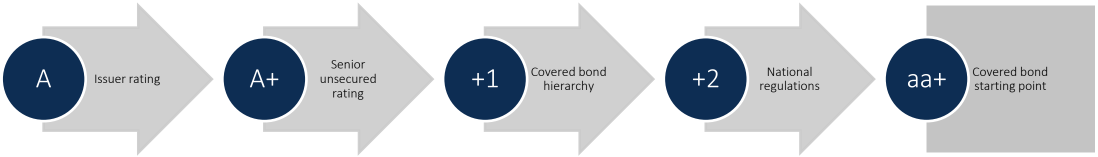
Following Sweden's adoption of the BRRD, the creditor hierarchy for Swedish banks is as follows:

- Secured or collateralised obligations, including covered bonds.
- Guaranteed deposits.
- Unguaranteed household and SME deposits.
- Senior preferred debt and wholesale and institutional deposits.
- Senior non-preferred debt.
- Subordinated debt.
- Tier 2 capital instruments.
- Additional Tier 1 instruments.
- Equity.

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 a further two notches to the rating on Danske Hypotek's covered bonds and resulting in a covered bond starting point of 'aa+'.

Figure 8. Danske Hypotek covered bond starting point



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 8 Jul. 2022 Sweden implemented its version of the EU's updated covered bond directive.

The revised 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;
- a liquidity buffer requirement covering 180 days of net outflows using extended maturity dates for extendable maturity (soft bullet) bonds;
- soft bullet bonds are only extended if approved by the Swedish regulator to avoid insolvency;
- acceptance of lower-rated derivative counterparties, where necessary, to avoid counterparty concentrations;
- separate bank accounts for pool-related transactions; and
- the national administrator's authority to borrow and issue derivatives, as well as sell assets, if necessary to maintain a balance between incoming and outgoing cash flows.

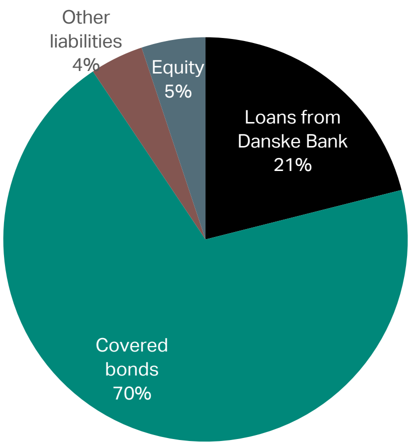
In addition, the law sets out the following conditions for cover pool assets:

- property exposures should be located in Sweden or other states of the European Economic Area;
- maximum loan to value (LTV) of 80% for residential mortgages and 60% for holiday properties included as eligible security;
- maximum LTV of 60% for commercial and agricultural mortgages included as eligible security, which can be increased to 70% if overcollateralisation in the cover pool exceeds 10% (agricultural mortgages are defined as either primarily residential or commercial);
- maximum of 5% single-name concentration in the cover pool;
- the amount of additional liquid security that can be pledged in the cover pool is 20%; and

- the nominal value of eligible pool assets must exceed bond liabilities by 5%, i.e. overcollateralisation of 5%.

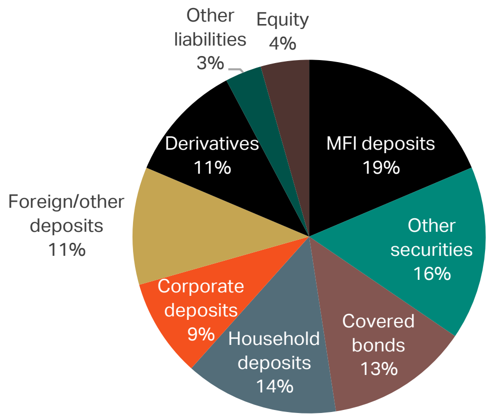
In addition to strong national regulations, covered bonds are a significant part of the Swedish financial fabric. They provide a material portion of Swedish bank financing with nearly SEK 2.5 trillion in outstanding covered bonds as of December 2022. This accounts for 13.1% of Sweden's monetary financial institution (MFI) liabilities and equity, making covered bonds one of the most important financing sources in the country's banking system. The share of covered bond financing fell from 15.5% at the end of 2021, driven by turbulent capital markets and an uncertain interest rate environment in 2022. During 2022, MFIs increased short-term commercial paper financing by 36% and derivative liabilities by 281% in response to rising interest rates. We expect covered bonds to remain around 15% of MFI financing over the long term.

