

## Research

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# Transaction Update: OP Mortgage Bank

## €15 Billion Medium-Term Covered Bond Program

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### Ratings Detail

Reference Rating Level	aa+	+	Jurisdiction-Supported Rating Level	aa+	+	Maximum Achievable Covered Bond Rating	aaa	=	Covered Bond Rating	
Resolution Regime Uplift	+2		Jurisdictional Support Uplift	+3		Collateral Support Uplift	+3		AAA/Stable	
Systemic Importance	Very Strong		Jurisdictional Support Assessment	Very Strong		Overcollateralization Adjustment	-1		Rating Constraints	aaa
Adjusted Issuer Credit Rating	aa-		Legal Framework	Very Strong		Liquidity Adjustment	0		Counterparty Risk	aaa
GRE And Sovereign Support	0		Systemic Importance	Very Strong		Available Credit Enhancement	+4		Country Risk	aaa
Issuer Credit Rating	AA-		Sovereign Credit Capacity	Very Strong						

### Major Rating Factors

#### Strengths

- The cover pool's assets are seasoned Finnish residential mortgage loans, which have low current weighted-average loan-to-value (LTV) ratios compared with Scandinavian peers.
- The interest rate characteristics of the mortgage assets are matched to the liabilities through swaps
- The ratings on the covered bonds benefit from three unused notches of jurisdictional support and two unused notches of collateral based uplift.

#### Weaknesses

- There is no legally binding obligation for the issuer to provide excess overcollateralization to maintain the currently assigned rating on the program.
- The issuer has no commitment to cover six-month's liquidity and despite issuing a majority of soft bullet covered bonds, a minor percentage are hard bullets, which may require additional liquidity for repayment.
- Due to the high level of fixed installment mortgages included in the cover pool, any increase in interest rates will result in delayed repayment of the mortgage assets.

## **Outlook: Stable**

The stable outlook reflects the fact that the ratings on the covered bonds benefit from three unused notches of jurisdictional support and two notches of unused collateral based uplift under our covered bond criteria (see "Covered Bonds Criteria," published on Dec. 9, 2014 and "Methodology And Assumptions For Analyzing Mortgage Collateral In Finnish And Norwegian Covered Bonds," published on Dec. 10, 2014). Therefore, if we were to lower our long-term issuer credit rating (ICR) on OP Corporate Bank PLC, we would not necessarily lower our ratings on the covered bonds. We could downgrade the covered bonds if the available credit enhancement were to decrease below the credit enhancement commensurate with the current ratings.

## **Rationale**

We are publishing this transaction update as part of our review of OP Mortgage Bank (OPMB)'s covered bond program.

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

We conducted a review of OPMB'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.

The issuer is a core entity to its parent, the OP Financial Group, and we derive the starting point of our analysis from the long-term ICR on OP Corporate Bank, whose rating reflects the creditworthiness of the wider OP Financial Group. OPMB is domiciled in Finland, which is part of the European monetary union (EMU). As of Jan. 1, 2016, Finland has fully implemented the Bank Recovery and Resolution Directive (BRRD), and our analysis gives credit to the eventual adoption of BRRD. Therefore, under our covered bonds criteria, we assess the reference rating level (RRL) as 'aa+'. The RRL is derived by removing any sovereign support incorporated in the ICR and adding two notches of uplift to reflect extraordinary government support to the issuer and the increased probability that the issuer can service its covered bonds due to the implementation of BRRD and the very strong systemic importance of covered bonds in Finland.

We consider the likelihood for the provision of jurisdictional support. Based on a very strong jurisdictional support assessment for mortgage programs in Finland, we may assign up to three notches of uplift from the RRL. However, the jurisdictional support uplift is limited by our long-term rating of the Finnish sovereign. Therefore, we assess the jurisdiction-supported rating level (JRL) as 'aa+'.

