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Research

Transaction Update: OP Mortgage Bank

€15 Billion Medium-Term Covered Bond Program

Primary Credit Analyst:
Casper R Andersen, London (44) 20-7176-6757; casper.andersen@spglobal.com

Secondary Contact:
Alejandro Marcilla, Madrid +34 91 389 69 44; alejandro.marcilla@spglobal.com

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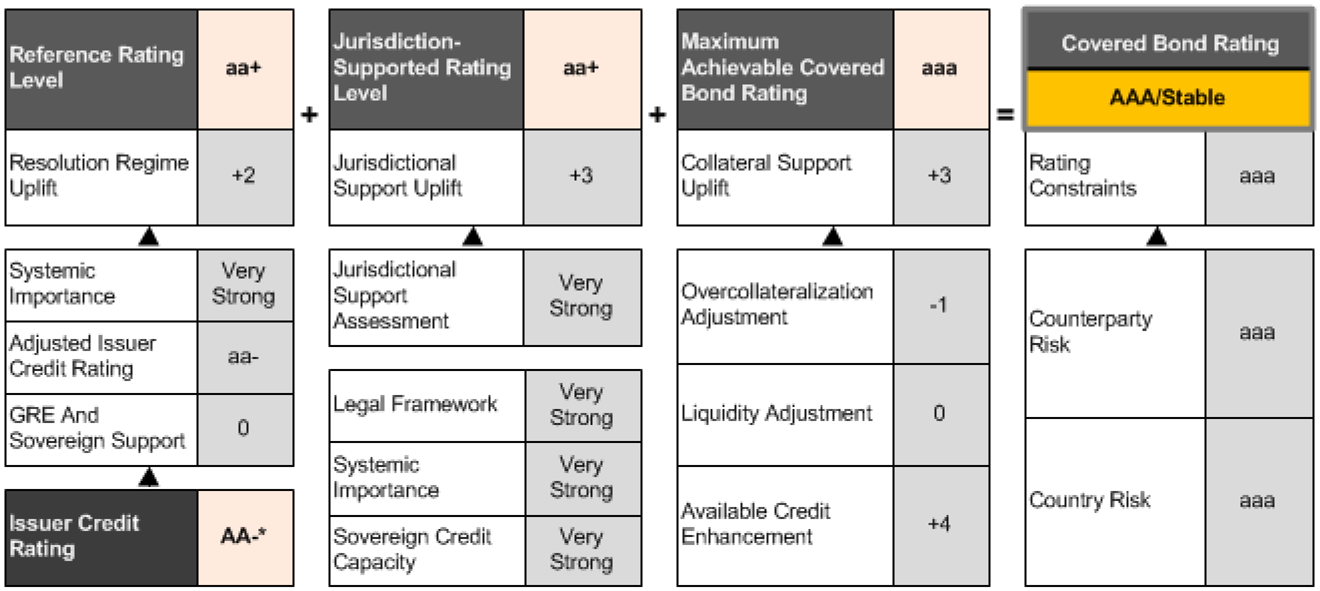
Ratings Detail



*We use the long-term rating on OP Corporate Bank PLC, which reflects the creditworthiness of OP Financial Group to which OP Mortgage Bank is considered a core entity.

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 principal repayment of the mortgage assets and a potential borrower payment shock.

Outlook: Stable

The stable outlook reflects 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 "Assessing Pools Of European Residential Loans," published on Aug. 4, 2017). 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 on 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, which 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 vast 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 analysis is based on the cover pool as of March 31, 2017 while the cash flow analysis reflects the cover pool as of June 30, 2017. At this time, the program's underlying assets comprise €11.944 billion of Finnish residential mortgage loans. Our measure of the weighted-average foreclosure frequency (WAFF; representing the level of defaults) stands at 16.21% (16.50% as of Q2 2016), and the weighted-average loss severity (WALS; our measure of possible losses upon default) at 17.28% (16.98% as of Q2 2016), based on a 'AAA' stress level. As of June 30, 2017, the current outstanding covered bonds total €9.835 billion.

The program's available credit enhancement of 21.45% (15.59% as of Q2 2016) significantly exceeds the 3.52% 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. €)	9,835
Redemption profile	Yes
Underlying assets	Finnish residential mortgage loans
Jurisdictional support uplift	3
Unused notches for jurisdictional support	3
Target credit enhancement (%)	5.41
Available credit enhancement (%)	21.45
Collateral support uplift	3
Unused notches for collateral support	2
Total unused notches	5

*Based on cash flows as of June 30, 2017.

