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The Mortgage Society of Finland

Primary Credit Analyst:
Salla von Steinaecker, Frankfurt (49) 69-33-999-164; salla.vonsteinaecker@spglobal.com

Secondary Contact:
Olivia Fleischmann, Stockholm (46) 8-440-5904; olivia.fleischmann@spglobal.com

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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/Stable/A-2

Major Rating Factors

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

Outlook: Stable

The outlook on The Mortgage Society of Finland (Hypo, or the bank) is stable. We believe that the improving economic environment and the sound growth in construction activity in Finland are aiding Hypo to reach its targeted loan growth over the next two years. We expect the bank to remain committed to high asset quality in loan origination and to elevated capitalization underpinned by its status as a mutual company.

We could lower the ratings if Hypo 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.

A positive rating action is, in our view, remote at this stage. It could be triggered by an improved funding profile demonstrated by more diversified funding mix and funding metrics in line with domestic peers.

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 additionally the government supportiveness towards 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'.

Table 1

The Mortgage Society of Finland -- Key Figures

		--Year ended Dec. 31--			
(Mil. €)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	2,624	2,302	1,958	1,499	1,219
Customer loans (gross)	2,035	1,807	1,421	1,204	978
Adjusted common equity	110	107	102	96	90
Operating revenues	9	18	17	17	14
Noninterest expenses	6	10	9	10	8
Core earnings	3	6	6	6	5

*As of June 30.

Business position: Monoline profile as residential mortgage financer in Finland

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

Hypo, with total assets of €2.6 billion as of June 2017, is a licensed bank and mutual company operating under Finland's Act on Mortgage Societies and is governed by its members. Hypo grants long-term loans to Finnish households and housing companies solely against a mortgage or other safeguarding collateral. The bank is active only in Helsinki, southern Finland, and in specified growth centers in the rest of the country and operates solely from its headquarters in Helsinki. This allows it, in our view, to operate more cost efficiently than its larger domestic peers.

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. Notwithstanding the concentrations in Hypo's business profile and its elevated growth targets, we consider that management has a conservative approach to risks and a very low risk appetite. The bank's conservative culture is also underpinned by Hypo's mutual legal structure, which subordinates short-term financial profitability targets. We don't anticipate any changes to Hypo's strategy, which is clearly defined by the Act of Mortgage Societies.

Hypo's revenues consist of:

- Net interest income from first-lien mortgages related to Finnish residential mortgages and loans to housing companies (45% of total operating revenues in first half 2017);
- Income from investments in housing and land property owned by Hypo (18%);
- Fee and commission income from lending, deposits, residential property trustee services (21%); and
- Net income from securities, financial assets, and other income (16%).

We expect this split will remain unchanged in the foreseeable future.

Table 2

The Mortgage Society of Finland -- Business Position					
		--Year ended Dec. 3100			
	2017*	2016	2015	2014	2013
Total revenues from business line (mil. €)	9	18	17	17	14
Commercial & retail banking/total revenues from business line	N.M.	98.53	97.29	94.67	95.64
Other revenues/total revenues from business line	N.M.	1.47	2.71	5.33	4.36
Return on equity	4.74	5.82	6.30	6.74	5.85

*As of June 30. N.M.--Not meaningful.

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 16%-17% over the next 24 months, compared with 18.1% as of Dec. 31, 2016.

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 2017-2018, driven primarily by improved margins benefiting from lower funding costs, and through increased lending volumes. As a mutual company, Hypo does not pay out dividends. Consequently, the retained profits are solely used for capital build-up. We expect the return on equity to hover around 6.0% in 2017-2019 (5.8% in 2016).

We consider Hypo's quality of capital to be adequate due to the small absolute size of its capital base 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. The net interest income and net fee and commission income constitute a major part of revenues, while the stable income from property holdings constitutes the remainder. The income from property holding is unusual compared with peers'. However, we understand Hypo is holding high-quality assets and does not display an opportunistic approach to achieving quick market value gains.

