S&P Global Ratings

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The Mortgage Society of Finland

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The Mortgage Society of Finland

SACP	bbb

\+

Support	0

\+

Additional Factors	0

Anchor	a-	
Business Position	Weak	-2
Capital and Earnings	Very Strong	+2
Risk Position	Moderate	-1
Funding	Below Average	-1
Liquidity	Adequate	

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating
BBB/Negative/A-3

Major Rating Factors

Strengths:	Weaknesses:
• Very strong capitalization. • Strong asset quality and exceptional loan loss track record. • Mutual business model.	• Narrow business operations as a residential mortgage financer. • Concentration risk, owing to focus on residential mortgage lending. • Predominantly wholesale funding profile.

Outlook: Negative

S&P Global Ratings' outlook on Finland-based credit institution The Mortgage Society of Finland (Suomen Hypoteekkiyhdistys, Hypo, or the bank) is negative. It reflects our view that the weak economic recovery in Finland's export-oriented economy could adversely affect the Finnish banking sector's performance in the next two years. This could lead us to revise down our anchor for Finnish banks, including Hypo, to 'bbb+' from 'a-', which in turn would likely prompt us to lower our long-term rating on Hypo.

In addition, we could downgrade Hypo if it unexpectedly changed its current conservative lending policies, leading to weakening of its asset quality and ensuing credit losses. We could also take a negative rating action if Hypo increased its business growth more aggressively than we assume and failed to maintain its very strong capital and earnings in line with our expectations.

We might revise the outlook to stable if we saw an improvement in the Finnish economy over the next 18-24 months.

Rationale

Our ratings on Hypo reflect our anchor of 'a-' for Finnish banks, Hypo's weak business position, its very strong capital and earnings, moderate risk position, below average funding, and adequate liquidity. We assess the bank's stand-alone credit profile (SACP) at 'bbb'. We consider Hypo to be of low systemic importance and regard the government's support toward the banking sector in Finland as uncertain. Consequently, we do not factor any extraordinary government support into our 'BBB' long-term rating on the bank.

Anchor: 'a-' for banks operating only in Finland

Under our bank criteria, we use our Banking Industry Country Risk Assessment's economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Finland, such as Hypo, is 'a-', based on an economic risk score of '2' and an industry risk score of '3'.

We view Finland as a competitive and resilient economy with high education levels. However, the country depends on exports from cyclical industries linked to investments, and its economy is subject to sub-par growth due to the fragile recovery in Europe. Moreover, lack of reforms to increase competitiveness could put pressure on the economy. Low corporate and moderate household debt, alongside a very strong payment culture, contribute to sound leverage.

Diverse Nordic banking groups largely control Finland's concentrated banking industry, which in our view is underpinned by robust profitability and stability. Deposits dominate funding, but the sector is a net external debtor, reflecting significant loan growth over the past decade and the country's lack of a deep domestic debt market.

Table 1

The Mortgage Society of Finland Key Figures

		--Year-ended Dec. 31--			
(Mil. €)	**2016***	**2015**	**2014**	**2013**	**2012**
Adjusted assets	2,147.3	1,957.5	1,499.0	1,218.9	910.9
Customer loans (gross)	1,649.3	1,420.7	1,204.4	978.2	725.4
Adjusted common equity	105.3	101.8	96.3	89.6	82.9
Operating revenues	9.7	16.7	17.3	14.0	11.9
Noninterest expenses	5.1	9.2	9.7	8.1	6.7
Core earnings	3.8	6.2	6.2	4.9	4.1

*Data as of June 30.

Business position: Monoline profile as a residential mortgage financer in Finland

We consider Hypo's business position to be weak, reflecting the bank's small size, its very low market share in Finland, and its concentrated niche market position focused on residential mortgage lending to households and housing companies, primarily in the Helsinki metropolitan area.

Hypo, founded in 1860, is a licensed bank and mutual company operating under Finland's Act on Mortgage Societies and is governed by its members. The purpose of the mortgage society is to grant long-term loans against a mortgage or other safeguarding collateral. The customers are members of the society as long as they have loans outstanding and no arrears. The bank grants loans to Finnish households and housing companies solely against housing or residential property collateral and had total assets of almost €2.15 billion and a loan portfolio of €1.6 billion as of June 30, 2016.

The bank is active only in the Helsinki metropolitan area, the Uusimaa region, and in specified growth centers in Finland. As such, we consider Hypo will be less exposed to adverse market price development in rural areas of Finland. Hypo operates solely from its headquarters in Helsinki and services its clients through online and telephone banking, allowing it, in our view, to operate more cost efficiently than its larger domestic peers.

