



Nykredit

Credit ratings of covered bonds – An issuer's perspective

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Nykredit's long term ratings

<u>STANDARD &POOR'S</u>	FitchRatings	MOODY'S	
AAA	AAA	Aaa	Investment grade
AA+	AA+	Aa1	
AA	AA	Aa2	
AA-	AA-	Aa3	
A+ (stable)	A+	A1	
A	A (stable)	A2	
A-	A-	A3	
BBB+	BBB+	Baa1	
BBB	BBB	Baa2 (negative)	
BBB-	BBB-	Baa3	
BB+	BB+	Ba1	Non-investment grade
BB	BB	Ba2	
BB-	BB-	Ba3	
...	
D	D	C	

Agenda

- **Introduction to Nykredit**
- A crash course in mortgage lending
- What is a rating?
- Rating of covered bonds
- Nykredit's rating considerations



Nykredit – the largest lender in Denmark

- Established as a mutual mortgage bank in 1851
- Today a full-service financial institution
- 30% of all domestic lending is provided by Nykredit
- Europe’s largest issuer of mortgage covered bonds
- 7th best capitalised bank in Europe (EBA stress test)
- Expected national SIFI

Strategy statements

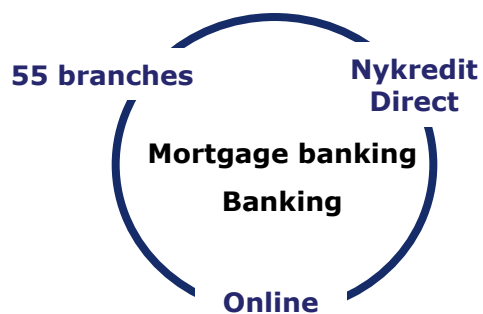
- Denmark is the primary geographical focus
- Increase business volume through organic growth
- Continue developing mortgage lending and banking
- Continue cultivating cross-selling opportunities
- The Totalkredit partnership is strategically important

Facts	2012 Q3
Customers	1.1mn
Staff	4,088
Equity	EUR 7.7bn
Total assets	EUR 193bn
Tier 1 capital	18.6%
Capital adequacy requirement	9.6%
Senior rating (S&P / Fitch)	A+ / A

Strategic market position in mortgage lending

Nykredit

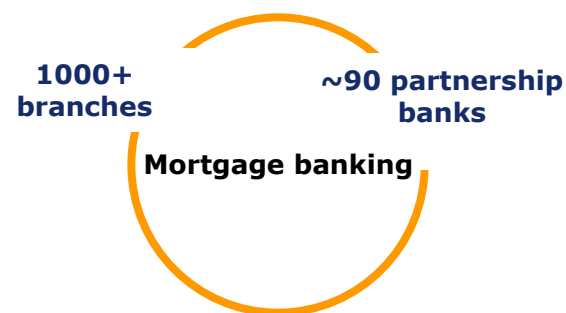
Banking and non-retail mortgage business



Mortgage loan portfolio
EUR 82.9bn

totalcredit

Retail mortgage business



Mortgage loan portfolio
EUR 68.8bn

- Strategic alliance with most Danish local and regional banks
- Nykredit and partner banks originates retail mortgage loans through Totalcredit
- Partner banks maintain credit risk on all loan amounts above 60% LTV

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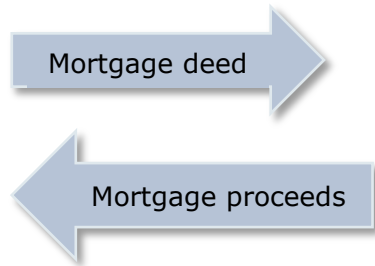


The basics of the system

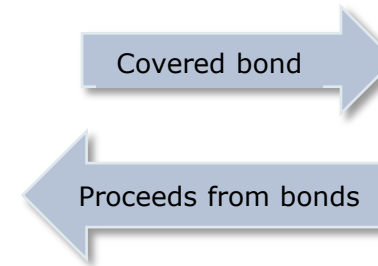
Mortgage origination



Borrower

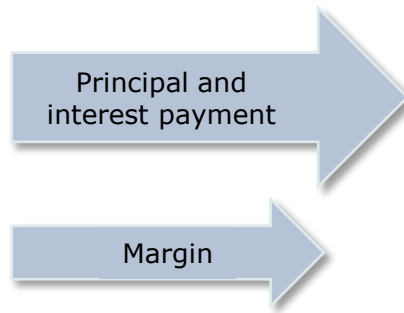


Mortgage bank



Investor

Payments



Mortgage bank



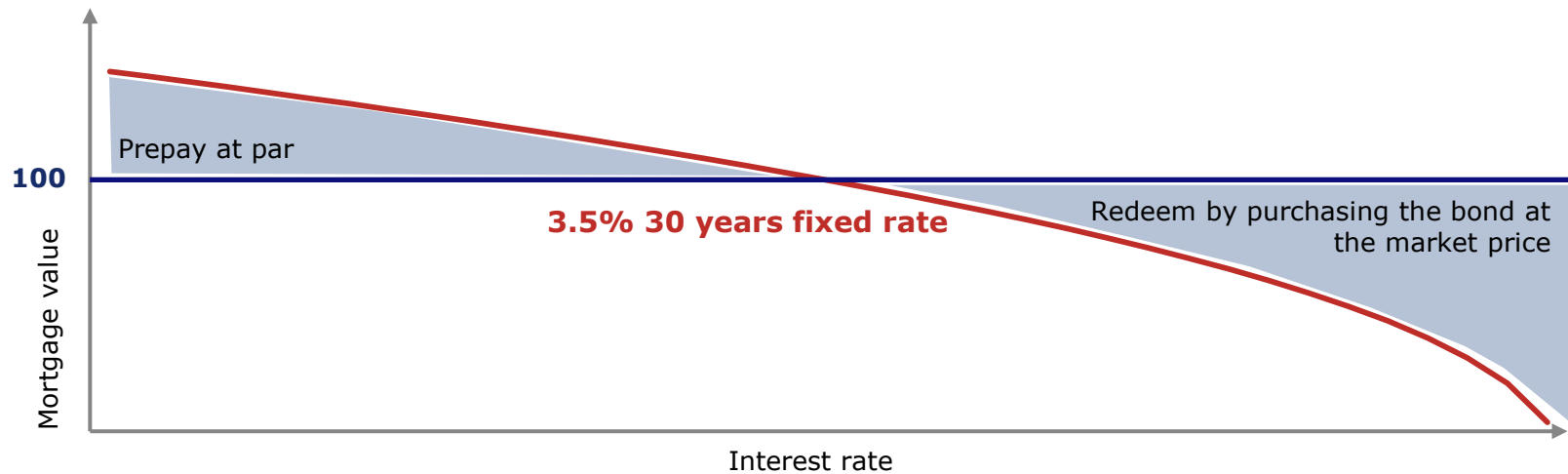
Investor

Loan types and bond types standardised accross issuers

Fixed Rate Mortgages	Adjustable Rate Mortgages	Floating Rate Mortgages
Fixed rate callable annuity loans with or without interest-only periods	Adjustable-rate annuity loans with or without interest only periods	Capped or uncapped floating rate mortgage loans with or without interest only periods
<ul style="list-style-type: none"> ▪ Funded by fixed rate callable bonds ▪ DKK-denominated ▪ Maturities: 10, 15, 20 and 30 years ▪ With or without interest-only options (max 10 years) ▪ Bonds tapped daily depending on the lending activity ▪ Bonds open for issuance for 3 years to build up volume 	<ul style="list-style-type: none"> ▪ Funded by fixed rate non-callable bullet bonds ▪ DKK- or EUR-denominated ▪ Customer’s interest lock in period equals bond maturity ▪ Daily tap issuance combined with auctions in March, September and December ▪ Bonds open for issuance until maturity 	<ul style="list-style-type: none"> ▪ Funded by capped or uncapped floating rate bonds respectively ▪ Maturities: 5, 10, 20 and 30 years ▪ With or without interest-only options (max 10 years) ▪ Coupon based on CIBOR or EURIBOR ▪ Daily tap issuance combined with auctions in March, June September and December

Principle of Balance Mortgages

- Danish mortgage loans can always be redeemed by purchasing the corresponding bond at the market price and many can be called at par.
- Since the value of homes and the associated mortgage bonds tend to move in the same direction, Principle of Balance prevents homeowners from having negative equity in their homes.