The covered bonds are eligible for four notches of collateral-based uplift, although this is reduced to three because of the lack of committed overcollateralization that is commensurate with the ratings. We consider that the soft bullet structure of the majority of the liabilities covers liquidity risk. At the same time, the European Central Bank (ECB) will remain a possible source of assistance for EMU covered bond issuers during a sovereign default, in our view (see

"Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published on Aug. 8, 2016).

Our credit and cash flow analysis is based on the cover pool as of June 30, 2016. At this time, the program's underlying assets comprise €10.512 billion of Finnish residential mortgage loans. Our measure of the weighted-average foreclosure frequency (WAFF; representing the level of defaults) stands at 16.50% (15.02% as of Q1 2015), and the weighted-average loss severity (WALS; our measure of possible losses upon default) at 16.98% (18.65% as of Q1 2015), based on a 'AAA' stress level. As of June 30, 2016, the current outstanding covered bonds total €9.095 billion.

The program's available credit enhancement of 15.59% (9.45% at Q1 2015) significantly exceeds the 3.66% target credit enhancement that we currently view as being commensurate with our 'AAA' ratings on the covered bonds.

The program's documented replacement frameworks address counterparty risk in accordance with our counterparty criteria (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013 and "Counterparty Risk Analysis In Covered Bonds," published on Dec. 21, 2015).

We assess country risk by applying our nonsovereign ratings criteria. In light of our 'AA+' sovereign rating on Finland, and the country's membership in the EMU, country risk does not constrain our 'AAA' ratings on the covered bonds.

## Program Description

**Table 1**

Program Overview*	
Jurisdiction	Finland
Year of first issuance	2011
Covered bond type	Legislation-enabled
Outstanding covered bonds (bil. €)	9,095
Redemption profile	Yes
Underlying assets	Finnish residential mortgage loans
Jurisdictional support uplift	3
Unused notches for jurisdictional support	3
Target credit enhancement (%)	3.66
Available credit enhancement (%)	15.59
Collateral support uplift	3
Unused notches for collateral support	2
Total unused notches	5

\*Based on data as of June 30, 2016.

OPMB established the €15 billion mortgage covered bond program to issue series of covered bonds, which are secured on a cover pool of residential mortgage loans. The assets are registered in the cover asset register and the covered bondholders have a priority claim on the cover pool's assets. The program's first issuance was in 2011. OPMB established the program following the enactment of the new Finnish Covered Bond Act in 2010. This program is OPMB's only remaining covered bond issuance platform.

The issuer is a part of the OP Financial Group, a statutory amalgamation of the Finnish cooperative banks. The group

is a financial consortium under the Act on Amalgamations of Deposit Banks. The group established OPMB to refinance its prime mortgage assets by issuing covered bonds. Its funding plans are an integral part of the cooperative group's funding strategy. OPMB is also subject to the Covered Bond Act, which provides specific regulations for a Finnish covered bond issuer.

The program's covered bonds are the issuer's direct unconditional and unsubordinated debt obligations and rank pari passu among themselves. The covered bonds are secured on a cover pool of euro-denominated Finnish residential mortgage loans. The outstanding liabilities are all denominated in Euro.