Figure 9. Danske Hypotek liabilities, year-end 2022



Based on company data.

Figure 10. Swedish monetary financial institutions' liabilities and equity, Dec. 2022



Source: Sweden Financial Market Statistics, Dec 2022.

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, as well as the 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.

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'. We expect the qualitative assessment of Danske Hypotek's covered bonds to remain 'aaa', even if Danske Hypotek or Danske Bank were to be downgraded by up to four notches, all else being equal. If the issuer rating were to fall by 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-

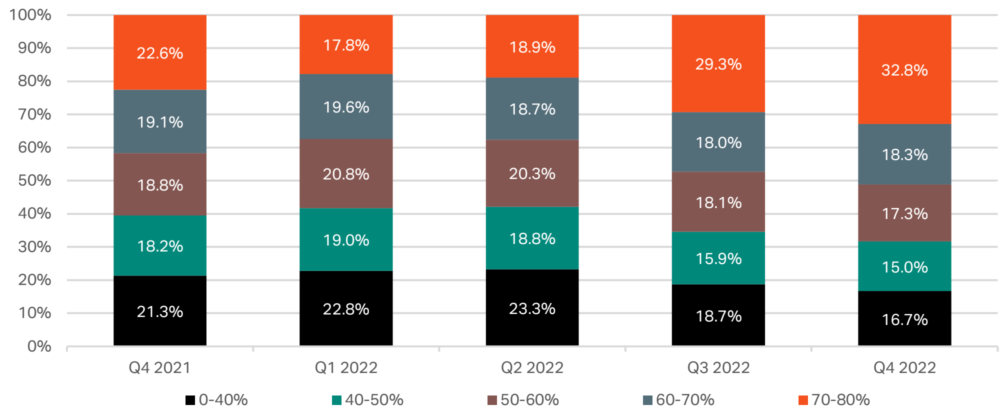
Source: NCR Covered Bond Rating Methodology.

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 'aaa' qualitative assessment, 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 as well as data from Danske Hypotek's European Covered Bond Council Harmonised Transparency Templates (ECBC HTT) to analyse pool assets and conduct sensitivity analysis and credit risk and cash flow stress testing on the cover pool according to 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.

Figure 12. Share of pool by borrower level LTV, last five quarters

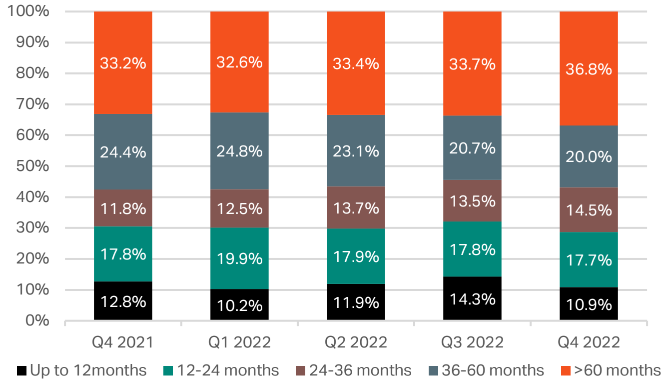


Source: company. Entire eligible loan amount in respective bucket based on borrowers' LTV.

LTV levels improved due to housing price increases

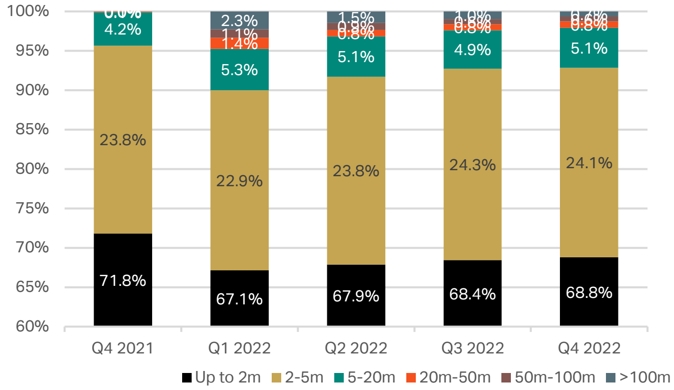
The following charts provide an overview of the characteristics of the cover pool assets. As of year-end 2022, the pool included SEK 121.0bn in eligible residential mortgage loans, i.e. loans qualifying for overcollateralisation, LTV and loan performance requirements. In addition, at year-end 2022 Danske 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 13. Share of pool by loan seasoning, last five quarters



