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Transaction Update: The Mortgage Society of Finland (Mortgage Covered Bond Program)

€1.5 Billion Covered Bond Program

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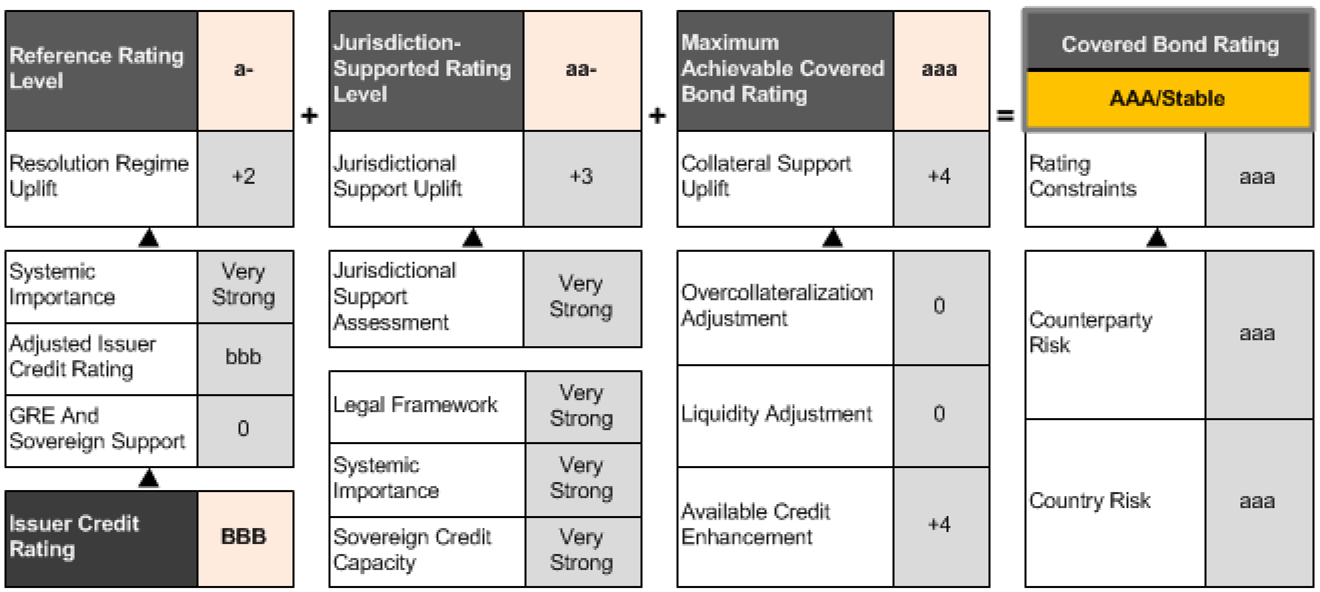
Ratings Detail



Major Rating Factors

Strengths

- The cover pool comprises loans with low loan-to-value (LTV) ratios.
- The program benefits from one unused notch of uplift.
- The program benefits from a public commitment to maintain a level of overcollateralization that is consistent with the rating. Furthermore, liquidity risk is covered through the soft-bullet repayment profile of the bonds.

Weaknesses

- High asset-liability mismatch in the covered bond program, altough improved since our last analysis. The structure benefits from interest rate swaps, but we do not give credit to them in our analysis because they do not comply with our counterparty criteria.
- Around 57% of the pool comprises housing associations, which we view as a higher risk to the program's creditworthiness than residential mortgages.

Outlook: Stable

The stable outlook reflects the fact that the ratings on the covered bonds benefit from one unused notch of collateral-based uplift under our covered bonds criteria (see "Covered Bonds Criteria," published on Dec. 9, 2014). Therefore, if we were to lower our long-term issuer credit rating (ICR) on The Mortgage Society of Finland (Suomen Hypoteekkiyhdistys, or Hypo) by one notch, we would not lower our ratings on the covered bonds, all else being equal.

We would lower the ratings on the covered bonds if we were to lower our long-term ICR on The Mortgage Society of Finland by more than one notch, all else being equal.

Rationale

We are publishing this transaction update following our affirmation of our ratings on The Mortgage Society of Finland's mortgage covered bond program and related issuances (see "Ratings Affirmed At 'AAA' On The Mortgage Society of Finland's Mortgage Covered Bonds Following Review; Outlook Stable," published on May 30, 2017, on RatingsDirect).