Table 3

The Mortgage Society of Finland -- Capital And Earnings

		--Year ended Dec. 31--			
(Mil. €)	**2017***	**2016**	**2015**	**2014**	**2013**
Tier 1 capital ratio	13.20	13.59	13.80	15.07	14.00
S&P RAC ratio before diversification (%)	N.M.	18.06§	18.63	19.71	20.36
S&P RAC ratio after diversification (%)	N.M.	9.87§	11.48	11.53	11.52
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Net interest income/operating revenues	44.37	30.35	27.44	37.25	37.66
Fee income/operating revenues	21.15	25.01	20.49	20.92	19.39
Market-sensitive income/operating revenues	14.79	17.23	11.43	16.10	0.73
Noninterest expenses/operating revenues	64.94	57.09	54.91	56.37	57.38
Preprovision operating income/average assets	0.25	0.36	0.43	0.55	0.56
Core earnings/average managed assets	0.21	0.29	0.36	0.45	0.46

*As of June 30. §According to S&P Global Ratings' "Risk-Adjusted Capital Framework Methodology," published July 20, 2017, on RatingsDirect. RAC--Risk-adjusted capital. N.M.--Not meaningful.

Table 4

The Mortgage Society of Finland Risk-Adjusted Capital Framework Data

	Exposure*	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global Ratings RWA**	**Average S&P Global Ratings RW (%)**
Credit risk					
Government and central banks	327,341,699	2,703,095	1	7,899,249	2
Institutions and CCPs	99,061,308	29,740,610	30	16,392,301	17
Corporate	122,271,601	76,275,923	62	51,538,679	42
Retail	1,797,928,665	533,757,245	30	422,218,716	23
Of which mortgage	1,734,863,294	514,426,452	30	402,314,798	23
Securitization§	0	0	0	0	0
Other assets†	68,224,870	68,188,708	100	67,420,972	99
Total credit risk	2,414,828,143	710,665,581	29	565,469,916	23
Credit valuation adjustment					
Total credit valuation adjustment	--	3,240,800	--	0	--
Market risk					
Equity in the banking book	132,375	132,375	100	1,323,748	1,000
Trading book market risk	--	0	--	0	--
Total market risk	--	132,375	--	1,323,748	--
Operational risk					
Total operational risk	--	28,964,946	--	23,468,518	--
		Basel III RWA		**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification		743,003,702		590,262,182	100

Table 4

The Mortgage Society of Finland Risk-Adjusted Capital Framework Data (cont.)				
Total Diversification/Concentration Adjustments	--		489,559,146	83
RWA after diversification	743,003,702		1,079,821,328	183
	Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings RAC ratio (%)**
Capital ratio				
Capital ratio before adjustments	100,939,643	13.6	106,622,538	18.1
Capital ratio after adjustments‡	100,939,643	13.6	106,622,538	9.9

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes deferred tax assets (DTAs) not deducted from ACE. ‡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, 2016, 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. We view positively the bank'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. Hypo's loan book of €2 billion demonstrates strong asset quality underpinned by high collateralization, with a weighted average loan-to-value ratio (LTV) of 38.3% as of June 30, 2017, which we assess to be lower than that of many specialized mortgage lenders in Europe. We anticipate that total nonperforming loans will remain at the current low of 0.20% of the loan portfolio (0.13% as of June 30, 2017)--well below the Finnish average.

We do not expect the bank will compromise its cornerstone conservative lending policies and high collateralization for targeted loan growth of 12%-20% in 2017-2019 (relatively evenly split between retail and housing companies). We therefore anticipate that Hypo will continue demonstrating 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.