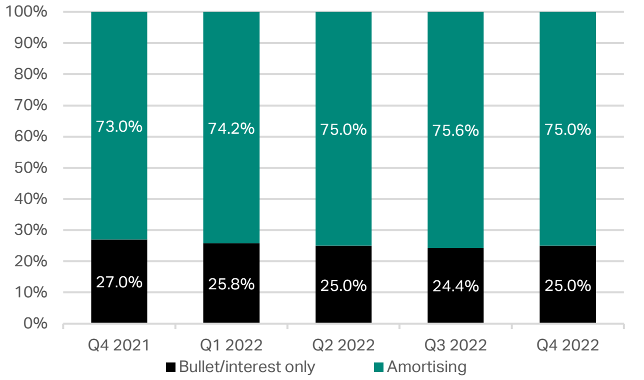
Source: company.

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



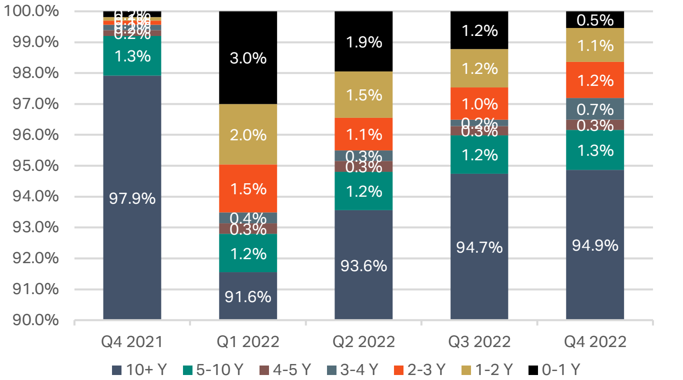
Source: company.

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



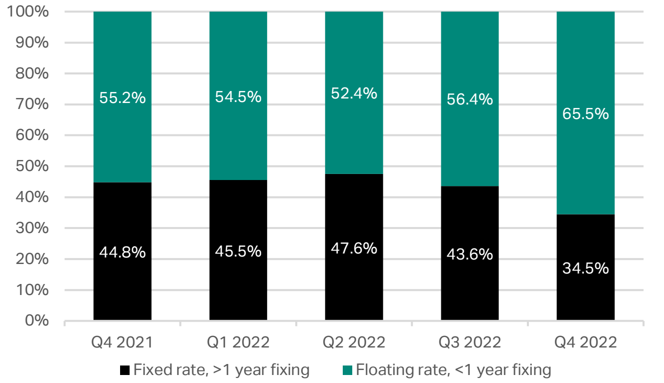
Source: ECBC HTT.

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



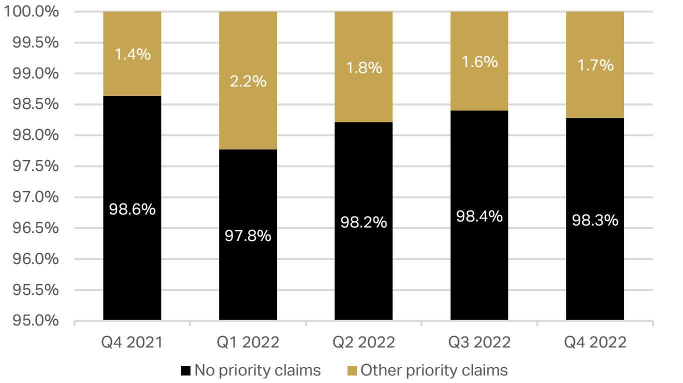
Source: company.

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



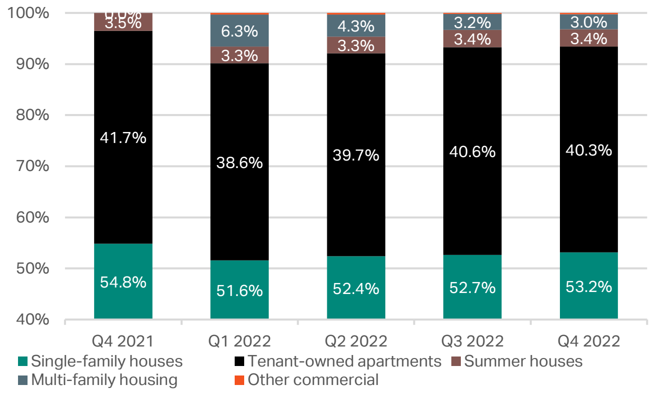
Source: company.