Chart 1

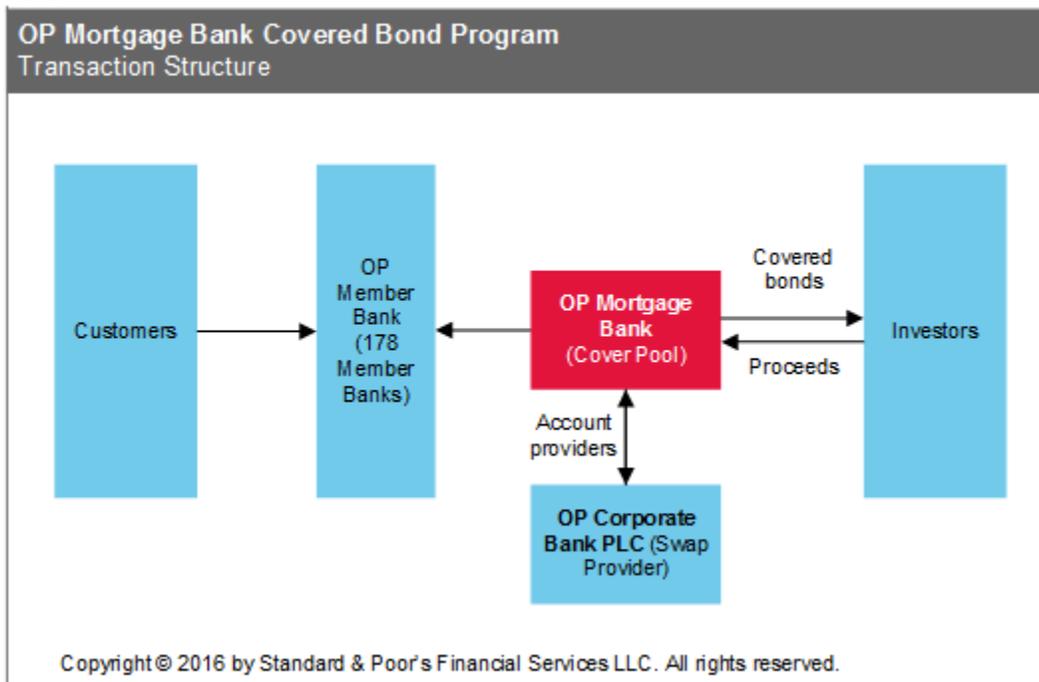


Table 2

Program Participants			
Role	Name	Rating	Rating dependency
Issuer	OP Mortgage Bank	N/A*	Yes
Originator	OP Mortgage Bank	N/A§	No
Bank account provider	OP Corporate Bank PLC	AA-/Negative/A-1+	Yes
Swap counterparty	OP Corporate Bank PLC	AA-/Negative/A-1+	Yes

\*Under our group rating methodology, the issuer is a core entity to its parent, the OP Financial Group. Therefore, we derive the ratings on the covered bonds by applying notches of uplift to the long-term ICR on OP Corporate Bank PLC, whose rating reflects the creditworthiness of the wider OP Financial Group. §Mortgage loan origination by member banks of the wider OP Financial Group. N/A--Not applicable.

## Rating Analysis

## **Legal and regulatory risks**

In our legal risk analysis, we applied our European legal criteria (see "Europe Asset Isolation And Special-Purpose Entity Criteria--Structured Finance," published on Sept. 13, 2013). 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 OP corporate Bank.

If the issuer defaults, bondholders can initiate regular insolvency proceedings. In addition, under the Covered Bond Act, they have a preferential claim to a cover pool. 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 monthly. The register also includes the counterparties to derivative contracts, which must be able to survive the issuer's insolvency.

If the issuer becomes insolvent, the Finnish regulator would appoint a special cover pool administrator to supervise the covered bondholders' interests. If necessary, the administrator can sell assets or accelerate the payment of the covered bonds if it considers this to be in the bondholders' best interests, subject to Finnish regulatory approval.

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

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**

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). The mortgage loan business is OP Financial Group's core business. OP Financial Group's central cooperative institution is headquartered in Helsinki and sets the group's basic lending criteria. However, OPMB can set additional limits. OPMB's credit risks are reported and compared with the set risk limits on a monthly basis and an internal audit is carried out at least once a year. The cover pool may include loans in arrears, which have installments that are 90 days overdue or less. These loans are not part of the program's eligible balance. The cover pool currently includes 0.05% of loans that are more than 30 days in arrears.

We consider the issuer's underwriting and servicing standards to be sufficient to support our ratings on the covered bonds. We therefore did not apply any analytical adjustments to account for operational and administrative risks.

## **Resolution regime analysis**

OPMB's covered bonds are subject to refinancing risk due to mismatches between the maturities of the mortgage assets in the cover pool and the covered bonds. As a result, we link the covered bond rating to the issuer's creditworthiness and determine the maximum achievable covered bond rating above the long-term ICR by analyzing the factors set out in our criteria.

