OP MORTGAGE BANK
Stock exchange release 2 August 2017
Interim Report

OP Mortgage Bank: Interim Report for January–June 2017

OP Mortgage Bank (OP MB) is part of OP Financial Group and its role is to raise, together with OP Corporate Bank plc, funding for the Group from money and capital markets. OP MB is responsible for the Group's funding for the part of covered bond issuance.

Financial standing

The intermediate loans and loan portfolio of OP MB increased to EUR 12,358 million (10,892)* during the reporting period. OP MB issued one fixed-rate covered bond with a maturity of seven years in international capital markets in March and another with a maturity of ten years in June. OP MB intermediated the bonds with a nominal value of EUR 1,000 million in intermediate loans in their entirety to OP cooperative banks as intermediate loans. On 30 June, OP cooperative banks had a total of EUR 3,853 million (1,853) in intermediate loans from OP MB.

The company's financial standing remained stable throughout the reporting period. Operating profit for January–June amounted to EUR 8.5 (11.0) million.

*The comparatives for 2016 are given in brackets. For income statement and other aggregated figures, January–June 2016 figures serve as comparatives. For balance-sheet and other cross-sectional figures, figures at the end of the previous financial year (31 December 2016) serve as comparatives.

Collateralisation of bonds issued to the public

On 30 June 2017, loans as collateral in security of the covered bonds issued under the Euro Medium Term Covered Note programme worth EUR 15 billion established on 12 November 2010 under the Laki kiinnityspankkitoiminnasta (688/2010) (Covered Bond Act) totalled EUR 11,944 million.

Capital adequacy

OP MB has presented its capital base and capital adequacy in accordance with the EU capital requirement regulation and directive (EU 575/2013). OP MB uses the Internal Ratings Based Approach (IRBA) to measure its capital adequacy requirement for credit risk. OP MB uses the Standardised Approach to measure its capital adequacy for operational risk.

The Common Equity Tier 1 (CET1) ratio stood at 113.1 % (109.5) on 30 June 2017. The CET1 capital requirement is 4.5% and the requirement for the capital conservation buffer is 2.5%, i.e. the total CET1 capital requirement is 7%. The minimum total capital requirement is 8% and 10.5% with increased capital conservation buffer.

OP MB's highest minimum capital requirement is determined by the Basel I floor. OP MB's capital base exceeded the Basel I floor by EUR 35.3 million in June. Information on the Basel I floor and capital surplus can be found in note "Capital base and capital adequacy".

The Financial Supervisory Authority has decided to set a 15% minimum risk weight on housing loans from the beginning of 2018 for at least two years. According to the Authority, this floor is aimed at preparing for a systemic risk related to household indebtedness. OP MB's loan portfolio comprises low-risk home loans on which the minimum risk weight will have the strongest effect in relative terms. Based on an assessment, OP MB's capital adequacy will, however, remain solid even after the entry into force of the floor since CET1 is estimated to be 27% and clearly above the minimum requirements set by the authorities.

Joint and several liability of amalgamation

Under the Act on the Amalgamation of Deposit Banks, the amalgamation of the cooperative banks comprises the organisation’s central cooperative (OP Cooperative), the central cooperative's member credit institutions and the companies belonging to their consolidation groups as well as credit and financial institutions and service companies in which the above together hold more than half of the total votes. This amalgamation is supervised on a consolidated basis. On 30 June 2017, OP Cooperative's members comprised 168 member cooperative banks as well as OP Corporate Bank plc, OP Mortgage Bank, OP Card Company Plc and OP Process Services Ltd.

The central cooperative is responsible for issuing instructions to its member credit institutions concerning their internal control and risk management, their procedures for securing liquidity and capital adequacy as well as for compliance with harmonised accounting policies in the preparation of the amalgamation’s consolidated financial statements.

