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The Mortgage Society of Finland

Primary Credit Analyst:
Marcus Kylberg, Stockholm + 46 8 440 5916; marcus.kylberg@spglobal.com

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

Research Contributor:
Sophie Nehrer, Frankfurt; sophie.nehrer@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/Negative/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Very strong risk-adjusted capitalization. • Strong asset quality and exceptional loan-loss track record in the past decades. • Very conservative lending and underwriting standards.	• Monoline business model as a pure residential mortgage financer. • Concentration and cyclical risk due to focus on residential mortgage lending. • Less stable deposit base compared with peers.

Outlook: Negative

The negative outlook on The Mortgage Society of Finland (Hypo) reflects our view that the weakening Finnish economy, induced by the COVID-19 pandemic, could weaken the bank's growth and profitability targets over the next two years.

Downside scenario

A prolonged recovery in Finland's export-oriented economy could adversely affect the Finnish banking sector's performance. 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 also take a negative rating action if Hypo failed to maintain its very strong capital and earnings in line with our expectations. At the same time we believe that Hypo's better-than-average portfolio quality and its loan loss track record provide more cushion in comparison with local peers.

Upside scenario

We could revise the outlook to stable if the Finnish economy proved more resilient than we expect over the next 12-24 months.

Rationale

Our ratings on Hypo reflect our anchor of 'a-' for Finnish banks, and our view of its concentrated niche business operations, which are focused on residential mortgage lending to households and housing companies in the Helsinki Metropolitan Area and other growth cities. The rating is supported by the very strong capital and earnings position, based mainly on our expectation of a risk-adjusted capital (RAC) ratio of 16.0%-17.0% in the next 12-24 months, which will continue to provide a robust buffer to absorb potential losses related to the COVID-19 induced recession, in our opinion.

We consider regional and product concentration risks in the retail mortgage loan book to be partly offset by Hypo's very conservative underwriting standards, strong asset quality, and exceptional loan-loss track record. In our view, Hypo's funding profile is weaker than that of domestic peers due to its dependence on wholesale funding, while we view liquidity as adequate owing to the company's comfortable liquidity position.

We do not factor any extraordinary support into our 'BBB' long-term issuer credit rating because we regard Hypo as having low systematic importance in Finland and we do not believe that the response to a non-viability of Hypo would be a bail-in resolution.

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

To determine a bank's anchor, we use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores. The anchor is the starting point in assigning an issuer credit rating under our criteria for banks. For a commercial bank like Hypo that operates only in Finland, we determine an anchor of 'a-'. The anchor is based on an economic risk score of '2' and an industry risk score of '3'.

We now see economic risk for Finland's Banking Industry Country Risk Assessment to be on a negative trend. If we saw more pronounced economic distress or weaker and delayed recovery, with cost of risk for the banking system exceeding our current expectations, we could negatively reassess economic risk on the Finnish banking sector.

We view Finland as an innovative, wealthy, and open economy, with mature political and institutional structures. The near-term economic picture has brightened following a prolonged recession over 2012-2015. The COVID-19 pandemic however is an unprecedented challenge and will send Finland into deep recession in 2020, in our opinion. After an anemic final quarter of 2019, Finland was already facing a muted growth outlook, with lower exports, weakening consumer confidence, and only moderate credit demand from households. Although we expect recovery in 2021, it is likely going to be less pronounced than in other Nordic countries. That said, the wide-ranging fiscal, monetary, and regulatory support measures will, in our view, partially mitigate this sharp shock to the Finnish economy, and so support the stability of the banking system.

We currently do not see major domestic economic imbalances in the Finnish economy since house prices have stabilized nationwide over the past years. Despite the decreased activity amid COVID-19, we do not project a correction in the real estate market. However, we see a risk of weaker private-sector debt-servicing capacity, especially from small and midsize enterprises (SMEs), which could lead to materially higher credit losses for banks. The historically high indebtedness of Finnish households could potentially also be a mounting credit risk for the banking sector (if not curbed by macroprudential measures). Still, in our base case, we forecast moderate credit losses from households despite increasing unemployment, increasing use of amortization, and more muted credit demand, before returning to pre-crisis levels in 2021-2022.