OPMB is domiciled in Finland, which is part of the EU. Finland implemented BRRD legislation in the beginning of 2016. Therefore, under our covered bonds criteria, we assess the RRL as 'aa+', reflecting the long-term ICR on the issuer, and adding two notches of support under our covered bond criteria as we assess the systemic importance of covered bonds as very strong.

### Jurisdictional support analysis

Under our analysis of jurisdictional support in our covered bonds criteria, we determine a JRL, which is our assessment of the creditworthiness of a covered bond program once we have considered the level of jurisdictional support, but before giving credit to the amount of collateral.

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 Bonds Criteria," published on Dec. 22, 2015). Under our covered bonds criteria, this means that the program can receive up to three notches of jurisdictional uplift from the RRL considering the current sovereign rating on Finland. This leads to a JRL for OPMB's mortgage covered bonds of 'aa+'. The JRL cannot exceed the rating of the sovereign providing the support to the covered bond.

### Collateral support analysis

We based our credit analysis on loan-by-loan data as of June 30, 2016. The pool comprises seasoned loans that are secured on Finnish residential properties. Since our last review, mortgage loans have been transferred from OPMB's now redeemed "old program" and the cover pool now reflects the inclusion of a number of low LTV and highly seasoned mortgage loans.

**Table 3**

Cover Pool Composition				
Asset type	June 31, 2016		March 31, 2015	
	Value (mil. €)	Percentage of cover pool (%)	Value (mil. €)	Percentage of cover pool (%)
Finnish residential mortgage loans	10.513	100	8.041	100
Substitute assets	0	0	0	0
Other asset type	0	0	0	0
Total	10.513	100	8.041	100

As of the cut-off date, the WAFF is 16.5% (as of Q1 2015) and the WALs is 16.98% (18.6% as of Q1 2016). The WAFF and WALs reflect the credit criteria which set a floor or minimum projected losses of 4.00% at the 'AAA' rating level. We mainly attribute the change in the WAFF and WALs to the minimum projected loss and the increase in original LTVs. The decrease in WALs is further driven by higher current valuations.

**Table 4**

Key Credit Metrics		
	June 31, 2016	March 31, 2015
Average loan size (€)	50,180	54,380
Weighted-average LTV ratio (%)	43.80	43.60
Weighted-average original LTV ratio (%)	66.30	62.10

**Table 4**

<b>Key Credit Metrics (cont.)</b>		
	<b>June 31, 2016</b>	<b>March 31, 2015</b>
Weighted-average loan seasoning (months)*	69.00	56.90
Balance of loans in arrears (%)	0.05	0.10
Buy-to-let loans (%)	0.60	0.53
Other relevant characteristic (e.g., self-employed borrowers)	3.27	3.37
Credit analysis results		
Weighted-average foreclosure frequency (WAFF; %)	16.50	15.02
Weighted-average loss severity (WALS; %)	16.98	18.65
AAA credit risk (%)	2.80	2.80

\*Seasoning refers to the elapsed loan term. LTV--Loan to value. N/A--Not applicable.

**Table 5**

<b>Covered Pool Assets By Loan Size</b>		
	<b>June 31, 2016</b>	<b>March 31, 2015</b>
<b>(€ '000s)</b>	<b>Percentage of cover pool (%)</b>	
0 to 100	53.8	50.1
100 to 200	35.1	37.6
200 to 300	7.9	9.3
300 to 400	1.9	1.9
400 to 500	0.7	0.6
500 to 600	0.3	0.2
Greater than 600	0.3	0.2

**Table 6**

<b>Current LTV Ratios</b>		
	<b>June 31, 2016</b>	<b>March 31, 2015</b>
<b>(%)</b>	<b>Percentage of cover pool (%)</b>	
0-60	80.02	80.60
60-70	14.96	9.90
70-80	4.53	5.90
80-90	0.33	2.90
90-100	0.05	0.60
Above 100	0.11	0.20
Total above 80	0.49	9.60
Weighted-average LTV ratios	43.84	43.60

LTV--Loan-to-value.