Our covered bond ratings process follows the methodology and assumptions outlined in our "Covered Bonds Criteria," published on Dec. 9, 2014, and "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

From our analysis of the legal and regulatory framework for Finnish covered bonds, we have concluded that the assets in the cover pool are isolated from the issuer's insolvency risk. The asset isolation allows us to rate the covered bond program at a higher rating level than the long-term ICR on Hypo.

We conducted a review of Hypo's mortgage operations, which we view as prudent. We believe there are sufficiently prudent and effective underwriting and servicing procedures in place to support our ratings on the covered bonds.

Under our covered bonds criteria, we first assess the reference rating level (RRL), which for Hypo's covered bonds is 'a-'. This reflects the ICR on Hypo, minus any notches of uplift for extraordinary sovereign support incorporated in the ICR (in this case, none), plus two notches of uplift to reflect our view of the protection offered to covered bondholders by the bail-in provisions specified under the EU's Bank Recovery and Resolution Directive (BRRD) in Finland.

We then consider the likelihood of jurisdictional support, which for mortgage programs in Finland we assess as very strong. This leads us to apply three notches of uplift from the RRL to determine the jurisdiction-supported rating level (JRL), which we therefore assess as 'aa-'.

We have reviewed the asset information provided as of Dec. 31, 2016. The program's underlying assets comprise €550.5 million of Finnish residential mortgage loans (42.7%) and loans to housing companies (57.3%). Based on our cash flow analysis, the available credit enhancement in the program exceeds the target credit enhancement, which means that covered bonds are eligible for up to four notches of collateral-based uplift. We do not reduce the total collateral-based uplift by any notches owing to Hypo's public statement committing to maintain a level of overcollateralization that is consistent with the current rating, and because we consider that the soft-bullet structure of the liabilities covers liquidity risk for 180 days.

There are currently no rating constraints to the 'AAA' ratings relating to counterparty and country risks.

We have based our analysis on the criteria articles referenced in the Related Criteria section.

Potential effects of proposed criteria changes

Our ratings are based on our applicable criteria, including our "Covered Bonds Criteria," published on Dec. 9, 2014.

However, the resolution regime analysis section of this criteria is under review (see "Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings," and "Request for Comment: Methodology For Assigning Financial Institution Resolution Counterparty Ratings," both published on Jan. 31, 2017).

As a result of this review, we may amend certain paragraphs of our covered bonds criteria. This change may affect the ratings on the outstanding covered bonds issued under this covered bond program. Until this time, we will continue to rate and surveil these covered bonds using our existing criteria (see "Related Criteria").

Program Description

Table 1

Program Overview*

Jurisdiction	**Finland**
Year of first issuance	2016
Covered bond type	Legislation-enabled
Covered bonds (mil. €)	400
Redemption profile	Soft bullet
Underlying assets	Residential mortgages and housing association loans
Jurisdictional support uplift	3
Unused notches for jurisdictional support	0
Target credit enhancement (%)	19.87
Available credit enhancement (%)	35.92
Collateral support uplift	4
Unused notches for collateral support	1
Total unused notches	1

*Based on data as of March 2017.