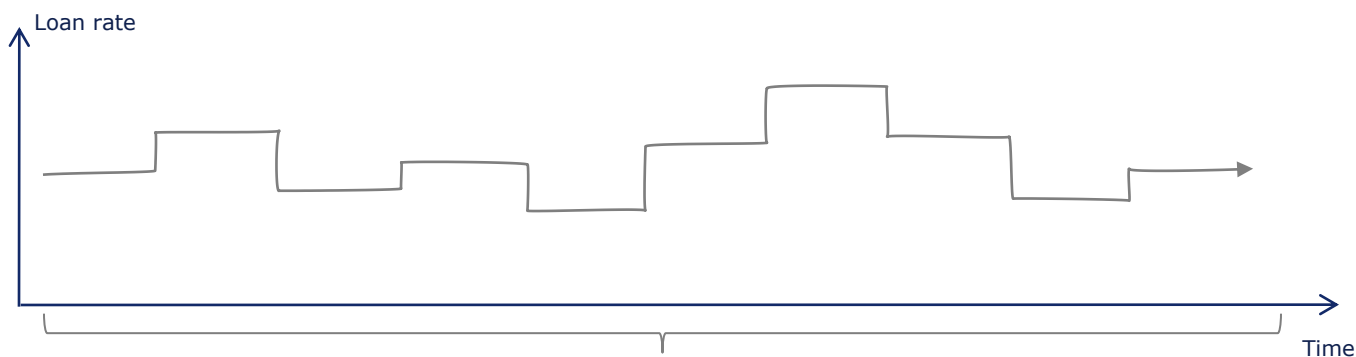


Refinancing of Adjustable Rate Loans

- Loan term typically 20 or 30 years
- The customer's interest fixing period is equal to the maturity of the bond issued to fund the loan
- At interest reset the loan rate is adjusted to the yield-to-maturity of the bonds sold for the purpose of refinancing plus a margin.

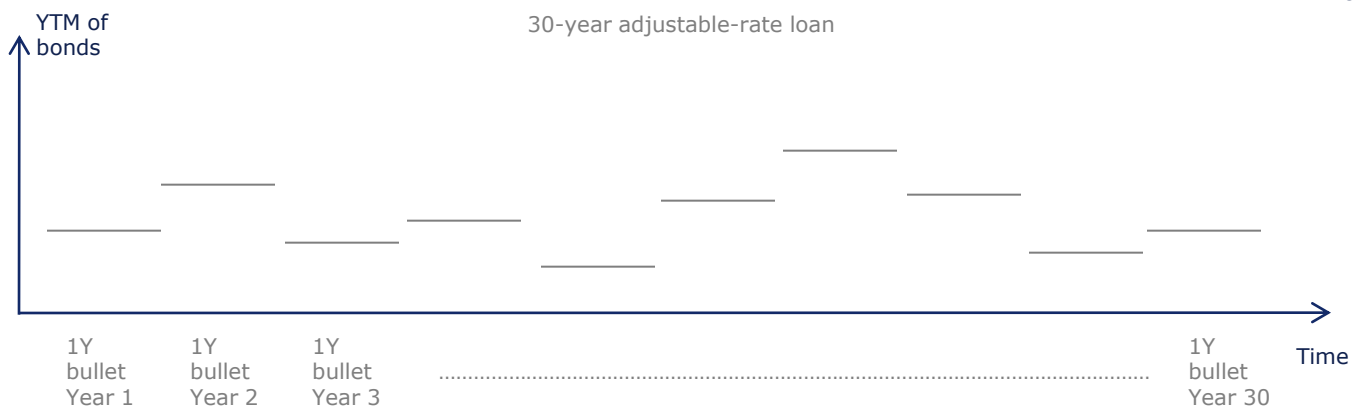


Borrower



Cash flow of loan

Investor



Cash flow of bonds

Strict underwriting standards

Real estate

- On site appraisal of all properties – maximum LTV determined by law
- Banks have access to detailed property data from public registers
- Land registry data, house price data and local knowledge
- Mortgage bank lending is stringently regulated by the Danish FSA

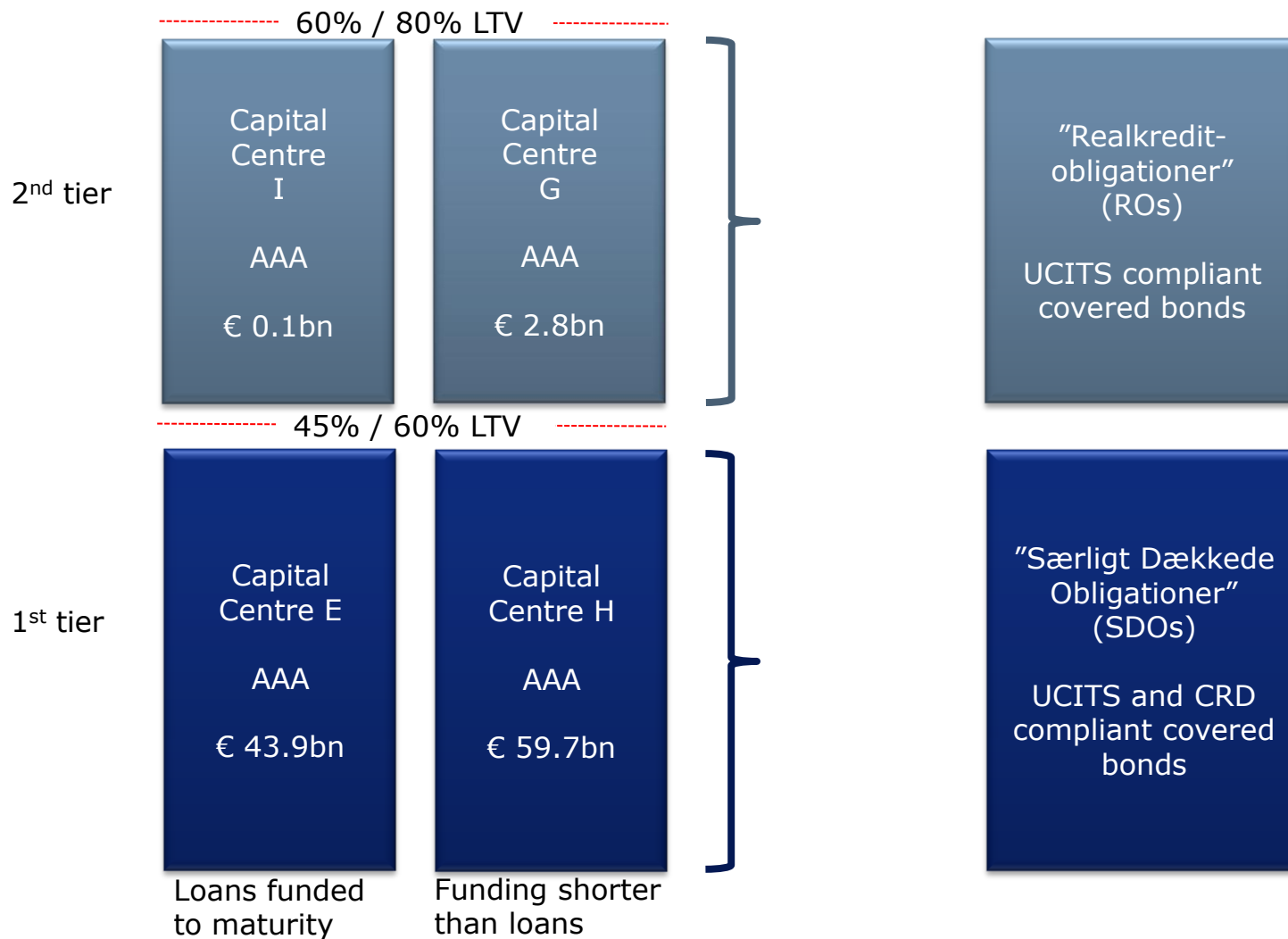
Borrower

- Sophisticated proprietary credit scoring model
- Nykredit demands household budget, payslips and income tax returns
- Negative credit register check (Experian)
- Customer must be able to afford fixed-rate 30Y amortising loan

Legal and policy

- Borrowers are personally liable for mortgage loans
- No financing of speculative buying – credit approval always based on ability to service debt
- Standard documentation eliminates legal uncertainty
- Flawless title and mortgage registration guaranteed by the government

Two-tier mortgaging



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What is a rating?