Hypo's niche position will continue to provide stability to the bank's business position and opportunities for risk-averse growth, in our opinion. Due to its small size and marginal market share of 0.4% in mortgage lending in Finland in 2015, Hypo does not compete with the larger market players on retail banking products but exclusively on mortgages. Owing to its solid reputation and special product offerings, such as loans to housing companies and reverse loans for elderly people (backed by real estate property), Hypo can be seen as an alternative bank to its customers. Therefore, the growth targets for the coming years--annual loan growth of 20%-25% in 2016-2017--are in our view not overly aggressive, as might be indicated by the absolute growth figures, and are small compared with the mortgage loan market.

We view Hypo's narrow product focus on residential mortgage lending as the main weakness to its business model, which may expose the bank to potential volatility in the real estate market in Finland. We don't anticipate any changes to Hypo's strategy, which is clearly defined by the Act of Mortgage Societies. As such, the bank will not be allowed to expand into corporate lending or commercial real estate financing, for example. Furthermore, it has no trading activities and no foreign business activities.

Hypo's revenues consist of net interest income from first-lien mortgages related to Finnish residential mortgages and loans to housing companies (27% of total operating revenues in 2015), income from investments in housing and land property owned by Hypo (41%), and fee and commission income from lending, deposits, residential property trustee services (20%), and other income (12%), a split that we expect will remain unchanged in the foreseeable future.

Notwithstanding the concentrations in Hypo's business profile, we consider that management has a conservative approach to risks and a very low risk appetite. Furthermore, we believe that, despite the elevated growth targets for the next two years, management will maintain the bank's conservative underwriting standards, and Hypo's niche position will allow it to continue growing very selectively. The bank's conservative culture is also underpinned by Hypo's mutual legal structure, which subordinates short-term financial profitability targets.

Table 2

The Mortgage Society of Finland Business Position

		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Total revenues from business line (mil.€)	9.7	16.7	17.3	14.0	11.9
Retail banking/total revenues from business line	37.5	44.5	58.0	57.7	48.3
Commercial & retail banking/total revenues from business line	37.5	44.5	58.0	57.7	48.3
Return on equity	7.3	6.3	6.7	5.8	5.3

*Data as of June 30.

Capital and earnings: Very strong capitalization and high profit retention as a mutual company

We assess Hypo's capital and earnings as very strong, mainly based on our expectation that our projected risk-adjusted capital (RAC) ratio for the bank will be in the 17%-18% range over the next 12-18 months, compared with 18.6% as of Dec. 31, 2015. The decrease in our projected RAC ratio over the next two years results from the bank's targeted loan growth, which translates into an increase in our calculation of risk-weighted assets that exceeds our anticipation of the bank's potential capital buildup, absent any additional capital measures. We anticipate that loan growth will be balanced between retail and housing company loans.

We expect that Hypo's interest income from loan business will strengthen in 2016-2017, driven primarily by improved margins benefitting from lower funding costs, and through increased lending volumes. However, the low interest rate environment and the increase in the liquidity portfolio will continue to weigh on the expense of lower net interest income. Furthermore, we expect Hypo's housing property investments will provide stable recurring income of about €4.0 million-€4.5 million over the next two years.

As a mutual company, Hypo does not pay out dividends. Consequently, the retained profits are solely used for capital buildup. Furthermore, we view the mutual structure as a positive because it minimizes the focus on short-term financial targets. Return on equity has been about 5% in the past five years, and we expect it will gradually increase to around 7% by 2018.

We consider Hypo's quality of capital to be adequate due to the small absolute size of its capital base (€106.4 million as of June 30, 2016) and the bank's limited flexibility to raise additional core capital in the market. We consider this as a weakness that we capture in our combined view of Hypo's capital and risk position. Hypo's total adjusted capital, our measure of loss-absorbing capital, consists solely of core capital. We have not included any additional capital measures into our forecast, but understand that Hypo could make use of hybrid capital issues if required to support loan growth. The quality of earnings is, in our view, adequate, because net interest income and net fee and commission income constitute a major part of revenues, while the stable income from property holding constitutes the remainder. The income from property holding is unusual compared with peers'; however, we understand Hypo is holding high-quality assets without any opportunistic approach to gain quick market value gains.

Table 3

The Mortgage Society of Finland Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Tier 1 capital ratio	12.9	13.8	15.1	14.0	15.9
S&P Global Ratings' RAC ratio before diversification	N.M.	18.6	19.7	20.4	N.M.
S&P Global Ratings' RAC ratio after diversification	N.M.	11.5	11.5	11.5	N.M.
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	21.1	27.4	37.2	37.7	28.9
Fee income/operating revenues	25.7	20.5	20.9	19.4	18.8
Market-sensitive income/operating revenues	16.5	11.4	16.1	0.7	0.1
Noninterest expenses/operating revenues	52.6	54.9	56.4	57.4	56.0
Preprovision operating income/average assets	0.4	0.4	0.6	0.6	0.6

Table 3

The Mortgage Society of Finland Capital And Earnings (cont.)