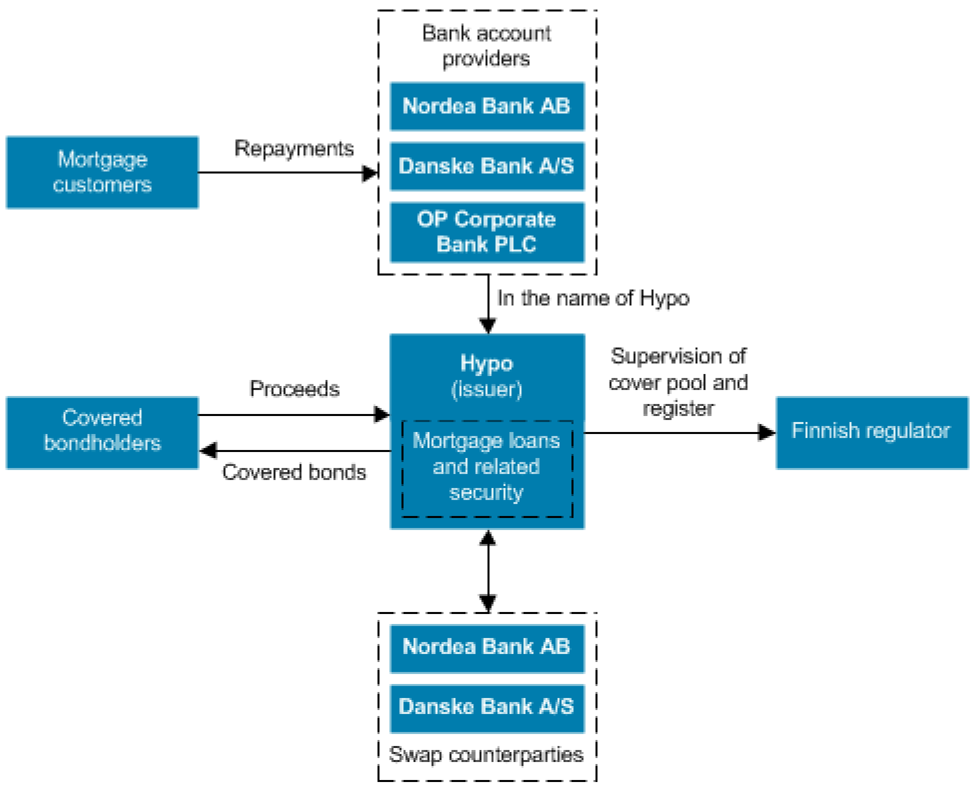
Hypo established in 2016 a €1.5 billion program from which senior unsecured notes, subordinated debentures, and covered bonds can be issued. The covered bonds issued from the program are secured by a cover pool of Finnish residential mortgage loans and loans to Finnish housing associations.

Hypo is a licensed credit institution and mutual company founded in 1860, with the sole purpose of granting long-term loans against mortgage or other safeguarding collateral. The customers of the bank are members of the society as long as they have loans outstanding and no arrears. The bank is only active in the Helsinki metropolitan area, the Uusimaa region, and in specified growth centers in Finland (with a positive track record in property values and population). Hypo operates solely from its headquarters in Helsinki and services its clients also through online and telephone banking.

The covered bonds under the program are the direct, unconditional, and unsubordinated debt obligations of the issuer and rank pari passu among themselves. The covered bonds are secured by a cover pool of euro-denominated Finnish residential mortgage loans and loans to housing companies. The issuances are also denominated in euros. The covered bondholders have a priority claim on the cover pool's assets.

Chart 1

The Mortgage Society of Finland Covered Bond Program Transaction Structure



Covered Bond Program Participants

Role	Name	Rating	Rating dependency
Issuer	The Mortgage Society of Finland	BBB/Stable/A-2	Yes
Originator	The Mortgage Society of Finland	BBB/Stable/A-2	No
Bank account	Nordea Bank AB	AA-/Stable/A-1+	Yes
Bank account	Danske Bank A/S	A/Stable/A-1	Yes
Bank account	OP Corporate Bank PLC	AA-/Stable/A-1+	Yes
Swap counterparty	Nordea Bank AB	AA-/Stable/A-1+	No

Covered Bond Program Participants (cont.)			
Role	**Name**	**Rating**	**Rating dependency**
Swap counterparty	Danske Bank A/S	A/Stable/A-1	No

Rating Analysis

Legal and regulatory risks

In our legal risk analysis, we applied our European legal criteria (see "Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017). The Finnish Covered Bond Act of 2010 sets out the legal framework for issuing Finnish covered bonds. In our opinion, the Finnish covered bond legal framework is in line with the relevant legal requirements of our covered bond criteria. This enables us to rate the covered bonds above the long-term ICR on Hypo.

Under the Covered Bond Act, if the issuer defaults, covered bondholders have a preferential claim to the cover pool. They can also initiate regular insolvency proceedings against the issuer. Under the legislation, the cover pool can comprise residential mortgage loans, commercial mortgage loans, public-sector loans, and substitute assets from European Economic Area countries.

Under the legal framework, the cover pool's assets must be registered in the issuer's cover pool to be isolated from the issuer's other assets in the event of insolvency. The issuer must report the information in the register to the Finnish regulator quarterly. The register also includes the counterparties to derivative contracts, which must be able to survive the issuer's insolvency. This means that swap counterparties would continue performing with no claim to the cover pool.