- ... an assessment of a debtors likeliness to pay creditors (on time)
- Many investors are by law or internal investment guidelines required to adhere to rating restrictions when making investment decisions
- There are just 4 global rating agencies



FitchRatings

STANDARD
& POOR'S

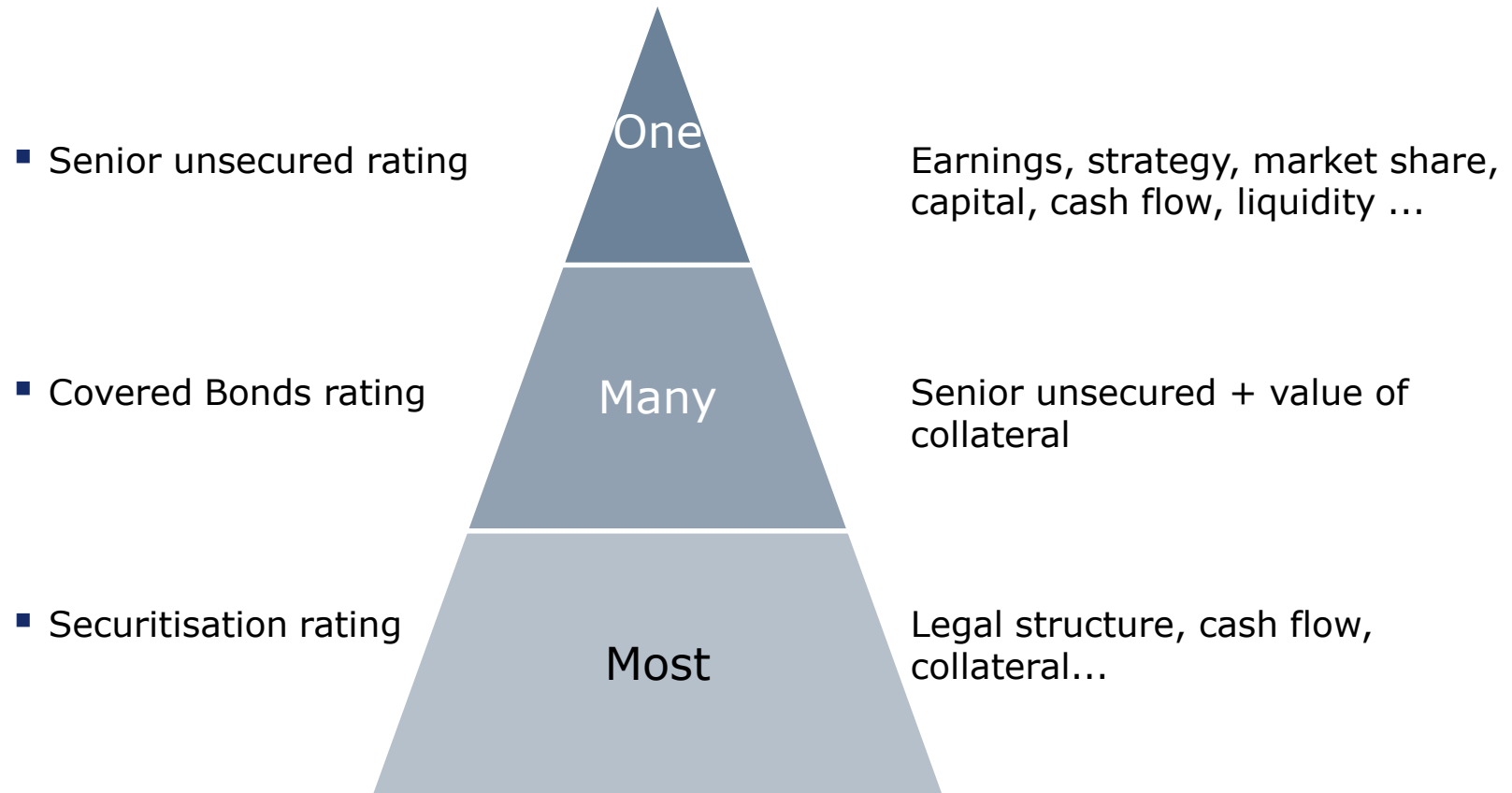
MOODY'S

- The agencies are profit maximising companies charging both issuers and investors for their services
- Rating agencies take no legal responsibility for their ratings
 - "Ratings are opinions voiced under the protection of the freedom of speech..."

Rating scales for Moody's

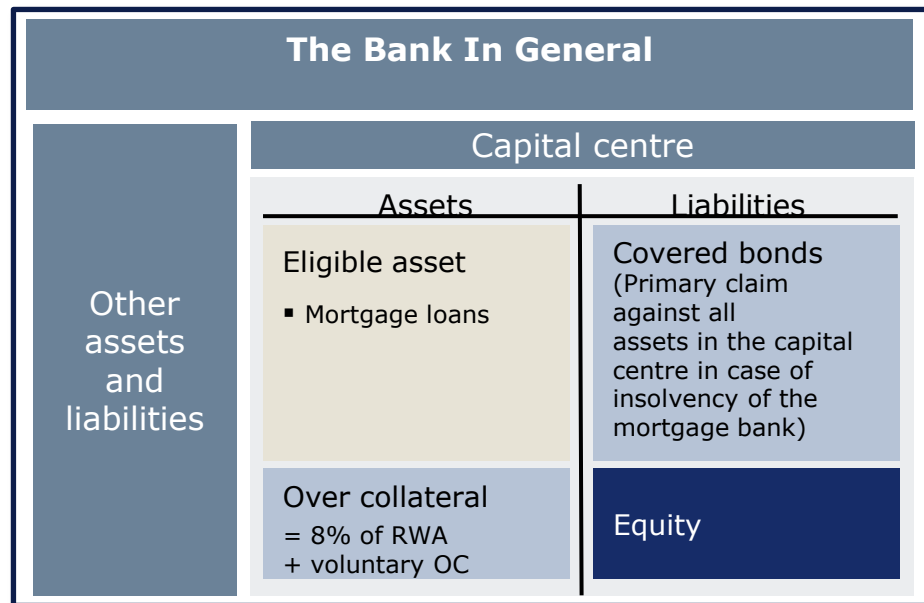
Long term > 1 year	Short term < 1 year	
AAA	Prime-1	Investment grade
Aa1		
Aa2		
Aa3		
A1		
A2	Prime-2	
A3		
Baa1		
Baa2	Prime-3	
Baa3		
Ba1	Not Prime	Non-investment grade "Junk"
Ba2		
Ba3		
...		
D		

Triple-A or Triple-A?