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



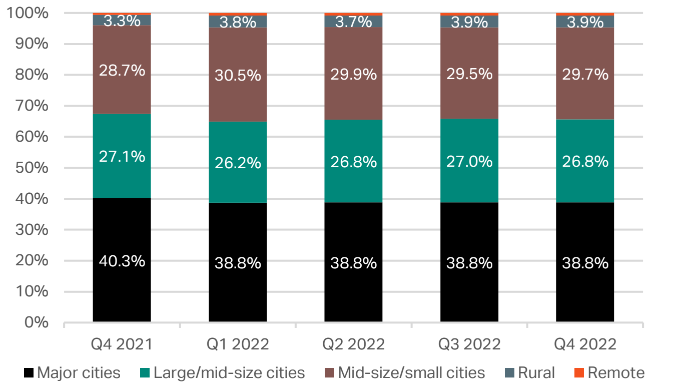
Source: company.

Figure 19. Property type, last five quarters



Source: company.

Figure 20. Region class, last five quarters



Based on company data, NCR region definitions.

Stress testing

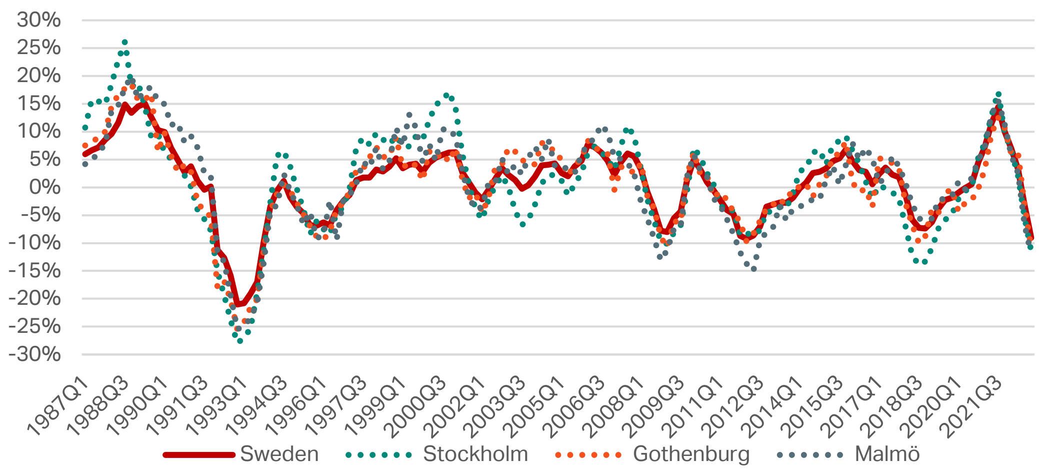
Our standalone stress testing of the cover pool assumes that all forms of external support for the pool are exhausted and that only the underlying assets can provide enough liquidity to make coupon and principal payments. This analysis begins with the assumption that the issuer and/or banking group is being liquidated and administrators have committed to winding down the pool and selling necessary assets at a discount to ensure investors receive timely payment. We conduct credit risk and cash flow stress testing on the cover pool assets using 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

Since 1987, average domestic housing prices have increased by 5.7% annually according to Statistics Sweden's one- and two-dwelling index. In our view, housing prices are likely to stabilise following the steep decline since their peak in the first half of 2022 (see Figure 21). We expect prices to continue to fall in the near term, given the likelihood of rising interest rates and the subsequent impact on affordability, before growing at rates closer to the long-term compound annual growth rate (CAGR).

Figure 21. Sweden 12-month housing price growth adjusted for CAGR, 1987–2022



Based on data from Statistics Sweden.

NCR's credit risk stress testing begins with standard assumptions (see Figure 22). Given the current market situation and the quick adjustment in property values, starting from Q4 2022, we base our cover pool stress scenarios on the assumption that Swedish housing prices are 5–15% below their long-term trend levels. Recent decreases in housing prices have increased the loan-to-value ratio in Danske Hypotek's portfolio, which we expect to continue into 2023. This results in a 15–35% fall in residential property prices in our stressed scenarios. In previous quarters the stressed scenarios assumed a 25–45% fall in residential property values, given higher property valuations.