If the issuer were to become insolvent, the Finnish regulator would appoint a special cover pool administrator to supervise the covered bondholders' interests. If necessary, the administrator can sell assets to make payments on the covered bonds. The administrator could also accelerate the payment of the covered bonds if it considers this to be in the bondholders' best interests, subject to Finnish regulatory approval. We consider this scenario to be rating remote, as our credit and cash flow analysis accounts for the ability of the cover pool to service the payments on the covered bonds.

To facilitate liquidity management, up to 15% of a mortgage cover pool can temporarily include substitute assets, and up to 20% of state, municipal, or other public-sector or financial entities assets.

Under the Covered Bond Act, the issuer's bankruptcy would not result in the covered bonds' early redemption or the suspension of payments to bondholders. Accordingly, we rate the covered bonds on the basis of their legal final maturity.

Operational and administrative risks

Hypo is a licensed credit institution and mutual company founded in 1860, with the sole purpose of granting mortgage loans to Finnish households and housing associations. The bank originates its loans in the Helsinki metropolitan area, the Uusimaa region, and other specified growth areas in Finland. Hypo's sole physical branch is located in Helsinki. Its services are complemented through online and telephone banking.

Hypo's credit underwriting policy consists of three main documents: General Terms (approved by the Supervisory Board), Credit Policy (approved by the Board of Directors), and the Employee Authorization (approved by Hypo's management group). We view Hypo's underwriting criteria as prudent, as reflected by the low average LTV ratio of its loan book and low historical levels of nonperforming loans.

In our opinion, there is no operational risk from the cover pool's management and loan origination that would constrain the covered bond ratings to the same level as the long-term ICR. Furthermore, we believe that it is highly likely that a replacement servicer would be appointed if the issuer were to become insolvent. We consider Finland to be an established covered bond market and we believe that the mortgage assets in Hypo's cover pool do not have product features that would materially limit the range of available replacement cover pool managers or servicers.

Our analysis of operational and administrative risks follows the guidelines in our criteria (see "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015).

Resolution regime analysis

Hypo is domiciled in Finland, which is part of the EU's Bank Recovery and Resolution Directive (BRRD). We assess the systemic importance of Finish mortgage covered bond programs as very strong (see "Assessments For Jurisdictional Support According To Our Covered Bonds Criteria," published on July 20, 2016). Under our covered bonds criteria, this means the RRL can be two notches above the adjusted long-term ICR (adjusted by removing the uplift allocated to reflect extraordinary government support to the issuer). This uplift recognizes that resolution regimes like the BRRD increase the probability that an issuer could service its covered bonds even following a default on its senior unsecured obligations because the law exempts covered bonds from bail-in risk if there is a bank resolution. We consider this as an internal form of support, because the bail-in of certain creditors of the issuer does not require direct government support. As a result, we assess the RRL as 'a-'.

Jurisdictional support analysis

In our jurisdictional support analysis, we assess the likelihood that a covered bond program facing stress would receive support from a government-sponsored initiative instead of from the liquidation of collateral assets in the open market.

Our assessment of the expected jurisdictional support for Finnish mortgage covered bond programs is very strong (see "Assessments For Jurisdictional Support According To Our Covered Bond Criteria," published on July 20, 2016). Under our covered bonds criteria, this means that the program can receive up to three notches of jurisdictional uplift from the RRL. This leads to a JRL for Hypo's mortgage covered bonds of 'aa-'. The JRL cannot exceed the rating on the sovereign providing the support to the covered bond, which in this case is 'AA+'.

Collateral support analysis

The cover pool comprises Finnish residential mortgage loans and housing company loans originated by The Mortgage Society of Finland. We base our analysis on loan-by-loan data as of a cut-off date of Dec. 31, 2016.

The cover pool includes loans granted to borrowers with multiple loan parts and, in some occasions, backed by different properties. These loans currently represent on average almost 38% of the property's current value. Finnish property prices have generally risen since 1996 but have stabilized in recent years. House prices and income levels have tended to move in tandem, suggesting that the housing market is not materially overvalued.

The weighted-average seasoning of the portfolio is around four years and the interest rate on almost 99% of the loans is floating.

We assess the credit quality of a typical residential mortgage cover pool by estimating the credit risk associated with each loan in the pool. The analysis of the residential mortgage loans is based on "Methodology And Assumptions: Assessing Pools Of European Residential Loans," published on Dec. 23, 2016. The analysis of the housing company loans is based on "Analyzing European Commercial Real Estate Collateral In European Covered Bonds," published on March 31, 2015.