The structure of a covered bonds

- A covered bond is a debt instrument with a dual claim in case of the issuer's insolvency:
 - On a segregated pool of high quality assets
 - On the issuing bank
- The ring fenced assets is referred to as the cover pool or the Capital Centre (in Denmark)
- Any assets over and beyond the amount of issued covered bonds is referred to as Over Collateral
- An issuer can have several cover pools



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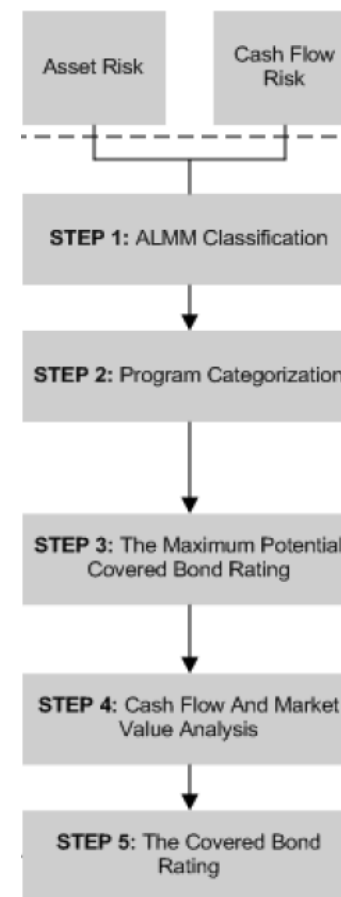
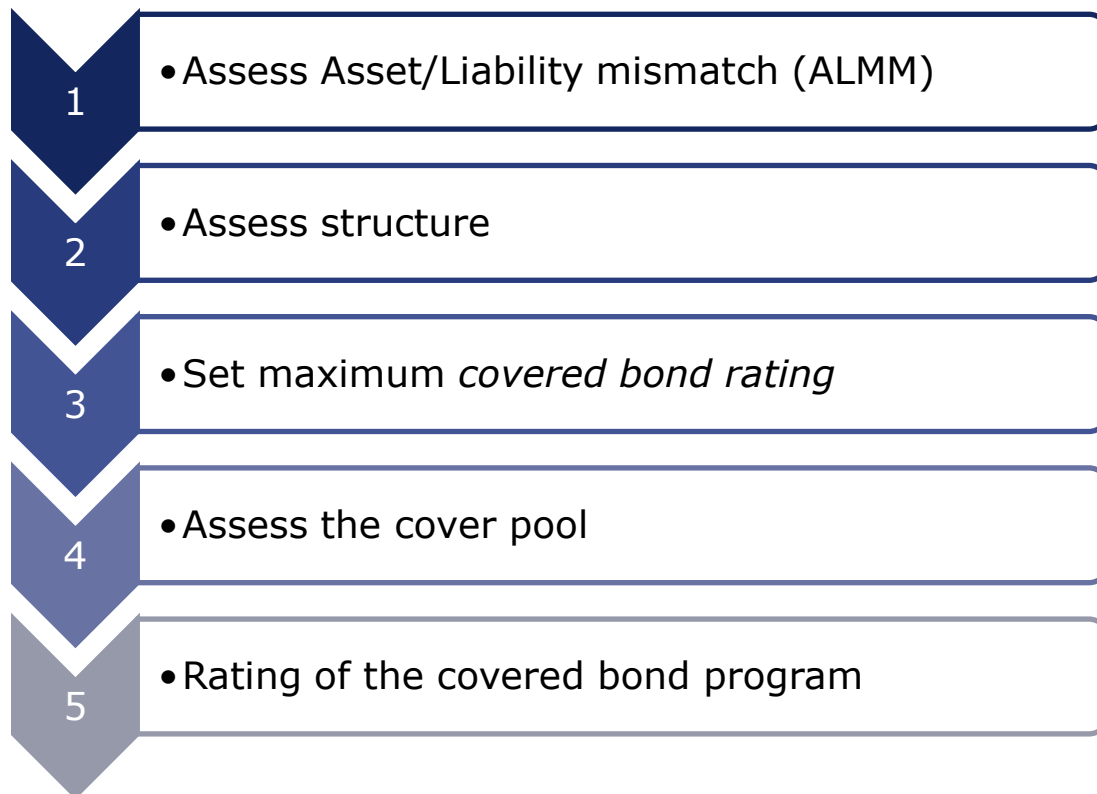
Rating covered bonds

- First you assess the risk of the issuing bank and assign a senior unsecured rating...
- ... then you assess the risk factors in relation to the covered bonds
- S&P has identified 5 main risk factors

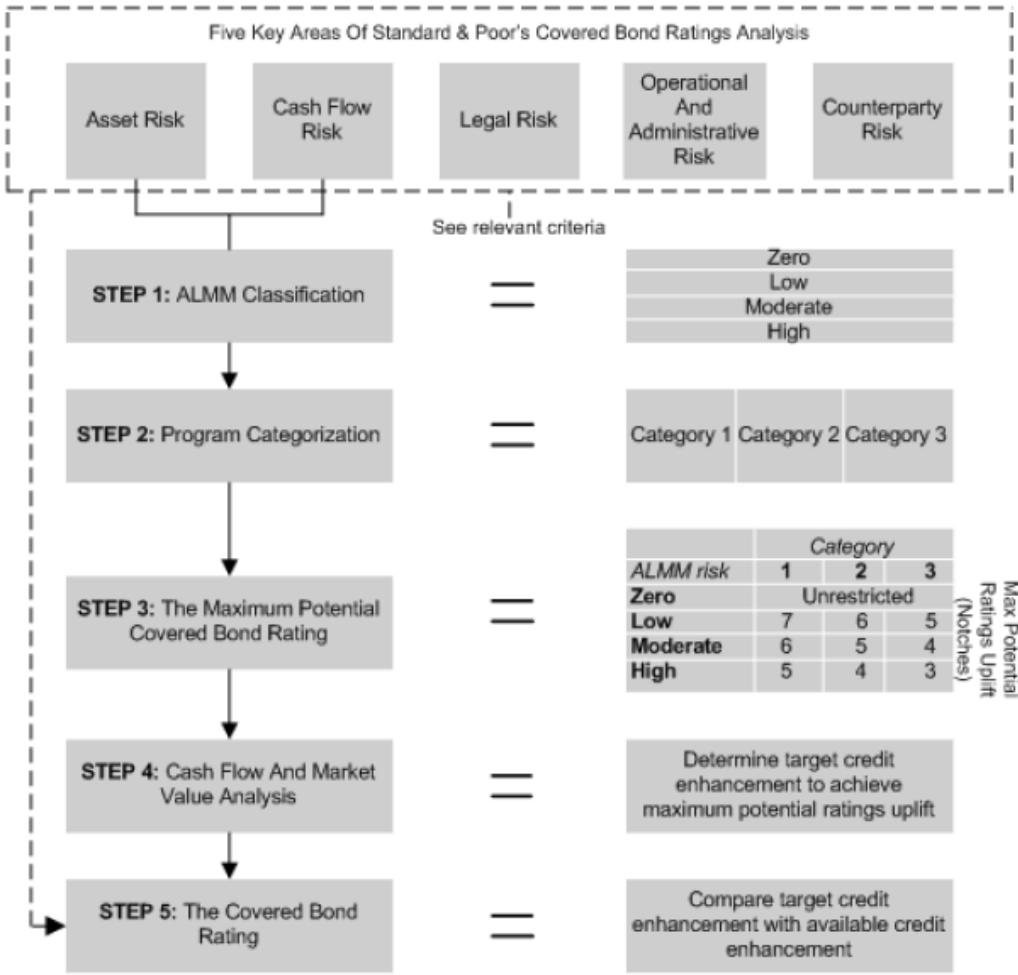


- The covered bond rating methodology focuses on credit risk and liquidity risk
- The other risk factors are assessed qualitatively or implicitly via the assessment of credit risk and liquidity risk

S&P's five-step model



S&P's five-step model



Rating the covered bond program

- The asset pool backing the issued covered bonds must be sufficient to cover any losses in a stress scenario
- If the assets fulfill this criteria the covered bonds will be assigned the maximum rating (from step 3) – this amount of assets is referred to as the “target asset pool”
- The target asset pool includes:
 1. The loan portfolio
 2. Extra assets to cover credit risk
Credit risk is calculated by stressing the loan portfolio
 3. Extra assets to cover any losses in relation to liquidation of the loan portfolio (from step 4).
Includes costs related to ALM mismatches

Rating the covered bond program

- The senior unsecured rating is the starting point...