In 2022, Danske Hypotek transferred about SEK 8bn in multi-family rental housing loans from Danske Bank to its own cover pool. We expect additional multi-family rental housing loans to be transferred by year-end 2023. 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. In terms of expected losses (see Figure 23), we assume that the one-year probability of default of these exposures is 1.8% ('BB' according to NCR's rating principles) and apply commercial property stress levels.

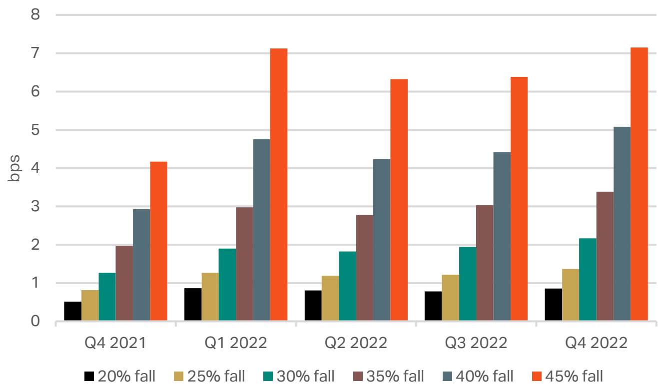
Figure 22. Standard asset quality assumptions used in credit risk stress testing, %

	Residential property, probability of default*	Residential property price fall	Commercial property probability of default* (3x)	Commercial property price fall (1.25x)
Level 1	4.0	15.0	12.0	18.8
Level 2	5.2	20.0	15.7	25.0
Level 3	6.9	25.0	20.6	31.3
Level 4	9.0	30.0	27.0	37.5
Level 5	11.8	35.0	35.4	43.8

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

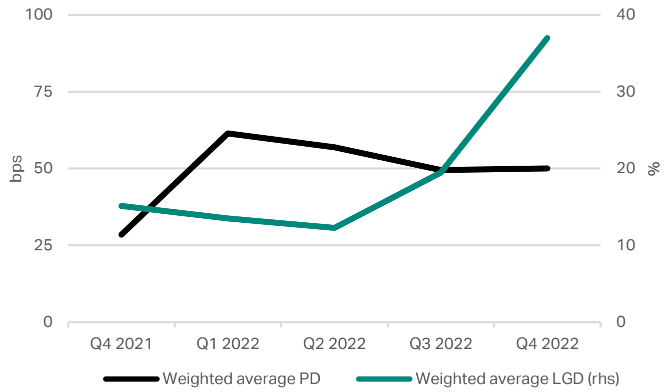
We also make adjustments to default assumptions to reflect foreclosure costs and the concentration of the portfolio, and to stressed property valuations based on the region class of the specific property. We have revised our concentration adjustment down to 4% (from 6% a year ago), reflecting a reduction in the relative geographic concentration of Danske Hypotek's loan assets compared with Swedish peers' cover pools. For more details of the stress assumptions, see *Appendix 1: Analysing the Cover Pool* in our *Covered Bond Rating Methodology*.

Figure 23. Expected loss as a share of cover pool loans, based on actual portfolio composition and NCR stress test, last five quarters



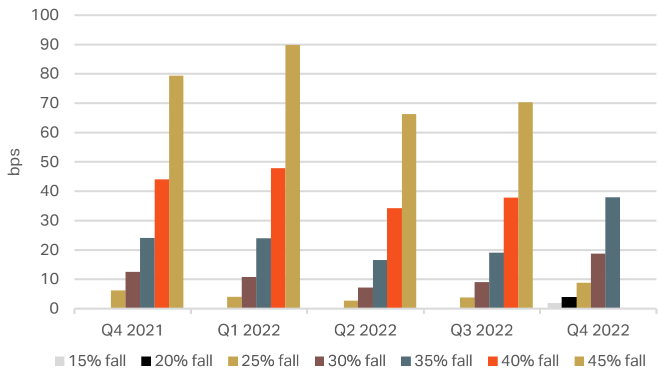
Based on NCR analysis of company data.