We then calculate the aggregate risk to assess the overall credit quality of the cover pool. In order to quantify the potential losses associated with the entire pool, we weight each loan's foreclosure frequency and loss severity by its percentage of the total pool balance. The product of the weighted-average foreclosure frequency (WAFF) and weighted-average loss severity (WALS) estimates the required loss protection, assuming all other factors remain unchanged.

As of December 2016, the WAFF and WALS for the pool are 24.37% and 13.70%, respectively. These figures are slightly higher than in our last review (22.84% and 10.43%). The main reason behind the increase is the larger share of loans granted to housing associations, which we view as having a higher credit risk when compared against residential mortgages. We based these metrics on the 'AAA' credit stresses that we applied.

Table 3

Hypo Covered Bond Program Cover Pool Composition

Asset type	As of December 31, 2016		As of April 22, 2016	
	Value (mil. €)	**Percentage of cover pool (%)**	**Value (mil. €)**	**Percentage of cover pool (%)**
Residential mortgages	234,892,643	42.67	185,008,564	50.27
Housing association loans	315,605,184	57.33	183,021,203	49.73
Total	550,497,827	100	368,029,767	100

Table 4

Hypo Covered Bond Program Key Credit Metrics

	As of December 31, 2016	As of April 22, 2016
Weighted-average Current LTV ratio (%)	37.27	37.90
Weighted-average loan seasoning (months)*	49.44	44.66
Balance of loans in arrears (%)	0.75	2.23
Buy-to-let loans (%)	5.11	2.32
Interest-only loans (%)	15.06	22.46
Credit analysis results:		
Weighted-average foreclosure frequency (WAFF; %)	24.37	22.84
Weighted-average loss severity (WALS; %)	13.7	10.43
AAA' credit risk (%)	3.4	3.24
Country averages:		
WAFF (%)	20.21	19.05

Table 4

Hypo Covered Bond Program Key Credit Metrics (cont.)		
	As of December 31, 2016	As of April 22, 2016
WALS (%)	17.97	15.34
AAA' credit risk (%)	9.96	10.29

*Seasoning refers to the elapsed loan term.

Table 5

Hypo Covered Bond Program LTV Ratios		
	As of December 31, 2016	As of April 22, 2016
Current LTV (%)	**Percentage of cover pool (%)**	**Percentage of cover pool (%)**
0-10	12.31	13.99
10-20	20.06	18.94
20-30	16.75	18.87
30-40	13.23	9.96
40-50	8.41	8.80
50-60	6.87	6.81
60-70	6.85	7.85
70-80	10.73	12.09
80-90	2.11	1.42
>90	2.68	1.27
Weighted-average LTV ratios	37.27	36.53

Table 6

Hypo Covered Bond Program Loan Seasoning Distribution*		
	AS of December 31, 2016	As of April 22, 2016
	Percentage of portfolio (%)	**Percentage of portfolio (%)**
0-60	77.13	76.68
60-72	6.88	4.08
72-84	4.43	4.55
84-96	4.01	4.17
96-108	2.46	3.63
108-120	1.79	2.34
More than 120	3.30	4.55
Weighted-average loan seasoning (months)	49.44	44.66

*Seasoning refers to the elapsed loan term.

Table 7

Hypo Covered Bond Program Geographic Distribution Of Loan Assets		
	As of December 31, 2016	As of April 22, 2016
Top five concentrations	**Percentage of cover pool (%)**	**Percentage of cover pool (%)**
East	0.26	0.75
Oulu	2.66	0.19
West	14.28	21.63

Table 7

Hypo Covered Bond Program Geographic Distribution Of Loan Assets (cont.)

	As of December 31, 2016	As of April 22, 2016
Top five concentrations	**Percentage of cover pool (%)**	**Percentage of cover pool (%)**
South	82.78	77.38
Lapland	0.02	0.05
Total	100	100

According to our criteria, the maximum potential collateral-based uplift on a covered bond program above the JRL is four notches. We then make adjustments to the maximum collateral-based uplift by reviewing the coverage of six months of liquidity and the level of commitment for the overcollateralization. The covered bonds issued by Hypo benefit from any public commitment on the level of overcollateralization. Additionally, the program includes soft-bullet issuances (with a 12-month an extendable maturity). Therefore, the maximum collateral uplift remains at four notches.