As a support measure referred to in the Act on the Amalgamation of Deposit Banks, the central cooperative is liable to pay any of its member credit institutions an amount that is necessary to prevent the credit institution from being placed in liquidation. The central cooperative is also liable for the debts of a member credit institution which cannot be paid using the member credit institution’s assets.

Each member bank is liable to pay a proportion of the amount which the central cooperative has paid to either another member bank as part of support action or to a creditor of such member bank in payment of an amount overdue which the creditor has not received from the member bank. Furthermore, in the case of the central cooperative’s default, a member bank has unlimited refinancing liability for the central cooperative’s debts as referred to in the Co-operatives Act.

Each member bank’s liability for the amount the central cooperative has paid to the creditor on behalf of a member bank is divided between the member banks in proportion to their last adopted balance sheets. OP Financial Group’s insurance companies do not fall within the scope of joint and several liability.

According to Section 25 of the Covered Bond Act, the holder of a covered bond has the right to receive a payment for the entire term of the bond from the assets entered as collateral before other receivables without this being prevented by OP MB's liquidation or bankruptcy.

Personnel

On 30 June 2017, OP MB had five employees. OP MB purchases all the most important support services from OP Cooperative and its Group members, reducing the need for its own personnel.

Administration

The Board composition is as follows:

Chairman	Harri Luhtala	Chief Financial Officer, OP Cooperative
Members	Elina Ronkanen-Minogue	Head of Asset and Liability Management and Group Treasury, OP Cooperative
	Hanno Hirvinen	Group Treasurer, OP Corporate Bank plc

OP MB's Managing Director is Lauri Iloniemi and Hanno Hirvinen is his deputy.

Risk exposure

The most typical types of risks related to OP MB are credit risk, structural funding risk, liquidity risk and interest rate risk. The key credit risk indicators in use show that OP MB's credit risk exposure is stable and the limit for liquidity risk set by the Board of Directors has not been exceeded. The liquidity buffer for OP Financial Group, managed by OP Corporate Bank plc, is exploitable by OP MB. OP MB has used interest rate swaps to hedge against its interest rate risk. Interest rate swaps have been used to swap housing loan interest, intermediate loan interest and interest on issued bonds into the same basis rate. OP MB has entered into all derivative contracts for hedging purposes, with OP Corporate Bank plc being their counterparty. The interest rate risk of OP MB may be considered to be low.

Outlook

It is expected that the bank's capital adequacy will remain strong, risk exposure favourable and the overall quality of the loan portfolio good. This will make it possible to issue new covered bonds in 2017.

Accounting policies

The Interim Report for 1 January–30 June 2017 has been prepared in accordance with IAS 34 (Interim Financial Reporting).

This Interim Report is based on unaudited figures. Given that all figures have been rounded off, the sum total of individual figures may deviate from the presented sums.

The Interim Report is available in Finnish and English. The Finnish version is official that will be used if there is any discrepancy between the language versions.

OP MB's related parties include the parent company OP Cooperative and its subsidiaries, the OP Financial Group pension insurance companies OP Bank Group Pension Fund and OP Bank Group Pension Foundation, and the company's administrative personnel. Standard loan terms and conditions are applied to loans granted to the related parties. Loans are tied to generally used reference interest rates. The financial year saw no major changes in related-party transactions.

The income statement layout grouping has been updated for the Interim Report 1 January–30 September 2016. Comparatives have been restated to correspond to the new grouping.

New standards and interpretations

IFRS 9 Financial Instruments

OP MB will for the first time apply IFRS 9 as of 1 January 2018. The comparatives will not be restated.

The quantitative effect of the application of the standard on the 2018 financial statements cannot yet be assessed reliably since it will depend on the amount of the financial instruments held at that time, the financial position at that time and the choice of the calculation principles and management judgement. The new standard requires OP Mortgage Bank to examine the calculation and monitoring processes for financial instruments. The changes to be made in them are not yet completed. OP Mortgage Bank will update the effects of the IFRS 9 transition presented in the financial statements for 2016, as follows:

Classification and measurement

The changes in the classification of OP Mortgage Bank's financial instruments will be small and will have no significant effect on OP MB's CET1 ratio.