Figure 24. Weighted-average probability of default (PD) and loss given default (LGD) of cover pool, last five quarters



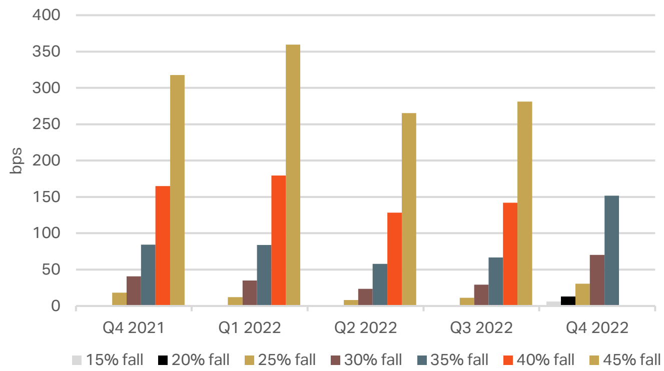
Based on NCR analysis of company data.

Figure 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. Stress levels from Q4 2022 reflect falling preces, as described above.

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



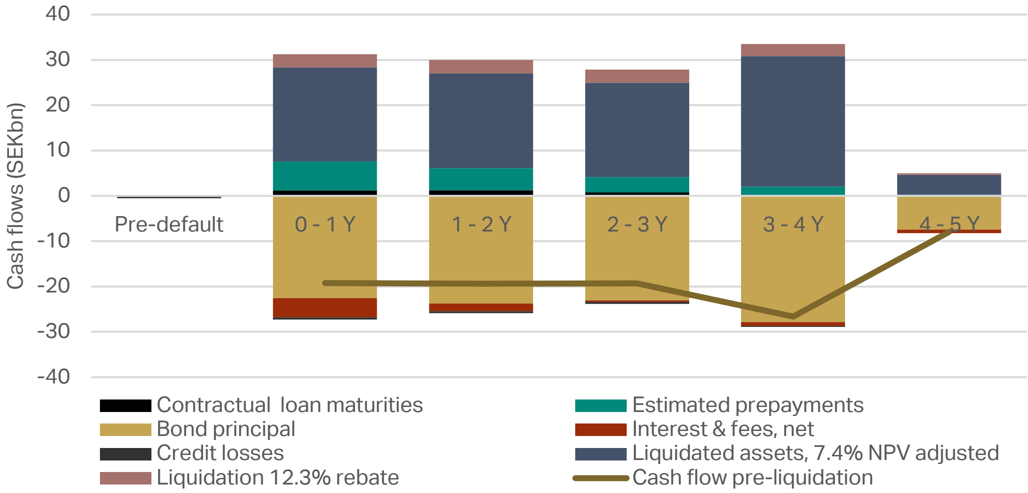
Based on NCR analysis of company data. Stress levels from Q4 2022 reflect falling preces, as described above.

Cash flow stress test shows shortage in year five of rundown

The stressed losses and non-performing loans are included in 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 27). 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 0.5% in the Level 5 scenario.

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 27. Stressed cash flows in NCR's level 5 scenario for Danske Hypotek as of 31 Dec. 2022



Source: NCR analysis of company data

ADDITIONAL FACTORS

Counterparty risk from intra-group 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 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 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.

Since July 2022, the Swedish covered bond act has allowed issuers 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. 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 28. Danske Hypotek key credit metrics, 2019–2025e

%	2019	2020	2021	2022	2023e	2024e	2025e
Net interest margin	1.4	1.2	1.1	0.9	1.0	1.1	1.0
Loan losses/net loans	0.00	-0.05	-0.03	0.00	0.02	0.01	0.00
Pre-provision income/REA	5.5	3.8	3.4	2.4	2.9	3.0	2.8
Return on ordinary equity	18.5	16.9	15.1	9.9	11.6	11.8	10.4
Loan growth	132.5	25.3	21.0	5.8	7.6	5.0	4.0
CET1 ratio	16.1	16.7	17.5	19.5	19.6	20.6	21.7
Tier 1 ratio	16.1	16.7	17.5	19.5	19.6	20.6	21.7

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 a resilient banking market, despite material changes in the operating environment for banks in the past year. Our view takes account of banks' stronger earnings due to higher interest rates and stable labour markets. However, we believe a moderate technical recession is likely in Sweden in 2023 and cost-of-living concerns are increasing. Residential property prices have fallen from recent highs, which has reduced the value of the collateral underlying Danske Hypotek's loan book. Despite the quick revision in monetary policy, we project modest credit losses in residential mortgage lending over the next few years.

Risk appetite assessment 'a'

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.

