Credit Rating Announcement

19 August 2020

Scope affirms at AAA/Stable the covered bonds issued out of Realkredit's capital centres S and T

The issuer rating of A+ combined with fundamental credit support results in the highest achievable ratings for the mortgage covered bonds. The cover pool provides additional rating stability.

Rating action

Scope Ratings has today affirmed ratings assigned to the Danish mortgage covered bonds (særligt dækkede realobligationer – SDRO) issued by Realkredit Danmark A/S (RD) out of capital centre S and capital centre T. All ratings have a Stable Outlook. The ratings reflect RD's issuer rating of A+ enhanced by fundamental credit support of up to six notches.

Additional information and research on the issuer and its covered bonds is available on scoperatings.com.

Rating rationale

Key rating drivers and rating-change drivers are summarised as follows:

Solid issuer rating (positive). RD has a solid issuer rating of A+[1]. It is a core and closely-integrated subsidiary of Danske Bank A/S, with a solid market position. As the second largest mortgage lender in Denmark, it demonstrates reassuring profitability and prudential capital metrics.

Fundamental credit support[2] (positive). Fundamental credit support is the primary rating driver for both capital centres. It provides RDs covered bonds with six notches of uplift above the issuer rating. As only four notches are needed to raise the covered bonds ratings to the highest achievable level, fundamental support already provides a buffer against issuer downgrades.

Cover pool support (positive)[3,4]. The capital centre-specific cover pool analyses show that both cover pools could provide additional rating stability of up to three notches reflecting:

1. **Over-collateralisation (positive).** The 7.5% of over-collateralisation as of 30 June 2020 for capital centre S and 6.5% for capital centre T can shield the current AAA ratings against a potential issuer downgrade of up to five notches.

2. **Sound credit quality (positive).** The cover pools comprise a mix of residential and commercial assets, predominantly secured by Danish mortgages. The cover assets benefit from a low average loan-to-value (LTV) of about 59.5% for capital centre S and 57.1% for capital centre T.

3. **Market risks (positive).** Aided by the Danish balance principle, market risk (in particular asset-liability mismatches) are almost fully eliminated.

Rating-change drivers

Covered bond ratings could be downgraded upon a deterioration in: i) the issuer rating by six notches or more assuming unchanged credit quality of the cover pool; and/or ii) Scope's view on fundamental support factors relevant to the issuer and Danish mortgage covered bonds in general.

Transaction overview

As of 30 June 2020, the DKK 298.3bn (up from DKK 274.7bn since our last review as of 31 March 2019) of cover assets under capital centre S provided 7.5% of over-collateralisation for DKK 277.6bn of covered bonds. For capital centre T, DKK 468.0bn (down from DKK 490.3bn) of cover assets provided 6.5% of over-collateralisation for DKK 439.3bn of covered bonds.

Both capital centres exhibit sound credit quality. They are highly granular, with 166,829 mortgage loans (down from 168,039) in capital centre S and 232,428 (down from 252,343) for capital centre T. The top 10 borrowers only account for 1.0% (down from 1.1%) in capital centre S and 1.7% (up from 1.6%) in capital centre T. Driven by size and granularity, the pools' other credit characteristics remain broadly stable, with only minor changes since our analysis of one year ago. Variations predominantly visible for capital centre T. For capital centre T, the weighted average loan-to-value (LTV) dropped by 3.7 percentage points to 57.1%, while it remained relatively stable at 59.5% (from 60.3%) for capital centre S.

The main difference between the two capital centres is the fixing of interest rates: 98.7% (from 97.7%) of mortgage loans in capital centre S are fixed for life. By contrast, all loans in capital centre T are floating-rate and reset loans, with most reset periods below five years. Also, the share of commercial loans in capital centre S is lower than in capital centre T. Mortgage loans with a residential purpose (including private rental residential, co-operative housing and subsidised housing) account for 89% (up from 88%) in capital centre S and 74% (up from 72%) in capital centre T.

Over-collateralisation is mainly needed to mitigate credit risks. Market risks are very contained and mainly result from the substitute assets held as minimum regulatory and voluntary over-collateralisation.

Only 0.2%of covered bonds in capital centre S and 1.0% in capital centre T are hard-bullet covered bonds. Potential asset-liability mismatches from the remaining hard-bullet bonds do not constitute a risk driver for either programme.

Further research on the issuer and a performance update on the bank's covered bonds is available on www.scoperatings.com or ScopeOne.

Quantitative analysis and assumptions

Scope tested the programmes' rating stability upon an issuer downgrade by performing an asset analysis using the assumptions detailed below.

The cash flow analysis projected cover-pool defaults assuming a normal inverse distribution. The agency derived an effective, weighted-average lifetime mean default rate of 3.9% for capital centre S (applying a cure rate of 50%), and 3.2% for T (cure rate of 50%), and a weighted-average coefficient of variation of 50% and 75%, respectively. Assumptions on the coefficient of variation for capital centre T incorporate a potential increase in borrower defaults if margins increased by up to 500bp – in case a covered bond's refinancing fails. These assumptions were based on credit performance data provided by the bank, in particular vintage and loss data, as well as benchmarking.

Scope also assumed asset-recovery rates ranging between 92.1% in the base and 74.7% in the stressed scenario for capital centre S, and between 64.7% and 77.1%, respectively, for capital centre T. Scope established total security-value haircuts for the properties securing the mortgage loans of 22.5%-65% in the base scenario and 42.5%-80% in the stressed scenario, with the level depending on the location and type of property.