1. Calculate maximum uplift

The maximum uplift is the lower of either the maximum covered bond rating (from step 3) or the number of notches to the maximum rating (AAA)

2. Calculate the maximum uplift in relation to hedging of ALM mismatch

Hedging of credit risk will lead to a one notch uplift. Hence the maximum uplift is reduced by one notch

3. Calculate sufficient amount of assets to fully cover ALM mismatches

The difference between the target asset pool and the liabilities (including assets needed to cover credit risk on the asset pool)

4. Identify additional uplift factors

Calculate additional assets needed per uplift: Sufficient amount of assets (no. 3) divided by maximum uplift in relation to hedging of ALM mismatches (no. 2)

5. Determine uplift

Actual amount of assets available for covering ALM mismatches divided by uplift factor (no. 4) = Number of rating notches uplift

=> **Covered bond rating**

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Nykredit's rating considerations

- We must have (high) ratings
 - How high and how many?

- Ratings are costly both in terms of money and man power

- Trade off between the rating level and the costs
 - Extra collateral needed to achieve/maintain the target rating(s)
 - Restrictions on investments, liquidity etc.
 - Agility in developing the business
 - Relative rating vis-a-vis competitors

How high and how many ratings?

	BRF		Nordea		Nykredit		RD		
	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's	Fitch
Jan. 2011	-	Aa1	AAA	Aaa	AAA	Aaa	AAA	Aaa	-
Dec. 2012	AAA	-	AAA	Aaa	AAA	-	AAA	-	AAA

- Rating differences is one of the factors driving prices differences in the bond market
- A lower bond price affects the issuer's competitiveness negatively due to the pass through funding model
 - Lower bond price = higher cost of funds for the bank
 - Interest rate for the home owner = bank's cost of funds + margin
- What happened to Moody's...?

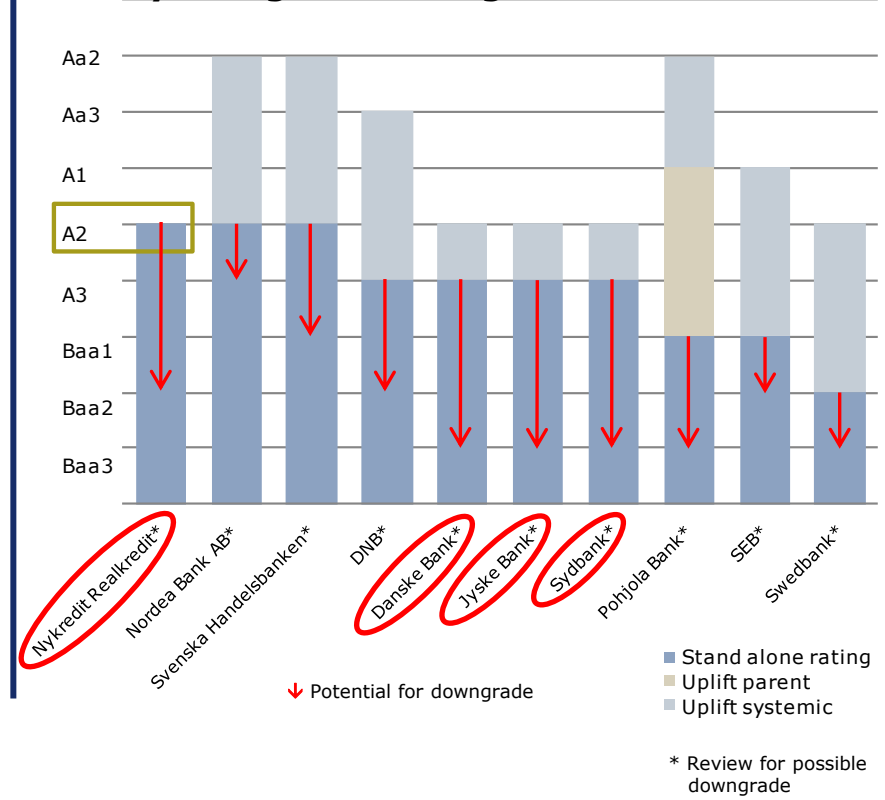
Slide from April 2012



Moody's: Negative view on Denmark and Nykredit

- Nykredit Realkredit is according to Moody's definition not systemically important
 - only deposit takers qualify
- Positive factors
 - Market leader in mortgage lending
 - Capital
 - Risk profile
- Negative factors
 - Low Danish growth
 - Household indebtedness
 - Falling house prices
 - Bank package III/Amagerbanken/the state has the resources but lack the will to support the financial sector
 - Dependent on capital market funding
 - F1-loans and IO loans
 - Low and volatile earnings
- Nykredit Bank strategically important
- Refinancing risk drags down TPI

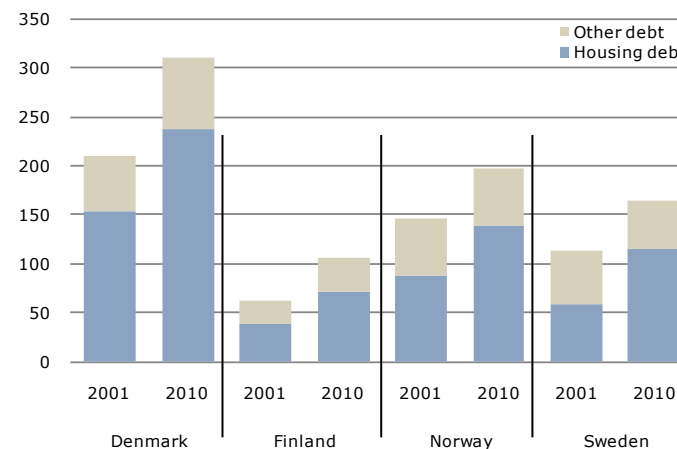
Moody's long term rating



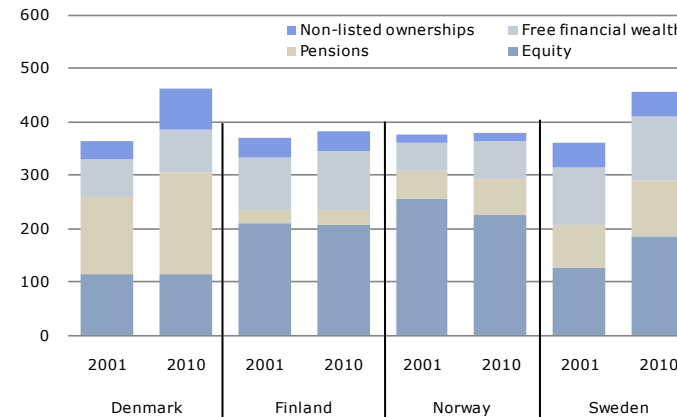
Household debt considerably offset by assets

- Household indebtedness remains high in a Nordic comparison...
- ... however, growth in debt off-set by growth in households assets
- Strong tax incentive in favour of pension savings rather than debt repayment
 - Both interest expenses and pension contributions are tax-deductible...
 - ... but a recent tax reform curbs pension contributions with tax benefits and reduces the tax deductibility of large interest expenses
- Households are therefore generally well consolidated...
- ... but obviously exposed to
 - Loss of employment income (Cash-flow)
 - Rising interest rates on financing
 - Falling asset prices