Danske Hypotek's capital position is strong; the company had a common equity Tier 1 (CET1) ratio of 19.5% at year-end 2022. We project that the ratio will remain stable in 2023, as it adds multi-family housing loans with 35% risk weights to the cover pool, but we expect capital generation to exceed growth in our forecast due to strong earnings, low market growth and a lack of dividend payments. The company's regulatory capital requirement was 13.1% as of year-end 2022 but excludes an additional 1% countercyclical buffer, which will take effect from June 2023. 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.

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 coverage and net stable funding ratios. All outstanding bonds are denominated in Swedish kronor, matching the assets.

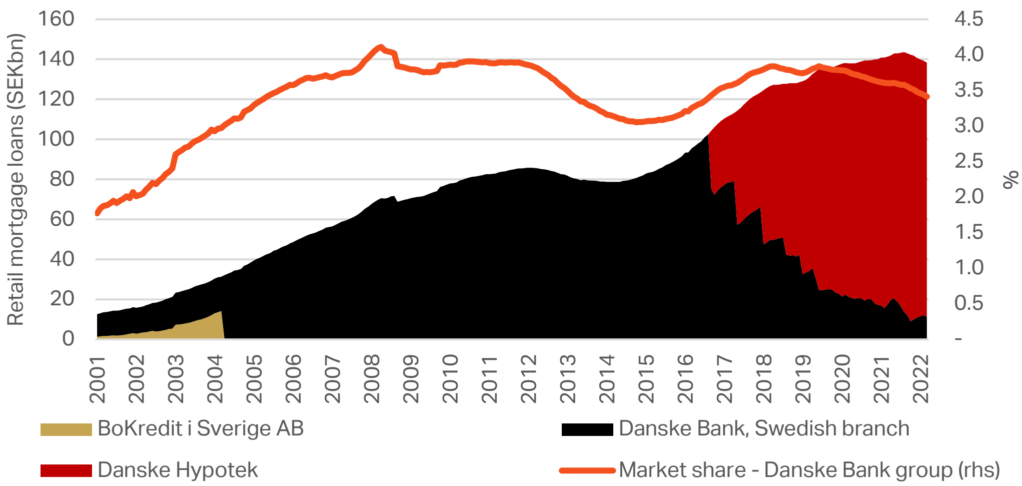
Danske Hypotek's credit risk profile is well reflected by the 25% regulatory risk weight floors used to calculate regulatory capital measures for residential mortgages. While there are some concentrations in the mortgage book, the respective loans are to borrowers based in Sweden's major cities and centres 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 addition of multi-family housing, and eventually cooperative housing loans, will lead to a marginal increase in credit risk and increase single-name concentrations, but we do not foresee significant credit losses from these exposures.

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 fallen steadily 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 over the next few years.

Figure 29. Danske Bank Swedish retail mortgage market share, Dec. 2001–Feb. 2023



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 strong cost efficiency and risk-adjusted earnings. In 2022, Danske Bank revised internal cost allocation, which we expect to lead to a permanent increase in cost level. While mortgage margins in Sweden are under pressure, the combination of regulatory capital floors for residential mortgages and a 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 year-end 2022, the bank had 44bps in net Stage 3 non-performing loans, down from 72bps at the end of 2021, which resulted from borrowers' use of a pandemic-driven relaxation of amortisation payments on mortgage loans. Due to higher interest rates and rising living costs, we see the potential for Danske Hypotek to offer forbearance to struggling customers and anticipate that Stage 3 loans will be elevated in 2023 and 2024. We do not expect this to result in material credit provisions, however, given the company's ability to transfer loans to Danske Bank.

Neutral aggregate ESG impact

Environmental, social and governance (ESG) factors are considered throughout our analysis where material to the credit assessment. On aggregate, we view Danske Hypotek's ESG profile as having a neutral impact on its creditworthiness.

Danske Hypotek's 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 the end of 2023. Danske Hypotek's role in the group's ESG strategy has not yet been precisely defined and is conducted in Sweden by the group's Swedish branch.

Figure 30. Danske Hypotek priority ESG factors

Issue/area	Risk/opportunity	Impacted subsections (impact on credit assessment*)
Control of sustainability issues	Proactive and rigorous measures mitigate regulatory and reputational risks and lend credibility to sustainability profile.	Risk governance (+) Credit risk (0)
Sustainable/green bond framework	Aim to become a green bond issuer now that it has established itself as a benchmark covered bond issuer.	Competitive position (0)
Physical climate risk to collateral	Climate-related damage to real-estate collateral (closely linked to supervision of insurance). Longer-term term effects on market values in flood risk areas.	Credit risk (-) Loss performance (0)

*Defined according to a 5-step scale ranging from double minus (--) to double plus (++), with (--) representing the most negative impact and (++) the most positive. See **ESG factors in financial institution ratings**.