In our view, regulatory standards and bank supervision in Finland are in line with those of European peers. Despite the concentrated banking sector--dominated by the two major banking groups, OP Financial Group and Nordea, and underpinned by intense competition and low lending margins--we believe the sector's overall profitability and capitalization will remain resilient and we expect banks to maintain their restrained risk appetite. We therefore expect the Finnish banking sector to be well prepared to weather the current shock although business prospects will weaken through 2021. We believe that the risk of tech disruption remains moderate given the banks' digital customer offerings and ongoing investments in innovation.

In our view, the dependence on external funding makes Finnish banks vulnerable to changes in confidence sensitivity, but they continue to demonstrate good access to capital markets. Additionally, the Nordic banking system remains highly interconnected, which results in potential spillover risks on the Finnish economy from external events.

Table 1

The Mortgage Society of Finland--Key Figures

	--Year ended December 31--				
(Mil. €)	**2020***	**2019**	**2018**	**2017**	**2016**
Adjusted assets	3,114.7	3,227.0	3,111.0	2,789.7	2,302.4
Customer loans (gross)	2,535.0	2,586.4	2,589.3	2,212.9	1,807.1
Adjusted common equity	125.3	125.4	118.7	113.1	106.6
Operating revenues	4.9	20.7	18.2	17.7	17.7
Noninterest expenses	3.9	12.3	11.0	11.1	10.1

Table 1

The Mortgage Society of Finland--Key Figures (cont.)

	--Year ended December 31--				
(Mil. €)	**2020***	**2019**	**2018**	**2017**	**2016**
Core earnings	0.8	6.8	5.9	5.5	6.1

*Data for 2020 as of first quarter.

Business position: Monoline profile as residential mortgage financer in Finland

Our assessment of Hypo's business position reflects our view of the bank as a small monoline player with a concentrated niche market position focused purely on residential mortgage lending to households and housing companies. Our expectation of continued business stability from Hypo's operations partly offsets its concentrated business profile and we expect the bank to produce resilient core earnings through 2022, despite the harmful economic consequences of the COVID-19 pandemic.

Hypo, with total assets of €3.1 billion and a loan portfolio of €2.5 billion as of March 31, 2020, is a licensed bank and a mutual company operating under Finland's Act on Mortgage Societies and is governed by its members. The bank has a marginal market share of roughly 0.8% in Finnish home mortgages and 1% in the total lending market in 2019. 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 specified growth centers in the rest of the country. Hypo operates solely from its headquarters in Helsinki and had 56 employees in March 2020.

We view Hypo's narrow product focus on residential mortgage lending as the main weakness of 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, we consider management to have a conservative approach to risk and a very low risk appetite. The bank's conservative culture is also underpinned by its mutual legal structure, which subordinates short-term financial profitability targets. We do not anticipate any changes to Hypo's strategy, which is clearly defined by the Act of Mortgage Societies.

We expect Hypo's revenue split will remain fairly unchanged in the foreseeable future. At first-quarter 2020, Finnish residential mortgages and loans to housing companies accounted for 75% of total operating revenue and fee and commission income from lending deposits, and residential property trustee services amounted to 17%. In addition, income from investments in housing and land property owned by Hypo continued to form a minor part at 7.5%.

The bank's cost-to-income ratio of 59.6% in 2019 (79.8% at first-quarter 2020, including resolution fund contribution) is in line with the domestic average. That said, we expect the planned information technology investments in core-banking systems renewal will increase operating costs over the next two years, which will weigh on Hypo's cost-to-income ratio through 2022.