Impairment

The expected credit loss are calculated on all balance sheet items amortised at cost and those recognised at fair value through other comprehensive income (FVOCI) and on off-balance-sheet loan commitments.

OP MB’s credit risk models and the development of related systems are still underway. The expected credit loss are calculated using modelled risk parameters and formula PDxLGDxEAD for the majority of the portfolios. The expected credit loss are calculated for each contract for 12 months or lifetime, depending on whether the instrument’s credit risk on the reporting day has increased significantly from the original one. Both qualitative and quantitative criteria are used to assess whether the credit risk has increased significantly. Qualitative factors consist of various credit risk indicators (such as forbearance measures) and they are primarily taken into account in credit rating models. Credit ratings influence for lifetime the PD value used as the basis for assessing the quantitative change. In addition, credit risk has increased significantly if payment is over 30 days past due. In assessing significant credit risk increase, OP MB applies the transitional provision permitted by IFRS 9 for the contracts for which the original lifetime PD cannot be calculated without incurring unreasonable costs and workload. In the definition of default, OP MB uses a uniform definition in capital adequacy measurement.

OP MB will include forward-looking information and macroeconomic scenarios in the model. The macroeconomic scenarios are the same that OP MB uses otherwise in its financial annual planning.

Expected credit loss provisions under IFRS 9 are assessed to increase significantly from their current level based on IAS 39 and they vary by portfolio. The provisions will reduce equity capital on the date of transition. Based on preliminary assessments, the increase in expected credit loss provisions is not expected to have any significant effect on OP MB's CET1 ratio on the transition date because the IFRS 9 compliant expected credit loss provisions are not expected to exceed the expected loss calculated in capital adequacy and the effect of used floors. The European Commission's proposal under preparation to amend the calculation of the CET1 ratio by gradually phasing in the effects of impairment loss measurement under IFRS 9 will, if implemented, also reduce the effects on capital adequacy.

Hedge accounting

For portfolio hedges, OP MB will continue to apply hedge accounting under IAS 39. OP MB has not yet made the decision to adopt IFRS 9 compliant hedge accounting.

IFRS 15 Revenue from Contracts with Customers

OP MB will apply IFRS 15 as of 1 January 2018. The new standard has no effect on the recognition of financial instruments but mainly applies to various commissions and fees. Based on the current assessment, OP Mortgage Bank will adopt IFRS 15 applying the cumulative effect method and will not restate comparative periods but will restate equity capital on 1 January 2018. In addition, it will present the amounts affecting each financial statement item when applying IFRS 15. The transition methodology will be confirmed after the completion of the final impact assessment. In OP Mortgage Bank, IFRS 15 mainly applies to fees not included in the calculation of the effective interest rate. The adoption of IFRS 15 has no significant financial effect.

Formulas for Alternative Performance Measures

The Alternative Performance Measures Guidelines issued by the European Securities and Markets Authority (ESMA) came into force on 3 July 2016. The Alternative Performance Measures are presented to illustrate the financial performance of business operations and to improve comparability between reporting periods. They should not be considered to be replacements for the performance measures defined in IFRS governing financial reporting.

The formulas for the used Alternative Performance Measures are presented below and they correspond to the previously presented performance indicators in terms of content.