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 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.

METHODOLOGIES USED

(i) Financial Institutions Rating Methodology, 18 Feb. 2022.
(ii) Covered Bond Rating Methodology, 6 Jul. 2022.
(iii) Rating Principles, 24 May 2022.
(iv) Group and Government Support Rating Methodology, 18 Feb. 2022.

RELEVANT RESEARCH

(i) The Swedish mortgage market (Q4, 2022), 31 Jan. 2023.

Figure 31. Danske Hypotek key financial data, 2018–2022

Key credit metrics (%)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
INCOME COMPOSITION					
Net interest income to op. revenue	105.8	103.1	106.4	104.8	108.1
Net fee income to op. revenue	-3.7	-1.9	-2.1	-1.8	-2.3
Net trading income to op. revenue	-2.1	-1.2	-4.4	-6.0	-6.3
Net other income to op. revenue	0.0		0.0	3.0	0.4
EARNINGS					
Net interest income to financial assets	1.4	1.2	1.1	1.0	0.9
Net interest income to net loans	1.5	1.2	1.1	1.1	0.9
Pre-provision income to REA	5.5	3.8	3.4	3.3	2.4
Core pre-provision income to REA (NII & NF&C)	5.6	3.8	3.5	3.4	2.5
Return on ordinary equity		16.9	15.1	14.3	9.9
Return on assets	1.0	0.8	0.7	0.7	0.5
Cost-to-income ratio	7.8	9.9	12.0	10.1	22.6
Core cost-to-income ratio (NII & NF&C)	7.6	9.8	11.5	9.8	21.3
CAPITAL					
CET1 ratio	16.1	16.7	17.5	18.3	19.5
Tier 1 ratio	16.1	16.7	17.5	18.3	19.5
Capital ratio	16.2	16.7	17.5	18.3	19.5
REA to assets	27.1	26.3	25.6	27.1	26.2
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	7.4
Loan growth	132.5	25.3	21.0	6.0	5.8
Deposit growth					
LOSS PERFORMANCE					
Credit provisions to net loans	0.00	-0.05	-0.03	0.01	0.00
Stage 3 coverage ratio	5.93	9.70	2.55	4.26	7.83
Stage 3 loans to gross loans	0.09	0.07	0.23	0.72	0.48
Net stage 3 loans to net loans	0.09	0.06	0.22	0.69	0.44
Net stage 3 loans/ordinary equity	1.67	1.19	4.55	13.15	8.02
FUNDING & LIQUIDITY					
Loan to deposit ratio					
Liquid assets to deposit ratio					
Net stable funding ratio	0.0	0.0	124.0	121.0	120.0
Liquidity coverage ratio	2929.0	1822.0	1192.0	628.0	3085.0

Key financials (SEKm)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
BALANCE SHEET					
Total assets	80,803	101,348	123,647	131,229	140,958
Total tangible assets	80,803	101,348	123,647	131,229	140,958
Total financial assets	80,758	101,060	123,628	131,209	137,102
Net loans and advances to customers	77,429	97,023	117,365	124,444	131,635
Total securities	2,465	3,379	4,800	4,657	4,544
Customer deposits	–	–	–	–	–
Issued securities	48,264	74,221	92,232	97,309	98,020
of which other senior debt	48,264	74,221	92,232	97,309	98,020
of which subordinated debt	–	–	–	–	–
Total equity	4,107	4,866	5,661	6,536	7,214
of which ordinary equity	4,107	4,866	5,661	6,536	7,214
CAPITAL					
Common equity tier 1	3,535	4,454	5,543	6,520	7,185
Tier 1	3,535	4,454	5,543	6,520	7,185
Total capital	3,554	4,454	5,543	6,520	7,185
REA	21,929	26,682	31,641	35,608	36,925
INCOME STATEMENT					
Operating revenues	780	1,018	1,119	1,242	1,106
Pre-provision operating profit	719	918	984	1,116	856
Impairments	2	-48	-27	15	2
Net Income	561	759	795	875	678

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

Figure 32. 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		**N2**

Figure 33. Capital structure ratings

Seniority	Rating
Covered bond	AAA
Senior unsecured	A+

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