OPMB established the €15 billion mortgage covered bond program to issue a 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.

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 Finnish covered bond law allows deposit banks and credit societies to participate indirectly in the issue of covered bonds by means of intermediary loans granted by a mortgage credit bank.

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

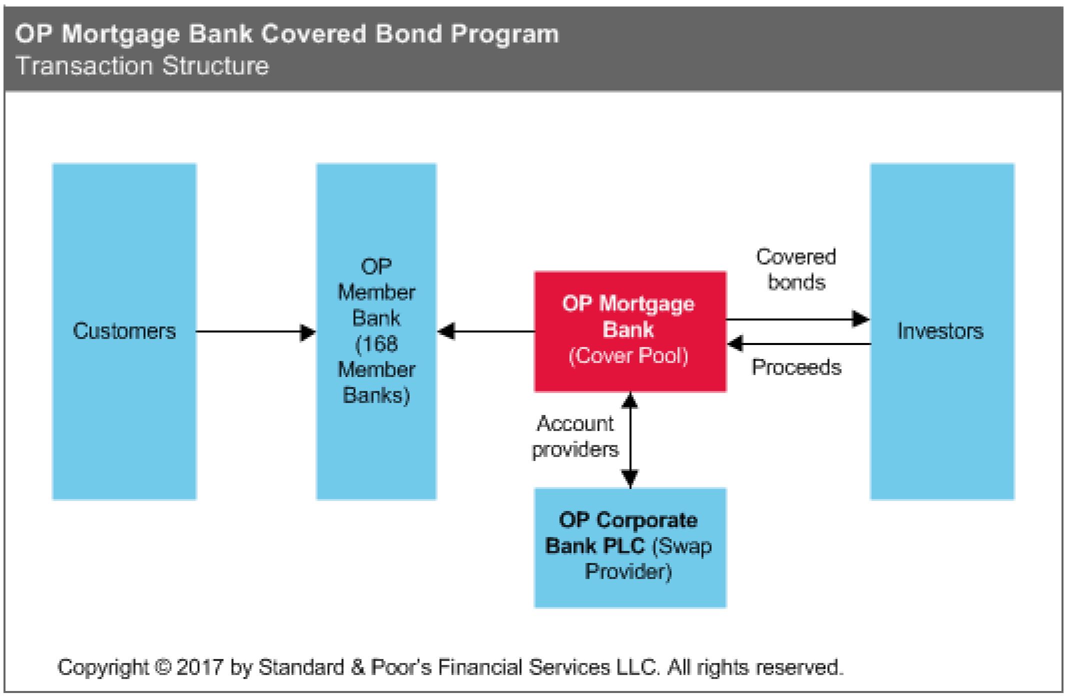


Table 2

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-/Stable/A-1+	Yes
Swap counterparty	OP Corporate Bank PLC	AA-/Stable/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.

The Finnish covered bond law allows deposit banks and credit societies to participate indirectly in the issue of covered bonds by means of intermediary loans granted by a mortgage credit bank. The cover pool currently includes 32% of mortgages funded by intermediary loans. We consider the security of the collateral backing intermediary loans to be comparable to direct transferred mortgage loans. We therefore consider all intermediary loans as would they already be transferred to the cover pool.

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, supplies administrative assistance, and is responsible for debt collection. OPMB can set additional limits to the lending criteria and actively selects loans to be included in the cover pool, manages the cover pool, and issues covered bonds. 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 0.04% 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 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 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, 2017. The pool comprises seasoned loans that are secured on Finnish residential properties.

Table 3

Cover Pool Composition

Asset type	June 30, 2017		March 31, 2017		June 30, 2016	
	Value (mil. €)	**Percentage of cover pool (%)**	**Value (mil. €)**	**Percentage of cover pool (%)**	**Value (mil. €)**	**Percentage of cover pool (%)**
Finnish residential mortgage loans	11,944	100	10.99	100	10.51	100
Substitute assets	0	0	0	0	0	0
Other asset type	0	0	0	0	0	0
Total	11,944	100	10.99	100	10.51	100

As of the cut-off date, the WAFF is 16.2% (16.5% as of Q2 2016) and the WALS is 17.28% (16.98% as of Q2 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 lower WAFF to a decrease in original LTVs and increase in WALS to the minimum projected loss.