Table 2

The Mortgage Society of Finland--Business Position

	--Year ended December 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Loan market share in country of domicile	N/A	1.0	1.1	1.0	N/A

Table 2

The Mortgage Society of Finland--Business Position (cont.)					
	--Year ended December 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Deposit market share in country of domicile	N/A	1.0	1.1	1.0	N/A
Total revenues from business line (mil. €)	4.9	20.7	18.2	17.8	19.4
Commercial & retail banking/total revenue from business line	100.0	100.0	99.3	97.8	98.5
Other revenues/total revenues from business line	0.0	0.0	0.7	2.2	1.5
Return on average common equity	2.4	5.5	5.0	4.9	5.8

*Data for 2020 as of first quarter. N/A--Not applicable.

Capital and earnings: Robust capitalization, supported by profit retention as a mutual company

We expect Hypo's capital and earnings to remain very strong over the next two years. This is mainly based on our expectation that our projected RAC ratio for the bank will be in the range of 16.0%-17.0% throughout 2022. As of Dec. 31, 2019, the bank's RAC ratio equalled 16.9%.

We expect Hypo's loan growth to amount to 2% through 2022, which reflects our assumption of muted demand in this COVID-19-induced recession. We also expect Hypo will focus more on maintaining stable margins instead of loan growth in the next two years and that loan growth will be fairly balanced between retail and housing company loans, confirming Hypo's low risk appetite.

We expect Hypo's interest income from loans to be somewhat lower in 2020 than 2019, due to turbulent market conditions and a cautious lending approach, followed by growth in 2021-2022, spurred primarily by improved margins from lower funding costs and gradually improving lending volumes. Net interest income and net fee and commission income constitute a major part of the bank's revenue, while the stable income from property holdings constitutes a minor part. Income from property holdings is unusual compared with peers'. However, we think Hypo holds high-quality assets and does not display an opportunistic approach to achieving quick market value gains.

As a mutual company, Hypo does not pay dividends. Consequently, the retained profits are solely used for capital buildup which is relatively stable over 2020-2022. Furthermore, we expect the return on average equity will be around 3.7% by 2021, and remain lower in comparison with peer banks.

As of April 6, 2020, the Finnish Supervision Authority made the decision to remove the systemic risk buffer of 1% to support banks' lending capacity amid COVID-19. However, we do not expect that this will have any major effect on the Hypo's growth or capital targets. Hypo exceeds current regulatory capital requirements with a common equity tier 1 ratio of 13.6% as of March 31, 2020.

Although Hypo's capital base consists solely of core capital, we consider its quality of capital to be weaker than rated peers because of the small absolute size of its capital base and its limited financial 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.

Table 3

The Mortgage Society of Finland Capital And Earnings

	--Year ended December 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Tier 1 capital ratio	13.6	13.4	12.1	12.7	13.6
S&P Global Ratings' RAC ratio before diversification	N/A	16.9	15.9	17.1	18.1
S&P Global Ratings' RAC ratio after diversification	N/A	10.0	9.0	9.7	9.9
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenue	75.4	69.8	67.7	50.8	30.3
Fee income/operating revenue	17.1	17.2	20.8	19.9	25.0
Market-sensitive income/operating revenue	(9.0)	(0.5)	(4.5)	12.1	17.2
Noninterest expenses/operating revenue	79.8	59.6	60.6	62.5	57.1
Preprovision operating income/average assets	0.1	0.3	0.2	0.3	0.4
Core earnings/average managed assets	0.1	0.2	0.2	0.2	0.3

*Data for 2020 as of first quarter. N/A--Not applicable

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	503,366,238.0	0.0	0.0	8,610,474.2	1.7
Of which regional governments and local authorities	138,747,851.0	0.0	0.0	4,994,922.6	3.6
Institutions and CCPs	76,619,055.0	19,097,183.0	24.9	11,800,234.9	15.4
Corporate	54,738,056.0	18,426,540.0	33.7	9,725,143.8	17.8
Retail	2,644,041,292.0	748,192,152.0	28.3	611,685,683.3	23.1
Of which mortgage	2,582,115,761.0	738,062,433.0	28.6	598,792,645.0	23.2
Securitization§	0.0	0.0	0.0	0.0	0.0
Other assets†	67,531,993.0	67,410,768.0	99.8	66,672,528.2	98.7
Total credit risk	3,346,296,634.0	853,126,643.0	25.5	708,494,064.4	21.2
Credit valuation adjustment					
Total credit valuation adjustment	--	6,815,512.5	--	0.0	--
Market risk					
Equity in the banking book	132,374.8	132,374.8	100.0	1,323,748.2	1,000.0
Trading book market risk	--	0.0	--	0.0	--
Total market risk	--	132,374.8	--	1,323,748.2	--
Operational risk					
Total operational risk	--	36,346,775.0	--	32,684,518.5	--
	Exposure	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification	--	896,421,305.3	--	742,502,331.1	100.0