The agency's credit risk analysis of substitute assets accounted for 7.0% of the cover pool of capital centre S and 6.1% of capital centre T's, using a portfolio-analysis framework. The portfolio's default and loss distribution did not materially contribute to the credit risk of the mortgage portfolios due to its strong credit quality.

Scope used the resulting loss distribution and default timing to project the covered bond programmes' losses and reflect their amortisation structures. The analysis also incorporated the impact of rating-distance-dependent interest-rate and FX stresses. Danish balance principle covered bond programmes are not very sensitive to changes of market-risk parameters. We have used a 'lower for longer' scenario, in which interest rates drop to minimum negative 1% after two years and remain at that rate until the last bond has been repaid. In combination with high prepayment scenarios, the programmes were most sensitive to an appreciation of EUR, NOK and SEK against the base currency – Danish Kroner – by up to 26% in the most stressful scenario.

Scope tested for low and high prepayments to stress the programmes' sensitivity to unscheduled repayments. Both programmes are most sensitive to high prepayments as these reduce the available excess spread over the life of the transaction.

Recovery lag assumptions were 18 months for residential loans and 30 months for commercial loans and substitute assets. A weighted annual average servicing fee of 27bp was assumed for capital centre S and 32bp for capital centre T.

To calculate the cover pools' net present value in the event of an asset sale (on the remaining grandfathered bullet bonds or an interest shortfall), a refinancing premium of 150bp for residential mortgage loans and 300bp for commercial mortgage loans was added to the rating-distance and scenario-dependent discount curve.

Rating driver references

1. Realkredit Danmark A/S – public issuer rating
2. Public information on Danish mortgage covered bonds' (særligt dækkede realobligationer – SDRO) framework
3. Public quarterly cover pool reporting
4. Confidential cover pool reporting

Stress testing

No stress testing was performed.

Cash flow analysis

Fundamental credit support is the primary rating driver for both capital centres. Hence, a cash flow analysis was not performed to support the ratings. However, Scope performed a cash flow analysis using Scope's covered bond model (CobEL version 1.0) to test for the programmes' stability in the event of an issuer downgrade. The model applies rating distance-dependent stresses to scheduled cash flows to simulate the impact of increasing credit and market risks. The model outcome is the expected loss for a given level of overcollateralisation as well as the impact of stressed asset sales or variables such as changing prepayment speeds or servicing costs.

Methodology

The methodology used for this rating and rating outlook (Covered Bond Rating Methodology, 22 July 2020) is available on https://www.scoperatings.com/#!methodology/list.
The model used for this rating and rating outlook (Covered Bonds Expected Loss Model version 1.0) is available in Scope's list of models, published under: https://www.scoperatings.com/#!methodology/list.
Information on the meaning of each rating category, including definitions of default and recoveries can be viewed in the "Rating Definitions - Credit Ratings and Ancillary Services" published on https://www.scoperatings.com/#!governance-and-policies/rating-scale. Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definitions of default and rating notations can be found at https://www.scoperatings.com/#governance-and-policies/rating-scale. Guidance and information on how Environmental, Social or Governance factors (ESG factor) are incorporated into the rating can be found in the respective sections of the methodologies or guidance documents provided on https://www.scoperatings.com/#!methodology/list.
The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rated entity and/or its agents participated in the rating process.
The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources.
Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the rating or outlook action, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended* before being issued.

* The sentence was amended on 19 August 2020. The text in the initial publication displayed "was amended".

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0.
Lead analyst: Mathias Pleißner, Director
Person responsible for approval of the rating: Karlo Fuchs, Managing Director
The ratings/outlooks were first released by Scope on 29 August 2018. The ratings/outlooks were last updated on 27 August 2019.

Potential conflicts

Please see www.scoperatings.com for a list of potential conflicts of interest related to the issuance of credit ratings.

Conditions of use / exclusion of liability

© 2020 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Analysis GmbH, Scope Investor Services GmbH and Scope Risk Solutions GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5 D-10785 Berlin.

Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Guillaume Jolivet.

About Scope Ratings GmbH

Scope Ratings GmbH is part of the Scope Group with headquarters in Berlin and offices in Frankfurt, London, Madrid, Milan, Oslo and Paris. As the leading European credit rating agency, the company specialises in the analysis and ratings of financial institutions, corporates, structured finance, project finance and public finance. Scope Ratings offers a credit risk analysis that is opinion-driven, forward-looking and non-mechanistic, an approach which adds to a greater diversity of opinions for institutional investors. Scope Ratings is a credit rating agency registered in accordance with the EU rating regulation and operating in the European Union with ECAI status.

Contact

Analyst	Mathias Pleissner	m.pleissner@scoperatings.com
Team leader	Karlo Fuchs	k.fuchs@scoperatings.com

Scope Ratings GmbH • Lennéstraße 5 • D-10785 Berlin • Phone: +49 30 27891-0 • Fax: +49 30 27891-0
www.scoperatings.com

Executive Board: Guillaume Jolivet • District Court: Berlin: HRB 192993 B • VAT identification number: DE226486027

Save paper! Please consider the environment before printing this email.This email may contain confidential and/or privileged information. If you are not the intended recipient (or have received this email by mistake) please notify the sender immediately and destroy this email. Any unauthorised copying, disclosure or distribution of the material in this email is strictly forbidden.

Subscription Center **Contact** **Legal Notice**