		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Core earnings/average managed assets	0.4	0.4	0.5	0.5	0.5

*Data as of June 30. RAC--Risk-adjusted capital. N.M.--Not meaningful.

Table 4

The Mortgage Society of Finland Risk-Adjusted Capital Framework Data

(€ 000s)	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' s RW (%)**
Credit risk					
Government and central banks	318,975	1,904	1	10,675	3
Institutions	138,093	47,310	34	24,623	18
Corporate	140,816	117,129	83	77,692	55
Retail	1,369,933	414,155	30	337,890	25
Of which mortgage	1,302,461	392,000	30	312,591	24
Securitization§	0	0	0	0	0
Other assets	71,973	71,867	100	71,066	99
Total credit risk	2,039,791	652,365	32	521,948	26
Market risk					
Equity in the banking book†	132	132	100	1,105	835
Trading book market risk	--	0	--	0	--
Total market risk	--	132	--	1,105	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	28,363	--	23,207	--
(€ 000s)		**Basel III RWA**		**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification		682,283		546,260	100
Total diversification/Concentration adjustments		--		340,408	62
RWA after diversification		682,283		886,668	162
(€ 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		94,009	13.8	101,785	18.6
Capital ratio after adjustments‡		94,009	13.8	101,785	11.5

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2015, S&P Global Ratings.

Risk position: Exceptional asset quality, but concentration risk on retail mortgage lending in Finland

In our view, Hypo's risk position is moderate, reflecting the concentration risk in the bank's loan book, which exposes it to potential volatility in the domestic real estate market, as well as to single names.

We view positively Hypo's focus on low-risk lending, consisting of mortgage loans to domestic retail customers and housing companies, and high granularity in its loan portfolio book. However, we still consider that the regionally focused retail loan book exposes the bank to concentration risk and makes it vulnerable to real estate price developments in some regions of Finland.

This is partly mitigated by Hypo's conservative underwriting standards. We consider that Hypo's loan book of €1.5 billion demonstrates strong asset quality underpinned by high collateralization, with a weighted average loan-to-value ratio (LTV) of 40.4% as of March 31, 2016, which we assess to be lower than that of many specialized mortgage lenders in Europe. We understand that Hypo uses more conservative haircuts than competitors on the market values of real estate, depending on the type of residential collateral, and we consider the collateral to be relatively liquid because Hypo is active only in the Helsinki metropolitan area and larger cities in Finland. The average maturity of the new loans is about 16 years, but the average duration of the total loan portfolio is much shorter, at 5-6 years.

We note that Hypo also finances housing companies under construction in the Helsinki metropolitan area and growth centers (1% of total loan portfolio as of March 31, 2016), which in our view represents higher risk than residential lending. The lending is solely against housing property collateral, and drawings under the facility are possible only according to the statement of readiness, such that the amount lent is always lower than the collateral value. Accordingly, the average LTV ratio on housing companies in the construction phase in Hypo's portfolio is 36.5%, below the average LTV of Hypo's overall portfolio. These exposures have an average tenor of 1.0-1.5 years and turn into housing company loans once the construction phase is over.

We consider Hypo's targeted loan growth of 20%-25% in 2016-2017, which we anticipate will be split relatively evenly between retail and housing companies, as challenging but not overly aggressive, considering that it has intentionally slowed loan portfolio increases in the past. We do not expect the bank will compromise its cornerstone conservative lending policies and high collateralization.

Furthermore, we do not expect Hypo's property investment portfolio, amounting to €71 million as of Dec. 31, 2015 (3.6% of its assets), will weaken the bank's overall risk profile. The portfolio consists of Hypo's headquarters, holdings in nonlisted property funds with investment in residential property land (with long-term rental agreements for multifamily housing companies, typically 50 years), and rented apartments mainly in highly valued residential areas in the Helsinki metropolitan area. That Hypo has no investments in commercial real estate further supports our assessment of the bank's risk position.

Hypo demonstrates an exceptional loan loss track record. Total credit losses are almost nonexistent, and losses in the past have resulted solely from household customers. To date, Hypo has not experienced credit losses from housing companies, housing companies with properties under construction, or housing investors, which demonstrates the bank's risk approach. We anticipate that total nonperforming loans will remain at the current low of 0.20% of the loan portfolio (0.24% as of June 30, 2016), well below the Finnish average. Given the liquidity and high level of collateral, we consider reserves to be adequate for Hypo's moderate amount of nonperforming loans.