Table 5

The Mortgage Society of Finland -- Risk Position					
		--Year ended Dec. 31--			
	2017*	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	25.26	27.19	17.96	23.12	34.85
Total diversification adjustment / S&P RWA before diversification	N.M.	82.94§	62.32	70.91	76.77
Total managed assets/adjusted common equity (x)	23.89	21.62	19.25	15.58	13.61
New loan loss provisions/average customer loans	0.00	0.02	0.00	0.00	0.00
Gross nonperforming assets/customer loans + other real estate owned	0.13	0.11	0.16	0.23	0.10

Table 5

The Mortgage Society of Finland -- Risk Position (cont.)					
		--Year ended Dec. 31--			
	2017*	2016	2015	2014	2013
Loan loss reserves/gross nonperforming assets	N/A	31.36	15.61	12.63	32.30

*As of June 30. §According to S&P Global Ratings' "Risk-Adjusted Capital Framework Methodology," published July 20, 2017, on RatingsDirect. RWA--Risk-weighted assets. N.M.--Not meaningful. N/A--Not available.

Funding and liquidity: Matched funding profile but dependent 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 arranged via wholesale funding, representing about 50% of total funding as of June 30, 2017, and is composed mainly of senior unsecured notes and, since 2016, also covered bonds. We view positively the well-matched funding profile. We believe that Hypo's funding mix will enable the bank to reduce the funding costs and improve the net interest margin in the next two years. The customer deposits constitute about 50% of the funding base and are mainly 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 157% as of June 30, 2017, continues to be weak in a peer comparison.

To improve its funding profile, Hypo aims to spread the maturities of its capital market funding mainly through the issuance of covered bonds. This is reflected in an 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. The bank has optimized its liquidity portfolio by increasing the size and by shifting the allocation chiefly to government and covered bonds. The liquidity portfolio of €514 million consists of cash and European Central Bank-eligible securities with 93% invested in counterparties with a rating of 'AA-' or above. As anticipated, these 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, 2017.

Table 6

The Mortgage Society of Finland -- Funding And Liquidity					
		--Year ended Dec. 31--			
(Mil. €)	2017	2016	2015	2014	2013
Core deposits/funding base	52.52	55.46	56.80	34.04	28.41
Customer loans (net)/customer deposits	157.39	150.16	136.71	257.24	310.22
Long term funding ratio	86.42	87.75	83.44	81.98	83.25
Stable funding ratio	103.45	103.56	102.97	93.29	92.63
Short-term wholesale funding/funding base	14.19	12.85	17.46	19.26	18.06
Broad liquid assets/short-term wholesale funding (x)	1.41	1.40	1.27	0.83	0.74
Net broad liquid assets/short-term customer deposits	10.99	9.31	8.28	(10.15)	(20.54)
Short-term wholesale funding/total wholesale funding	29.88	28.85	40.42	29.20	25.23
Narrow liquid assets/3-month wholesale funding (x)	12.75	6.70	4.50	1.55	1.80

No uplift for external support

We consider Finland to have a fully-fledged resolution regime in place since January 2016. Since Hypo has low systemic importance, in our view it would unlikely be subject to a well-defined bail-in process. As such we do not consider the additional loss absorbing criteria to be applicable to it.

Additional Rating Factors

No additional factors affect this rating.

Related Criteria

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment Update: September, Sept. 8, 2017
- Nordic Banks Improve Their Capital Thanks To Steady Retained Earnings And Hybrid Issuance, July 12, 2017
- Nordic Banking Regulation Compared, July 10, 2017
- Banking Industry Country Risk Assessment: Finland, Jan. 30, 2017
- Various Positive Rating Actions On Finnish Banks On Improved Economic Conditions, Nov. 17, 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 14, 2017)

The Mortgage Society of Finland	
Counterparty Credit Rating	BBB/Stable/A-2
Senior Secured	AAA/Stable
Senior Unsecured	BBB
Counterparty Credit Ratings History	
26-Apr-2017	BBB/Stable/A-2
17-Nov-2016	BBB/Stable/A-3
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.

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@spglobal.com