**Table 7**

<b>Original LTV Ratios</b>		
	<b>As of June 31, 2016</b>	<b>As of March 31, 2015</b>
<b>(%)</b>	<b>Percentage of cover pool (%)</b>	
0-60	36.62	64.23

**Table 7**

<b>Original LTV Ratios (cont.)</b>		
	<b>As of June 31, 2016</b>	<b>As of March 31, 2015</b>
<b>(%)</b>	<b>Percentage of cover pool (%)</b>	
60-70	16.71	17.72
70-80	16.48	10.15
80-90	14.77	6.07
90-100	5.99	1.13
Above 100	9.43	0.69
Total above 80	30.19	7.89
Weighted-average LTV ratios	66.30	62.06

LTV--Loan-to-value.

**Table 8**

<b>Loan Seasoning Distribution*</b>		
	<b>June 31, 2016</b>	<b>March 31, 2015</b>
	<b>Percentage of portfolio (%)</b>	
Less than 18 months	10.01	12.6
18 to 60	38.69	47.8
More than 60	51.3	39.6
Weighted-average loan seasoning (months)	69.1	57

\*Seasoning refers to the elapsed loan term.

According to our criteria, the maximum potential collateral based uplift on a covered bond program above the JRL is four notches. We then look to 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. For OPMB, the majority of covered bonds includes a 12-month maturity extension, which combined with the countries membership of the EMU we consider to satisfy the six-month liquidity coverage. OPMB does not provide a commitment for overcollateralization. Therefore we do not consider any commitment and the collateral-based uplift is limited to three notches.

We conducted our cash flow analysis by applying the "Methodology and Assumptions for Analyzing Mortgage Collateral in Finnish and Norwegian Covered Bonds," published on Dec. 10, 2014.

The cover pool consists of 68% equal installment mortgage loans with variable maturity. The installment paid by the borrower must always cover interests, but may lead extension of repayments should the whole installment be used for interest. Of the pool, 16% are variable interest loans, while 10 % are constant annuities where installment remains the same. The loan period will not change as interest rates change, but any residual payment is due on the final repayment date. Our analysis of the covered bonds' payment structure indicates that the assets' cash flows would be sufficient to make timely payment of interest and ultimate payment of principal to the bondholders at a 'AAA' level.

We analyze cash flows under 'AAA' credit stresses, as well as liquidity and interest rate stresses. We consider various default and prepayment patterns. We model the program on a post-swap basis by considering the swap that is in place to hedge interest rate mismatches between the assets and liabilities. To assess market value risk, we apply a target

asset spread in our cash flow analysis. We apply a spread of 425 basis points (bps) as outlined in our relevant criteria (see "Assessments For Target Asset Spreads According To Our Covered Bonds Criteria," published on Dec. 22, 2015).

Based on our cash flow analysis considering the cover pool as of June 30, 2016, we have determined that the available credit enhancement of 15.59% exceeds the target credit enhancement of 3.66%, which we consider to be commensurate with a 'AAA' rating.

**Table 9**

<b>Geographic Distribution Of Loan Assets</b>		
	<b>June 31, 2016</b>	<b>March 31, 2015</b>
	<b>Percentage of cover pool (%)</b>	
Southern Finland	44.8	44.1
Eastern Finland	9.8	10.2
Western Finland	34.3	33.6
Oulu	9.5	10.1
Lapland	1.4	1.6
Aland	0.2	0.2
Total	100	100

### Counterparty risk

In our opinion, the program's structural features address its counterparty risk exposure, which therefore does not constrain our rating.

### Bank account provider

OP Corporate Bank is the cover pool's bank account provider. Its commitment to replace itself if its short-term rating falls below 'A-1' mitigates bank account risk.