By applying our credit and cash flow stresses, we calculate a target credit enhancement of 19.87%, down from the 22.14% target credit enhancement as of April 2016. The decrease is primarily due to a significant improvement in the asset-liability structure of the program following the issuance of the second covered bond under the program in 2017. This has driven the narrowing of the maturity gap between the cover pool and the outstanding covered bonds.

The target credit enhancement is less than the available credit enhancement of 35.92%, allowing for the full four notches of collateral-based uplift. With a JRL of 'aa-', the program only requires three notches of collateral uplift to attain a 'AAA' rating. The overcollateralization that is commensurate the rating is therefore 15.75% (which corresponds to 'AAA' credit risk plus 75% refinancing costs).

Table 8

Hypo Covered Bond Program Collateral Uplift Metrics

	As of March 31, 2017	As of April 22, 2016
Asset WAM (years)	9.21	9.02
Liability WAM (years)	5.62	5
Available credit enhancement	35.92	47.21
Target credit enhancement for maximum uplift (%)	19.87	22.14
Potential collateral-based uplift (notches)	4	4
Adjustment for liquidity (Y/N)	N	N
Adjustment for committed overcollateralization (Y/N)	N	N
Collateral support uplift (notches)	4	4

WAM--Weighted-average maturity.

Counterparty risk

We have identified several counterparty risks to which the covered bonds are exposed. However, as these are either structurally addressed in line with our current counterparty criteria or taken into account in our cash flow modeling, we believe that they do not constrain the rating from a counterparty risk perspective (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013 and "Counterparty Risk Analysis In Covered Bonds," published on Dec. 21, 2015).

Bank account provider

Payments from borrowers are made into a number of external bank accounts in Hypo's name. The accounts benefit from replacement language consistent with our counterparty criteria.

Swaps

The program benefits from swaps with Nordea Bank AB and Danske Bank A/S to swap the variable interest earned on the assets to fixed interest, payable on the covered bond. However, the contracts do not reflect our current counterparty criteria. As our covered bond ratings are above the long-term ICR on the swap counterparty, we consider that the latter could default and leave the covered bond program unhedged.

The deviations in the swap contracts from our counterparty criteria cannot be classified as a "variant". This means that, according to our covered bond counterparty criteria, the covered bond rating could not exceed the higher of the issuer's RRL plus one notch, the JRL and the counterparty's long-term ICR unless, the available credit enhancement were to be sufficient to cover the risk of a default of the derivative counterparty. All this is subject to the termination payments being subordinated to payments on the covered bonds.

We understand that, if the issuer defaults, any termination payments will be subject to Hypo's bankruptcy estate and the cover pool will not take over the issuer's obligations under the swap agreements.

As a result, we have performed our cash flow analysis without giving credit to the swaps in the transaction. Conversely, we also look at the case where the swap counterparty performs and look at the cash flows including the swaps. We then retain the most conservative result.

Country risk

We assess country risk by applying our ratings above the sovereign criteria (see "Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published on Aug. 8, 2016). Under these criteria, we consider that the assets in the pool have a moderate sensitivity to country risk. According to our criteria, due to the 12-month maturity extension feature of the issued covered bond, we can rate the covered bond up to four notches above the rating on the sovereign, Finland (AA+/Stable/A-1+). Based on the current sovereign rating, country risk does not constrain our rating on the covered bond.

Related Criteria And Research

Related criteria

- Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Assessing Pools Of European Residential Loans, Dec. 23, 2016
- Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, Aug. 8, 2016
- Counterparty Risk Analysis In Covered Bonds, Dec. 21, 2015
- Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
- Methodology And Assumptions: Analyzing European Commercial Real Estate Collateral In European Covered Bonds, March 31, 2015
- Covered Bonds Criteria, Dec. 9, 2014
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Methodology: Credit Stability Criteria, May 3, 2010

- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related research

- Ratings Affirmed At 'AAA' On The Mortgage Society of Finland's Mortgage Covered Bonds Following Review; Outlook Stable, May 30, 2017
- Global Covered Bond Characteristics And Rating Summary Q1 2017, April 20, 2017
- Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings, Jan. 31, 2017
- Request For Comment: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, Jan. 31, 2017
- Banking Industry Country Risk Assessment: Finland, Jan. 30, 2017
- The Mortgage Society of Finland, Sept. 19, 2016
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Jul. 20, 2016
- Assessments For Target Asset Spreads According To Our Covered Bonds Criteria, Aug. 15, 2016

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