Return on equity (ROE), % = Annualised profit for the period / Equity capital (average equity capital at the beginning and end of the period) × 100

Cost/income ratio, % = (Personnel costs + Depreciation/amortisation and impairment loss + Other operating expenses) / (Net interest income + Net commission and fees + Net investment income + Other operating income) × 100

Income statement, TEUR	**H1/2017**	**H1/2016**	**Q2/2017**	**Q2/2016**	**Q1–Q4/2016**
Net interest income	36,258	38,039	18,102	19,173	76,171
Interest income	34,199	45,898	16,486	21,598	84,978
Interest expenses	-2,059	7,859	-1,615	2,425	8,807
Net commissions and fees	-24,892	-24,176	-12,499	-12,020	-47,757
Net investment income	1	2	0		7
Other operating income	1	1	0	0	22
Total income	**11,368**	**13,866**	**5,603**	**7,153**	**28,443**
Personnel costs	169	171	76	82	321
Depreciation/amortisation and impairment loss	418	418	209	209	836
Other operating expenses	2,130	2,111	1,029	1,156	4,243
Total expenses	**2,718**	**2,700**	**1,314**	**1,447**	**5,400**
Impairment loss on receivables	-132	-158	-212	-91	-400
Earnings before tax	**8,519**	**11,007**	**4,077**	**5,616**	**22,643**
Income tax expense	1,703	2,240	815	1,161	4,566
Profit for the period	**6,815**	**8,768**	**3,262**	**4,455**	**18,077**

Statement of comprehensive income, TEUR	**H1/2017**	**H1/2016**	**Q2/2017**	**Q2/2016**	**Q1–Q4/2016**
Profit for the period	6,815	8,768	3,262	4,455	18,077
Items that will not be reclassified to profit or loss					
Gains/(losses) arising from remeasurement of defined benefit plans					-138
Income tax on gains/(losses) on arising from remeasurement of defined benefit plans					28
Total comprehensive income	**6,815**	**8,768**	**3,262**	**4,455**	**17,967**

Key ratios	**H1/2017**	**H1/2016**	**Q2/2017**	**Q2/2016**	**Q1–Q4/2016**
Return on equity (ROE), %	3.7	4.8	3.5	4.9	4.8
Cost/income ratio, %	24	19	23	20	19

Cash flow from operating activities, TEUR	**H1/2017**	**H1/2016**
Profit for the financial year	6,815	8,768
Adjustments to profit for the financial year	6,046	3,213
Increase (-) or decrease (+) in operating assets	**-1,467,167**	**-554,857**
Receivables from credit institutions	-2,000,000	-1,119,400
Receivables from the public and public-sector entities	534,961	546,245
Other assets	-2,128	18,298
Increase (+) or decrease (-) in operating liabilities	**377,263**	**122,491**
Liabilities to credit institutions and central banks	370,000	143,000
Other liabilities	7,263	-20,509
Income tax paid	-1,947	-3,163
Dividends received	1	2
A. Net cash from operating activities	**-1,078,988**	**-420,385**
Cash flow from investing activities		
Purchase of PPE and intangible assets		
B. Net cash used in investing activities		
Cash flow from financing activities		
Increases in debt securities issued to the public	1,986,645	243,488
Decreases in debt securities issued to the public	-1,250,000	
Dividends paid and interest on cooperative capital	-9,038	-16,282
C. Net cash used in financing activities	**727,608**	**227,206**
D. Effect of foreign exchange rate changes on cash and cash equivalents	**0**	**0**
Net change in cash and cash equivalents (A+B+C+D)	**-351,381**	**-193,180**
Cash and cash equivalents at year-start	**451,787**	**245,120**
Cash and cash equivalents at year-end	**100,824**	**52,359**
Change in cash and cash equivalents	**-350,963**	**-192,762**
Interest received	32,310	64,074
Interest paid	-8,945	28,411
Adjustments to profit for the financial year		
Non-cash items		
Unrealised net gains on foreign exchange operations	0	0
Impairment losses on receivables	131	160
Other	5,915	3,053
Total adjustments	**6,046**	**3,213**
Cash and cash equivalents		
Receivables from credit institutions payable on demand	100,824	52,359
Total cash and cash equivalents	**100,824**	**52,359**