Gross indebtedness, % of disposable income

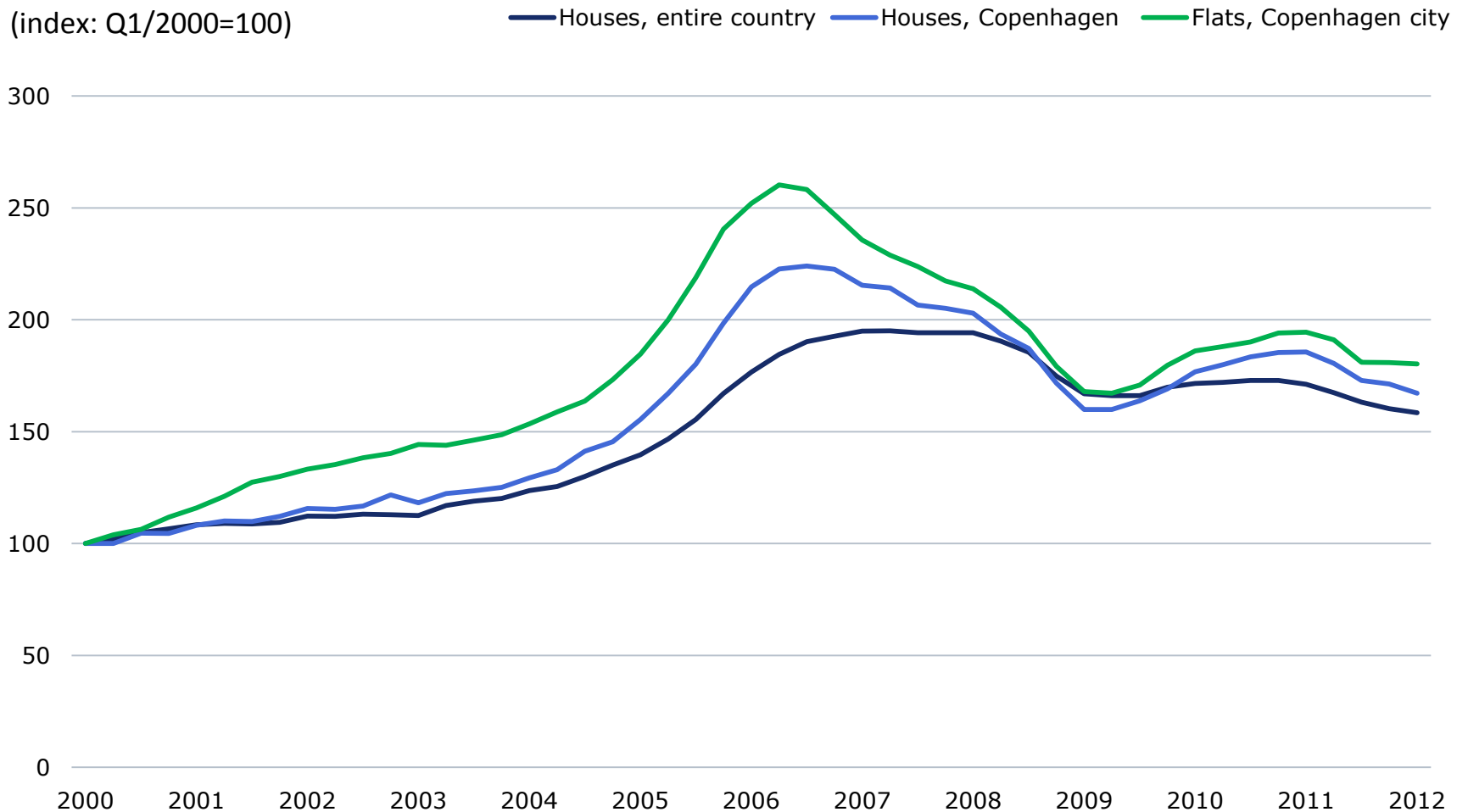


Households' net-wealth, % of disposable income



House price development

(index: Q1/2000=100)



Indexed Loan-to-value (LTV) Q3 2012

EURbn	0-20%	20-40%	40-60%	60-80%	80-100%	Above 100%	Total	LTV ¹ , %
Owner-occupied	27	25	21	14	4	1	93	74.8
Private	6	4	3	2	0	0	15	64.5
Non-profit ²	-	-	-	-	-	-	9	-
Industry	2	1	1	0	0	0	3	48.4
Office	6	5	3	1	0	0	15	55.9
Agriculture	6	4	3	1	0	0	14	57.4
Other	1	1	0	0	0	0	2	50.4
Total	48	40	31	18	5	1	152	67.1

¹Average current LTV is calculated on the basis of the top LTV bracket for the loans granted by the Nykredit Realkredit Group.

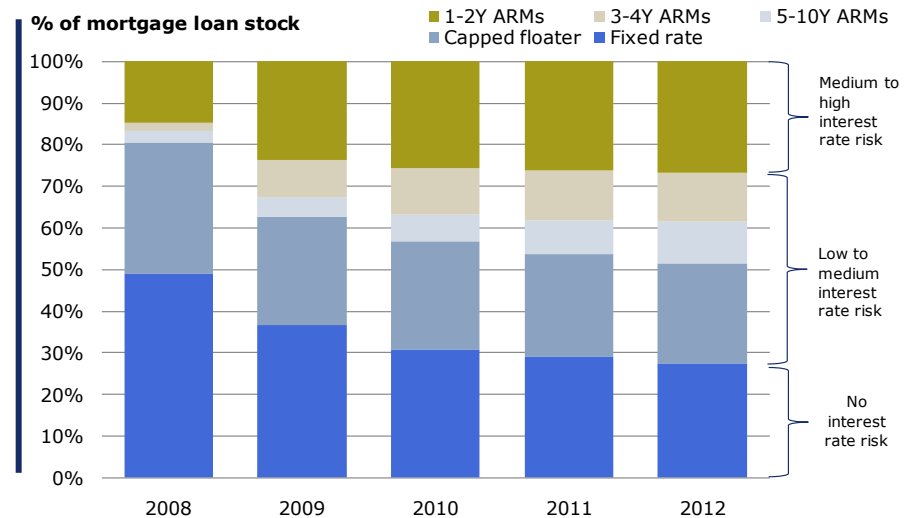
²All mortgages granted in the non-profit housing segment are subject to special Danish legislation as well as public authority guarantees. Therefore, LTV figures do not give relevant risk information. Public authority guarantees currently amount to EUR 4.1bn in total.

Source: Nykredit Realkredit Covered Bond Investor Report Q3 2012

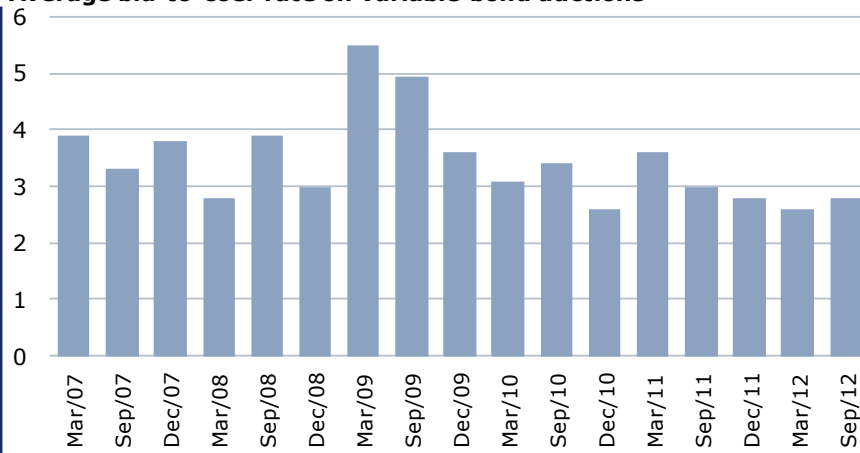


Increasing popularity of Adjustable Rate Mortgages

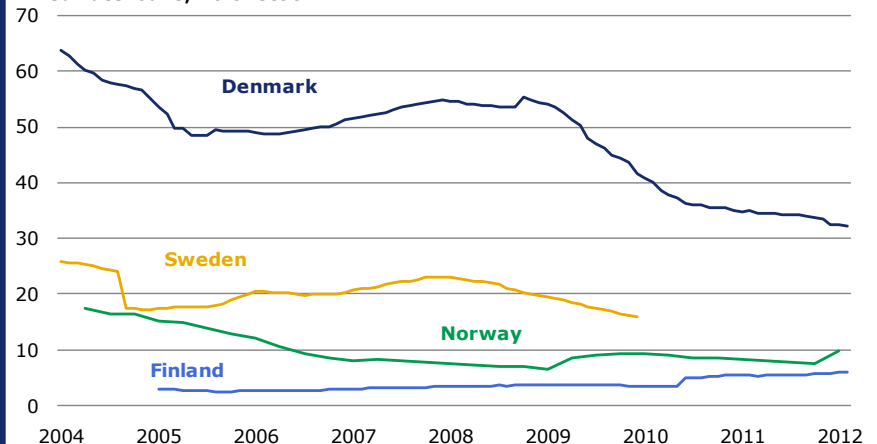
- Danish homeowners increasingly choose ARM's to reduce borrowing costs
- Majority of homeowners are still protected against raising interest rates
- Issuers' refinancing risk mitigated by strong investor base and well functioning bond market