Table 4

Key Credit Metrics

	March 31, 2017	June 30, 2016
Average loan size (€)	50,495	50,180
Weighted-average LTV ratio (%)	42.2	43.8
Weighted-average original LTV ratio (%)	64.6	66.3
Weighted-average loan seasoning (months)*	71.6	69
Balance of loans in arrears (%)	0.04	0.05
Buy-to-let loans (%)	0.64	0.6
Self-employed borrowers	2.17	3.27
Credit analysis results		
Weighted-average foreclosure frequency (WAFF; %)	16.21	16.5
Weighted-average loss severity (WALS; %)	17.28	16.98
AAA credit risk (%)	2.8	2.8

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

Table 5

Covered Pool Assets By Loan Size

	March 31, 2017	June 30, 2016
(€ '000s)	**Percentage of cover pool (%)**	
0 to 100	53.3	53.8
100 to 200	35.0	35.1
200 to 300	8.3	7.9
300 to 400	2.1	1.9
400 to 500	0.7	0.7
500 to 600	0.3	0.3
Greater than 600	0.3	0.3

Table 6

Current LTV Ratios

	March 31, 2017	June 30, 2016
(%)	**Percentage of cover pool (%)**	
0-60	83.43	80.02
60-70	13.11	14.96
70-80	3.25	4.53
80-90	0.18	0.33
90-100	0.02	0.05
Above 100	0.02	0.11
Total above 80	0.21	0.49

Table 6

Current LTV Ratios (cont.)

	March 31, 2017	June 30, 2016
(%)	Percentage of cover pool (%)	
Weighted-average LTV ratios	42.19	43.84

LTV--Loan-to-value.

Table 7

Original LTV Ratios

	As of March 31, 2017	As of June 30, 2016
(%)	Percentage of cover pool (%)	
0-60	37.85	36.62
60-70	17.25	16.71
70-80	16.48	16.48
80-90	14.13	14.77
90-100	5.93	5.99
Above 100	8.36	9.43
Total above 80	28.42	30.19
Weighted-average LTV ratios	64.57	66.3

LTV--Loan-to-value.

Table 8

Loan Seasoning Distribution*

	March 31, 2017	June 30, 2016
	Percentage of portfolio (%)	
Less than 18 months	10.4	10.01
18 to 60	36.6	38.69
More than 60	53.0	51.3
Weighted-average loan seasoning (months)	71.6	69.1

*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 (98.8%) includes a 12-month maturity extension, which combined with the liquidity generated by the assets and 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 criteria "Assessing Pools Of European Residential Loans," published on Aug. 4, 2017.

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 to the 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. Such loans attract an adjustment of credit risk in line with our criteria. Our analysis of the covered bonds' payment structure shows 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 as outlined in our relevant criteria (see "Assessments For Target Asset Spreads According To Our Covered Bonds Criteria," published on Aug. 15, 2016).

Based on our cash flow analysis considering the cover pool as of June 30, 2017, we have determined that the available credit enhancement of 21.45% exceeds the credit enhancement of 3.52%, which we consider to be commensurate with a 'AAA' rating.

Table 9

Geographic Distribution Of Loan Assets

	March 31, 2017	June 30, 2016
	Percentage of cover pool (%)	
Southern Finland	46.0	44.8
Eastern Finland	9.7	9.8
Western Finland	33.4	34.3
Oulu	9.4	9.5
Lapland	1.4	1.4
Aland	0.1	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, OP Corporate Bank has committed to replace itself as swap counterparty should we lower the ICR to below 'A', or 'BBB+' if it posts collateral. We therefore consider 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

- Criteria - Structured Finance - General: Methodology And Assumptions: Assessing Pools Of European Residential Loans, Aug. 4, 2017
- Legal Criteria: Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Criteria - Structured Finance - General: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, Aug. 8, 2016
- Criteria - Structured Finance - Covered Bonds: Counterparty Risk Analysis In Covered Bonds, Dec. 21, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
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- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Criteria - Structured Finance - General: Global Derivative Agreement Criteria, June 24, 2013
- General Criteria: Methodology: Credit Stability Criteria, May 3, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Global Covered Bond Characteristics And Rating Summary Q2 2017, July 11, 2017
- Finland Ratings Affirmed At 'AA+/A-1+'; Outlook Stable, March 17, 2017
- Banking Industry Country Risk Assessment: Finland, Jan. 30, 2017
- Outlook Assumptions For The Finnish Residential Mortgage Market, Sept. 20, 2016
- OP Corporate Bank PLC, Aug. 17, 2016

- Assessments For Target Asset Spreads According To Our Covered Bonds Criteria, Aug. 15, 2016
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, July. 20, 2016
- Covered Bond Monitor: Technical Note, Feb. 14, 2006

Additional Contact:
Covered Bonds Surveillance; CoveredBondSurveillance@spglobal.com