Balance sheet, TEUR	30 June 2017	30 June 2016	31 Dec. 2016
Receivables from credit institutions	3,953,593	1,915,128	2,304,556
Derivative contracts	151,770	315,908	220,461
Receivables from customers	8,504,785	9,063,453	9,039,563
Investments assets	40	40	40
Intangible assets	1,322	2,157	1,739
Other assets	58,340	60,525	56,212
Tax assets	703	0	460
Total assets	**12,670,553**	**11,357,211**	**11,623,031**
Liabilities to credit institutions	2,258,000	1,518,000	1,888,000
Derivative contracts	40,330	6,039	6,233
Debt securities issued to the public	9,916,185	9,380,372	9,277,801
Provisions and other liabilities	84,638	87,976	77,375
Tax liabilities		402	
Total liabilities	**12,299,153**	**10,992,789**	**11,249,409**
Shareholders’ equity			
Share capital	60,000	60,000	60,000
Reserve for invested unrestricted equity	245,000	245,000	245,000
Retained earnings	66,399	59,422	68,622
Total equity	371,399	364,422	373,622
Total liabilities and shareholders’ equity	**12,670,553**	**11,357,211**	**11,623,031**

Off-balance-sheet commitments, TEUR	30 June 2017	30 June 2016	31 Dec. 2016
Irrevocable commitments given on behalf of customers	8	51	8

Statement of changes in equity, TEUR	Share capital	Other reserves	Retained earnings	Total equity
Shareholders’ equity 1 Jan. 2016	**60,000**	**245,000**	**66,937**	**371,937**
Reserve for invested unrestricted equity				
Profit for the period			8,768	8,768
Total comprehensive income				
Other changes			-16,282	-16,282
Shareholders’ equity 30 June 2016	**60,000**	**245,000**	**59,422**	**364,422**
Shareholders’ equity 1 Jan. 2017	**60,000**	**245,000**	**68,622**	**373,622**
Reserve for invested unrestricted equity				
Profit for the period			6,815	6,815
Total comprehensive income				
Other changes			-9,038	-9,038
Shareholders’ equity 30 June 2017	**60,000**	**245,000**	**66,399**	**371,399**

OP MB has presented its capital base and capital adequacy in accordance with the EU capital requirement regulation and directive (EU 575/2013).

Capital base and capital adequacy, TEUR	**30 June 2017**	**31 Dec. 2016**
Shareholders' equity	371,399	373,622
Common Equity Tier 1 (CET1) before deductions	**371,399**	**373,622**
Intangible assets	-1,322	-1,739
Excess funding of pension liability	-67	-67
Share of unaudited profits	-6,815	-18,077
Impairment loss – shortfall of expected losses	-2,722	-2,612
Common Equity Tier 1 (CET1)	**360,473**	**351,126**
Tier 1 capital (T1)	**360,473**	**351,126**
Total capital base	**360,473**	**351,126**
Total risk exposure amount		
Credit and counterparty risk	278,177	286,845
Operational risk	40,554	33,898
Total	**318,730**	**320,743**
Key ratios, %		
CET1 capital ratio	113.1	109.5
Tier 1 capital ratio	113.1	109.5
Capital adequacy ratio	113.1	109.5
Basel I floor		
Capital base	360,473	351,126
Basel I capital requirements floor	325,144	322,006
Capital buffer for Basel I floor	35,329	29,120

Classification of financial assets and liabilities 30 June 2017, TEUR				
Financial assets	**Loans and other receivables**	**Recognised at fair value through profit or loss**	**Available for sale**	**Total**
Receivables from credit institutions	3,953,593			3,953,593
Derivative contracts		151,770		151,770
Receivables from customers	8,504,785			8,504,785
Shares and participations			40	40
Other receivables	58,340			58,340
Other assets	2,025			2,025
Total	**12,518,742**	**151,770**	**40**	**12,670,553**
Financial liabilities		**Recognised at fair value through profit or loss**	**Other liabilities**	**Total**
Liabilities to credit institutions			2,258,000	2,258,000
Derivative contracts		40,330		40,330
Debt securities issued to the public			9,916,185	9,916,185
Other liabilities			84,638	84,638
Total		**40,330**	**12,258,823**	**12,299,153**
Valuation difference of debt securities issued to the public (difference between fair value and carrying amount) 30 June 2017			173,663	**173,663**