Average bid-to-coer rate on variable bond auctions

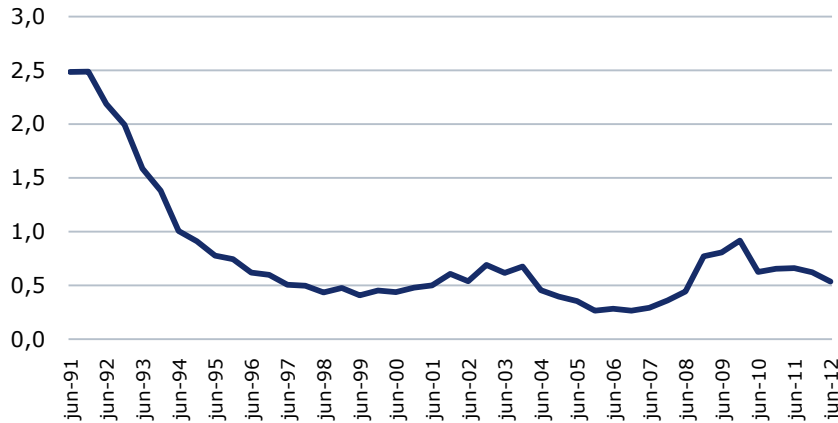


Fixed rate loans, % of stock

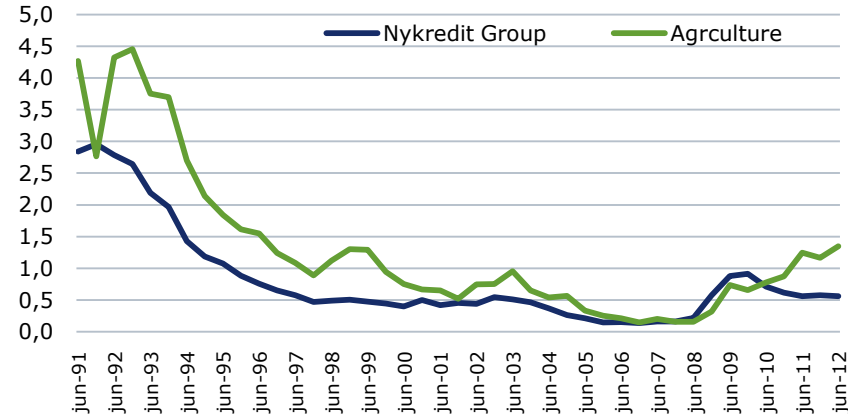


Robust loan performance despite economic headwind

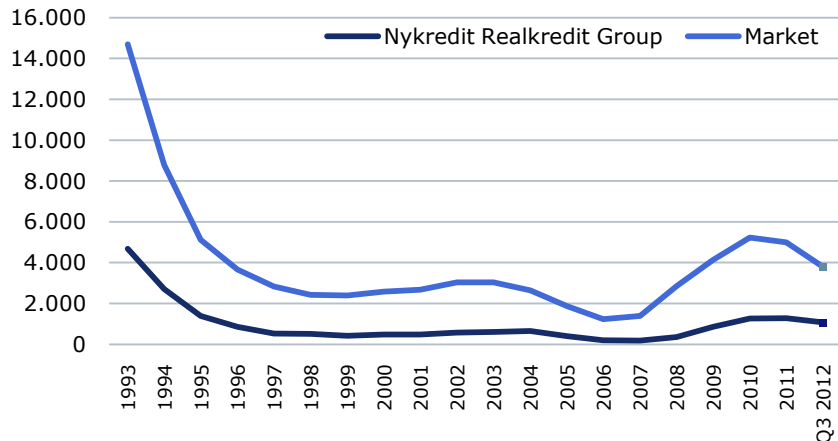
Retail delinquencies at 75 days, %



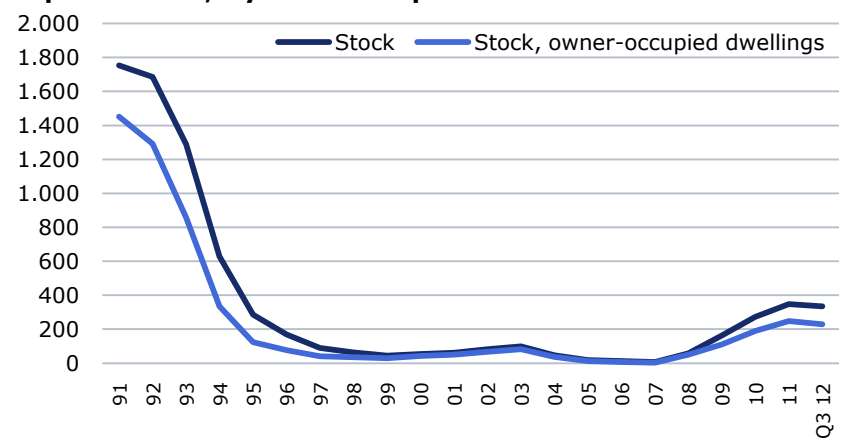
Delinquencies at at 75 days, %



Forced sales in Denmark



Repossessions, Nykredit Group

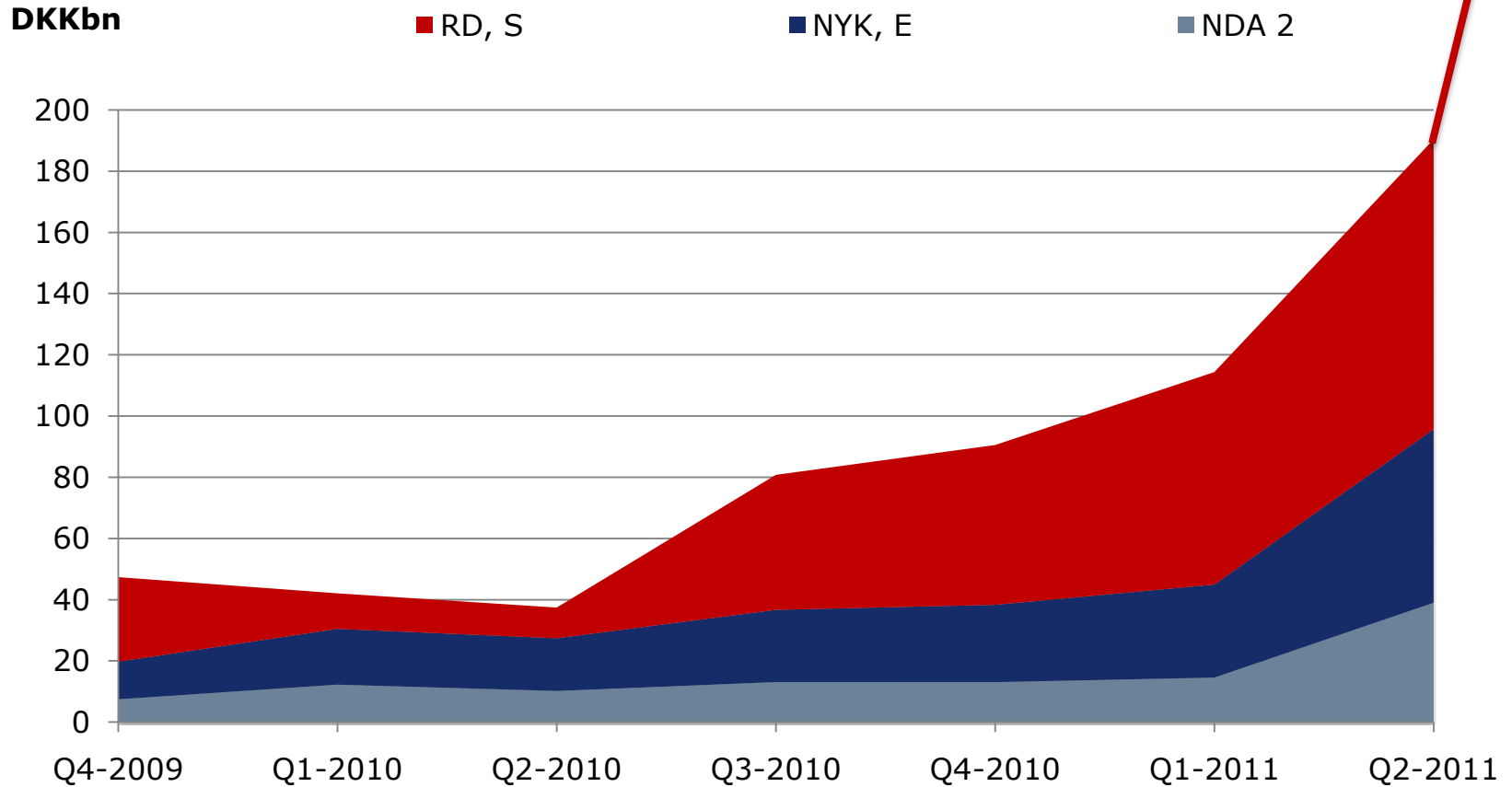


Losses ascertained as a percentage of debts outstanding

	Owner-Occ.	Commercial	Agriculture	Rental housing	Total
1992	0.40%	1.05%	0.18%	0.16%	0.42%
1993	0.37%	1.86%	0.32%	0.19%	0.56%
1994	0.21%	1.51%	0.33%	0.17%	0.42%
1995	0.13%	1.26%	0.22%	0.07%	0.31%
1996	0.05%	0.61%	0.10%	0.09%	0.15%
1997	0.04%	0.46%	0.04%	0.01%	0.09%
1998	0.02%	0.37%	0.01%	0.01%	0.06%
1999	0.02%	0.15%	0.05%	0.00%	0.04%
2000	0.01%	0.16%	0.01%	0.01%	0.03%
2001	0.02%	0.05%	0.01%	0.01%	0.02%
2002	0.03%	0.13%	0.02%	0.01%	0.04%
2003	0.03%	0.02%	0.02%	0.01%	0.02%
2004	0.02%	0.07%	0.00%	0.01%	0.02%
2005	0.01%	0.06%	0.01%	0.00%	0.01%
2006	0.00%	0.03%	0.02%	0.00%	0.01%
2007	0.00%	0.04%	0.01%	0.01%	0.01%
2008	0.00%	0.00%	0.00%	0.00%	0.00%
2009	0.02%	0.05%	0.00%	0.01%	0.02%
2010	0.05%	0.09%	0.01%	0.03%	0.05%
2011	0.06%	0.13%	0.01%	0.04%	0.06%
Q3 2012	0.06%	0.10%	0.07%	0.06%	0.07%

Slide from April 2012

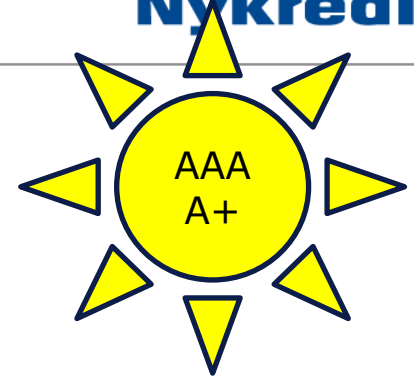
Volatile Over Collateral requirements made current Moody's Aaa-model unsustainable for Danish issuers



Moody's rating action on Danish banks

- Mid-April 2012, Nykredit terminated its cooperation with Moody's due to:
 - Moody's volatile view of the Danish mortgage industry
 - Diminished significance of the ratings to Nykredit and to Nykredit's investors
- End-May, Moody's downgraded 8 Danish banks and (on an unsolicited basis) Nykredit
- Key drivers for Moody's rating actions...
 1. Difficult operating environment in Denmark