Table 4

The Mortgage Society of Finland--Risk-Adjusted Capital Framework Data (cont.)					
Total diversification/ concentration adjustments	--	--	--	506,188,552.3	68.2
RWA after diversification	--	896,421,305.3	--	1,248,690,883.3	168.2
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC Ratings ratio (%)**
Capital ratio					
Capital ratio before adjustments		120,028,576.0	13.4	125,370,600.0	16.9
Capital ratio after adjustments‡		120,028,576.0	13.4	125,370,600.0	10.0

*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 2019', S&P Global Ratings.

Risk position: Exceptional asset quality and loan-loss track record, but concentration on retail mortgage lending in Finland

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

This concentration risk is partly mitigated by Hypo's conservative underwriting standards, which we do not expect the bank to compromise. The bank's loan book of €2.5 billion on March 31, 2020, demonstrates strong asset quality underpinned by high collateralization. The average loan-to-value ratio stood at 35.2% on March 31, 2020, which we assess to be very low and more conservative than many specialized mortgage lenders in the Nordics. Furthermore, 99% of Hypo's loans are amortizing and 1% are bullet loans.

Due to the ongoing COVID-19 crisis, we expect finish banks' asset quality to come under pressure. While we expect some higher losses in the unsecured lending and the SME segment, we still believe that losses in residential mortgages will remain low. We understand that since the Finnish Banking Crisis in the 1990s, 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. Hypo's loan-loss track record in recent decades is outstanding compared with peers', in our view.

We do not expect the bank will abandon its conservative lending policies and high collateralization for targeted loan growth. We therefore anticipate that Hypo will continue demonstrating an exceptional loan-loss track record over 2020-2021. We anticipate that total nonperforming loans will remain at the current level of €6.6 million or 0.26% of the loan portfolio as of March 31, 2020--well below the average of peer banks.

Table 5

The Mortgage Society of Finland--Risk Position					
	--Year ended December 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Growth in customer loans	(8.0)	(0.1)	17.0	22.5	27.2

Table 5

The Mortgage Society of Finland--Risk Position (cont.)

	--Year ended December 31--				
(%)	2020*	2019	2018	2017	2016
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	68.2	77.1	76.5	82.9
Total managed assets/adjusted common equity (x)	24.9	25.8	26.2	24.7	21.6
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	0.3	0.1	0.1	0.1	0.1
Loan loss reserves/gross nonperforming assets	3.8	9.1	20.1	9.7	31.4

*Data for 2020 as of first quarter. RWA--Risk-weighted assets. N/A--Not applicable.

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

In our view, Hypo's funding profile is more confidence-sensitive and prone to volatility during adverse market and economic conditions compared with domestic peers. This reflects Hypo's predominantly wholesale funding profile, with covered bonds representing 42% of total funds on March 31, 2020. This is above the ratio of its Finnish peer banks but compares well with banks in Norway and Sweden, which have a similar funding assessment. Core customer deposits constituted about 52% of the funding base as of March 31, 2020, and are mainly from housing companies and institutional clients, which we consider in general to be less stable than retail deposits in times of stress.

Through the issuance of covered bonds, Hypo continues to improve upon its funding maturity, resulting in a well-matched funding profile. We expect this to have a positive effect on the stable funding ratio, which was 110% on Dec. 31, 2019. Asset encumbrance has increased somewhat during the past years because of covered bond issuances, but we believe Hypo will have the appetite and capacity for further issuances.