Table 5

The Mortgage Society of Finland Risk Position					
		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Growth in customer loans	32.2	18.0	23.1	34.9	17.9
Total diversification adjustment/ S&P Global Ratings' RWA before diversification	N.M.	62.3	70.9	76.8	N.M.
Total managed assets/adjusted common equity (x)	20.4	19.3	15.6	13.6	11.0
New loan loss provisions/average customer loans	0.0	(0.0)	0.0	(0.0)	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.2	0.2	0.2	0.1	0.1
Loan loss reserves/gross nonperforming assets	N/A	15.6	12.6	32.3	30.7

*Data as of June 30. RWA--Risk-weighted assets. N.M.--Not meaningful.

Funding and liquidity: Matched funding profile but dependence on wholesale funding

We consider Hypo's funding to be below average, incorporating its predominantly wholesale funding profile, and regard its liquidity position as adequate.

Much of Hypo's funding is done via wholesale funding, representing about 40% of total funding as of June 30, 2016, and is composed mainly of senior unsecured bonds and covered bonds issued under a €1,500 million note program and certificates of deposit (CD) under a €200 million CD program. Hypo obtained a covered bond license from Finland's Financial Supervisory Authority in 2016 and made a covered bond debut by issuing €250 million in May 2016. We expect the bank will issue yearly going forward. Short-term wholesale funding share had decreased to below 15% of wholesale funding as of June 30, 2016. We view positively the well-matched funding profile, with the long-term funding ratio equaling about 87%. The change in the funding mix will enable the bank to reduce the funding costs and improve the net interest margin in the next two years.

Hypo has gradually increased the customer deposits collected through deposit-taking subsidiary AsuntoHypoPankki (AHP), which now constitute about 60% of the funding base (versus less than one-third as of year-end 2013). We expect their share will be around 50% over the next two years, still below levels for domestic peers. Furthermore, the deposits are mainly collected from housing companies and institutional clients, which we consider in general to be less stable than retail customer deposits, in times of stress. Consequently, we consider that Hypo's loan-to-deposit ratio, at 155% as of June 30, 2016, continues to be weak in a peer comparison. The Finnish deposit guarantee fund covers approximately 12% of Hypo's customer deposits.

To improve its funding profile, Hypo aims to spread the maturities of its capital market funding, mainly through issuance of covered bonds, which we believe will result in a S&P Global Ratings stable funding ratio of about 100%, compared with 103% on June 30, 2015. Hypo's current asset encumbrance is, in our view, very low.

We consider Hypo's liquidity to be adequate, because we believe that the bank will be able to survive under stressful conditions for more than six months. To comply with new regulatory requirements in Finland, Hypo has optimized its liquidity portfolio, amounting to €420 million as of June 30, 2016, by increasing the size and by shifting the allocation chiefly to government and covered bonds. Currently, about one-half of investments are in central government bonds, and the remainder is invested in covered bonds and in financial institutions. Moreover, almost 80% is invested in counterparties with a rating of 'A' or above. The liquidity portfolio consists almost fully of European Central

Bank-eligible securities. As anticipated, these planned measures have improved our liquidity metrics for Hypo--namely broad liquid assets to short-term wholesale funding--to about 1.4x as of June 30, 2015, compared with 0.74x on Dec. 31, 2013.

Table 6

The Mortgage Society of Finland Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Core deposits/funding base	53.0	56.8	34.0	28.4	33.1
Customer loans (net)/customer deposits	155.5	136.7	257.2	310.2	270.0
Long term funding ratio	87.4	83.4	82.0	83.2	73.9
Stable funding ratio	103.0	103.0	93.3	92.6	79.8
Short-term wholesale funding/funding base	13.3	17.5	19.3	18.1	28.7
Broad liquid assets/short-term wholesale funding (x)	1.4	1.3	0.8	0.7	0.4
Net broad liquid assets/short-term customer deposits	10.8	8.3	(10.1)	(20.5)	(72.4)
Short-term wholesale funding/total wholesale funding	28.3	40.4	29.2	25.2	42.9
Narrow liquid assets/3-month wholesale funding (x)	5.1	4.5	1.5	1.8	1.2

*Data as of June 30.

External support: No notches of uplift to the SACP

We consider Hypo to be of low systemic importance and consequently do not factor any extraordinary government support into our ratings on the bank.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research

Related Criteria

- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Finland Outlook Revised To Stable On Gradual Economic Recovery; Ratings Affirmed At 'AA+/A-1+', Sept. 16, 2016
- Banking Industry Country Risk Assessment Update: August 2016, Aug. 10, 2016
- Nordic Banks' Capital Growth Tapers Off, Aug. 2, 2016
- Banking Industry Country Risk Assessment: Finland, Jan. 25, 2016

Anchor Matrix

Industry Risk	Economic Risk									
	1	**2**	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	**a-**	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of September 19, 2016)

The Mortgage Society of Finland	
Counterparty Credit Rating	BBB/Negative/A-3
Counterparty Credit Ratings History	
31-Aug-2015	BBB/Negative/A-3
Sovereign Rating	
Finland (Republic of)	AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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