Classification of financial assets and liabilities 31 Dec. 2016, TEUR				
Financial assets	**Loans and other receivables**	**Recognised at fair value through profit or loss**	**Available for sale**	**Total**
Receivables from credit institutions	2,304,556			2,304,556
Derivative contracts		220,461		220,461
Receivables from customers	9,039,563			9,039,563
Shares and participations			40	40
Other receivables	56,212			56,212
Other assets	2,199			2,199
Total	**11,402,530**	**220,461**	**40**	**11,623,031**
Financial liabilities		**Recognised at fair value through profit or loss**	**Other liabilities**	**Total**
Liabilities to credit institutions			1,888,000	1,888,000
Derivative contracts		6,233		6,233
Debt securities issued to the public			9,277,801	9,277,801
Other liabilities			77,375	77,375
Total		**6,233**	**11,243,176**	**11,249,409**
Valuation difference of debt securities issued to the public (difference between fair value and carrying amount) 31 Dec. 2016			277,485	**277,485**

Debt securities issued to the public are carried at amortised cost. The fair value of these debt instruments has been measured using information available in markets and employing commonly used valuation techniques. The difference between the fair value and carrying amount is presented as valuation difference in the "Classification of financial assets and liabilities" note.

Derivative contracts 30 June 2017, TEUR	Nominal values/residual term to maturity			
	Less than 1 year	1–5 years	More than 5 years	Total
Interest rate derivatives				
Hedging	443,506	8,049,977	9,237,466	17,730,949
Total	**443,506**	**8,049,977**	**9,237,466**	**17,730,949**

	Fair values		Credit equivalent
	Assets	Liabilities	
Interest rate derivatives			
Hedging	151,770	40,330	384,367
Total	**151,770**	**40,330**	**384,367**

Derivative contracts 31 Dec. 2016, TEUR	Nominal values/residual term to maturity			
	Less than 1 year	1–5 years	More than 5 years	Total
Interest rate derivatives				
Hedging	2,759,875	8,216,977	6,838,247	17,815,099
Total	**2,759,875**	**8,216,977**	**6,838,247**	**17,815,099**

	Fair values		Credit equivalent
	Assets	Liabilities	
Interest rate derivatives			
Hedging	220,461	6,233	414,976
Total	**220,461**	**6,233**	**414,976**

Financial instruments classification, grouped by valuation technique, TEUR			
30 June 2017	**Fair value measurement at year end**		
	Balance sheet value	**Level 1**	**Level 2**
Recurring fair value measurements of assets			
Derivate contracts	151,770		151,770
Total	**151,770**		**151,770**
Recurring fair value measurements of liabilities			
Derivate contracts	40,330		40,330
Total	**40,330**		**40,330**
Financial liabilities not measured at fair value			
Debt securities issued to the public	9,916,185	9,729,156	360,692
Total	**9,916,185**	**9,729,156**	**360,692**
31 Dec. 2016	**Fair value measurement at year end**		
	Balance sheet value	**Level 1**	**Level 2**
Recurring fair value measurements of assets			
Derivate contracts	220,461		220,461
Total	**220,461**		**220,461**
Recurring fair value measurements of liabilities			
Derivate contracts	6,233		6,233
Total	**6,233**		**6,233**
Financial liabilities not measured at fair value			
Debt securities issued to the public	9,277,801	9,189,185	366,101
Total	**9,277,801**	**9,189,185**	**366,101**

OP MB does not hold any transfers between the levels of fair value valuation.

Financial reporting 2017

Schedule for Interim Reports in 2017:

Interim Report Q1–3/2017	1 November 2017

Helsinki, 2 August 2017

OP Mortgage Bank
Board of Directors

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