We consider Hypo's liquidity as adequate. On March 31, 2020, Hypo had a liquidity position of about €475 million (15.2% of total assets), consisting mainly of cash (55%) at the Finnish Central Bank and European Central Bank-eligible debt securities with a credit rating of at least 'AA-'. We believe that under stressful conditions involving the closure of capital markets, Hypo could survive for more than six months without dependence on central bank operations. Moreover, Hypo's broad liquid assets to short-term wholesale funding multiple increased to 3.7x by Dec. 31, 2019 (2.5x in 2018), due to a decline in short-term wholesale funding. Hypo's adequate liquidity profile is also demonstrated by its liquidity coverage ratio (LCR) of 142.6% as of March 31, 2020, satisfying the regulatory minimum of 100%. We understand that Hypo is targeting a LCR well above the regulatory minimum.

Having said that, we note that Hypo's monoline business model, small size, and relatively high share of wholesale funding may require stronger liquidity buffers in a stress event than larger, more diversified peers. We could therefore negatively assess Hypo's liquidity profile if the bank manages its liquidity buffers more aggressively, leading to a substantial weakening of its liquidity ratios.

Table 6

The Mortgage Society of Finland--Funding And Liquidity

	--Year-ended December 31--				
(%)	2020*	2019	2018	2017	2016
Core deposits/funding base	51.6	53.6	58.2	58.2	55.5

Table 6

The Mortgage Society of Finland--Funding And Liquidity (cont.)

	--Year-ended December 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Customer loans (net)/customer deposits	167.9	158.8	150.7	143.6	150.2
Long-term funding ratio	96.1	96.2	94.4	87.7	87.7
Stable funding ratio	N/A	110.2	108.0	104.1	103.6
Short-term wholesale funding/funding base	4.1	3.9	5.8	12.8	12.9
Broad liquid assets/short-term wholesale funding (x)	N/A	3.7	2.5	1.4	1.4
Net broad liquid assets/short-term customer deposits	33.7	20.1	15.2	9.1	9.3
Short-term wholesale funding/total wholesale funding	8.4	8.5	13.9	30.7	28.9
Narrow liquid assets/3-month wholesale funding (x)	N/A	77.7	5.3	12.0	6.7

*Data for 2020 as of first quarter. N/A--Not applicable.

Support: No uplift for external support and no resolution counterparty ratings

In our view, Finland has had a fully-fledged resolution regime in place since January 2016. Since Hypo has low systemic importance, we believe it is unlikely to be subject to a well-defined bail-in process. Therefore, we do not consider the additional loss-absorbing criteria to be applicable, nor do we think that Hypo is eligible for our resolution counterparty rating (RCR). RCRs recognize the default risk of certain bank liabilities that rank senior to other liabilities in a resolution. In our view, the response to a non-viability of Hypo will not be a bail-in resolution.

Related Criteria

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

Related Research

- Banking Industry Country Risk Assessment Updated: June 2020, June 26, 2020
- COVID-19: Resilient Fundamentals And Assertive Policy Measures Will Buoy Nordic Banking Systems, June 16, 2020
- Seven Finnish Banks Outlooks Revised to Negative On Deepening COVID-19 Downside Risks, May 19, 2020

- EMEA Financial Institutions Monitor 2Q2020: Resilient But Not Immune To COVID-19, May 14, 2020
- How COVID-19 Risks Prompted European Bank Rating Actions, April, 29, 2020
- European Banks' First-Quarter Results: Many COVID-19 Questions, Few Conclusive Answers, April 1, 2020
- Banking Industry Country Risk Assessment: Finland, Oct. 9, 2019

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 August 13, 2020)*	
The Mortgage Society of Finland	
Issuer Credit Rating	BBB/Negative/A-2
Senior Secured	AAA/Negative
Issuer Credit Ratings History	
19-May-2020	BBB/Negative/A-2
26-Apr-2017	BBB/Stable/A-2
17-Nov-2016	BBB/Stable/A-3
31-Aug-2015	BBB/Negative/A-3
Sovereign Rating	
Finland	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