 2. Substantial market-funding reliance
 3. High household debt levels... and Nykredit specific
 4. Exposure to more volatile sectors (agriculture and commercial real estate) – despite the low loan loss and arrears ratios by international standards
- Nykredit has not seen any material market reactions on the back of Moody's rating actions

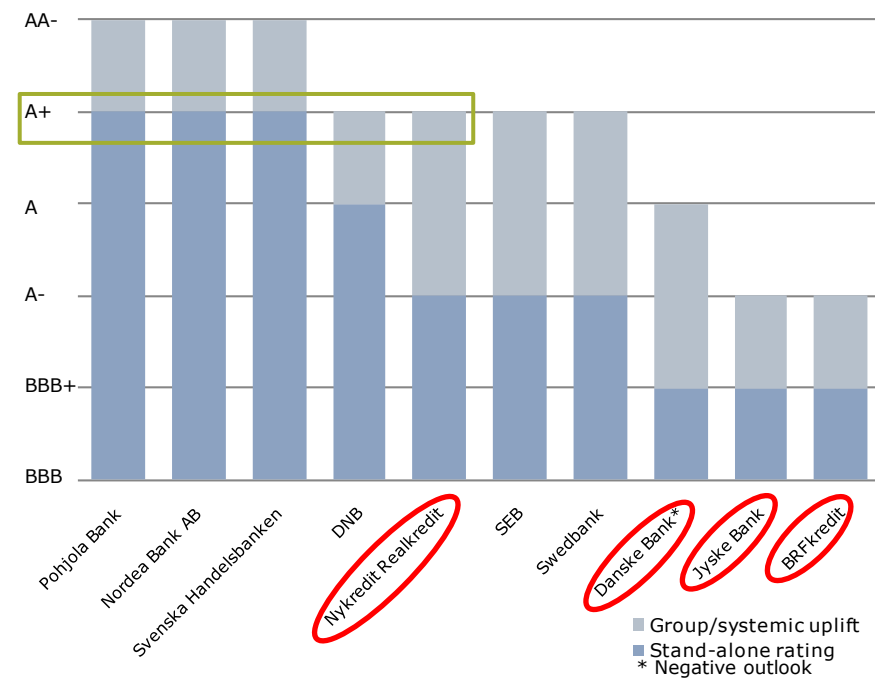
Slide from April 2012



S&P has a predominately positive view on Nykredit

- New rating methodology introduced in December 2011
- Nykredit's senior unsecured rating unchanged
 - Stable outlook
 - One notch uplift due to risk profile
 - Two notch uplift for "high" systemic importance
- Positive factors
 - Market leader in mortgage lending, ...
 - stabile core earnings
 - dependence on capital market funding partly mitigated by well functioning bond market
 - Room for fiscal flexibility in Denmark
- Negative factors
 - Household indebtedness
 - Low margins on mortgage loans
 - Increasing volume of loans with refinancing risk
 - Low Danish growth
- Mortgage refinancing risk is incorporated in CB ratings via a slightly higher credit risk factor

Standard & Poor's long term rating



Concluding remarks

- An issuer needs ratings in order to sell bonds at competitive spreads
- There are significant costs associated with high ratings
- The issuer needs to trade off benefits of a given rating with costs and business restrictions imposed by that rating
- Ultimately an issuer may choose to terminate the cooperation with a rating agency, but it is not a decision to take lightly
- Rating methodologies and sentiment change over time



Contacts and more information

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- General information
- Press releases
- Financial reports
- Risk and capital reports
- Prospectuses
- Publications on markets
- Bond data

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