### Commingling risk

The borrowers make payments to the bank account of the member banks that originated the loans. These funds are credited to the cover pool account on a daily basis. OPMB has a claim against OP Corporate Bank for any amounts credited to this account, and OP Corporate Bank waives all deposit set-off rights against these funds. If the short-term rating on OP Corporate Bank falls below 'A-1', it will open and maintain an issuer collection account with a bank rated at least 'A-1'. All borrower payments following a downgrade of OP Corporate Bank would be transferred to the issuer's collection account on daily basis. If the long-term ICR on OP Corporate Bank falls below 'BBB', within 30 days, the issuer will notify all borrowers to pay directly to the issuer's collection account, thereby mitigating commingling risk.

### Swaps

OPMB has entered into hedging agreements with OP Corporate Bank to address interest rate mismatches between the assets and liabilities. There are no currency mismatches, as all of the assets and liabilities are euro-denominated. The interest rate swap documentation is consistent with our counterparty criteria for achieving a maximum rating of 'AAA'. Additionally, OPMB has guaranteed to replace itself as swap counterparty should we lower its ICR to below 'A', or 'BBB+' if it posts collateral. We therefore gave credit to the swaps in our cash flow modeling.

## Country risk

We assess country risk by applying our ratings above the sovereign criteria. In light of the long-term 'AA+' sovereign rating on Finland and the country's membership in the EMU, country risk does not constrain our 'AAA' ratings on the covered bonds. Our 'AA+' sovereign rating caps the achievable rating on the transaction based on the JRL. However, as OPMB is based in an EMU sovereign, we can assign a rating equal to the lower of a three-notch rating elevation above the sovereign and the rating that could be assigned based on the application of our covered bonds criteria. The rating is limited to three notches above the sovereign as not all bonds are extendable.

## Related Criteria And Research

### Related criteria

- Criteria - Structured Finance - Covered Bonds: Counterparty Risk Analysis In Covered Bonds – Dec. 21, 2015
- General Criteria: Methodology: Credit Stability Criteria - May 03, 2010
- Criteria - Structured Finance - General: Global Derivative Agreement Criteria - June 24, 2013
- Criteria - Structured Finance - Covered Bonds: Methodology And Assumptions For Analyzing Mortgage Collateral In Finnish And Norwegian Covered Bonds - December 10, 2014
- Criteria - Structured Finance - Covered Bonds: Covered Bonds Criteria - December 09, 2014
- Criteria - Structured Finance - Covered Bonds: Covered Bond Ratings Framework: Methodology And Assumptions – June 30, 2015
- Criteria - Structured Finance - General: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions – August 8, 2016
- Legal Criteria: Europe Asset Isolation And Special-Purpose Entity Criteria--Structured Finance - September 13, 2013
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions - June 25, 2013
- General Criteria: Understanding Standard & Poor's Rating Definitions - June 03, 2009
- Criteria - Structured Finance - Covered Bonds: Methodology And Assumptions For Assessing Portfolios Of International Public Sector And Other Debt Obligations Backing Covered Bonds And Structured Finance Securities - December 09, 2014
- General Criteria: Group Rating Methodology - November 19, 2013

### Related research

- Global Covered Bond Characteristics And Rating Summary Q2 2016, July 7, 2016
- Finland Ratings Affirmed At 'AA+/A-1+'; Outlook Remains Negative , March 18, 2016
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Dec. 22, 2015
- Assessments For Target Asset Spreads According To Our Covered Bonds Criteria, Dec. 22, 2015
- Pohjola Bank PLC, August 24, 2015
- Ratings Affirmed On OP Mortgage Bank's Covered Bonds Following Revised Criteria Application; Outlook Stable, June 4, 2015
- Banking Industry Country Risk Assessment: Finland, Jan. 29, 2015
- Outlook Assumptions For The Finnish Residential Mortgage Market, Jan. 12, 2015
- Covered Bond Monitor: Technical Note, Feb. 14, 2006

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