Credit Rating Announcement

04 April 2018

Scope assigns first-time issuer rating of A- to Norwegian Landkreditt Bank; covered bonds at AAA

Issuer ratings of A- for both Landkreditt Bank and wholly-owned subsidiary Landkreditt Boligkreditt reflect the Norwegian bank's solid credit fundamentals. AAA covered bond ratings reflect sound credit quality of cover pool and fundamental credit support.

Scope Ratings has today assigned first-time issuer ratings of A- to Norwegian Landkreditt Bank AS (LKB) and its wholly-owned subsidiary Landkreditt Boligkreditt AS (LKBol). The agency also assigned first-time ratings of BBB+ to senior unsecured debt issued by Landkreditt Bank as well as first-time ratings of AAA to the covered bonds (Obligasjoner med fortrinnsrett – OMF) issued by LKB. All ratings have a Stable Outlook.

Bank ratings rationale

According to Scope, the ratings on Landkreditt Bank are based on the strength of the group, Landkreditt SA, a leading provider of financial services to Norway's agricultural sector. The bank's cooperative ownership structure and strategic aims support a relatively low-risk business in secured lending. Similar to other Norwegian banks, there is a reliance on market funding. However, the bank maintains comfortable liquidity buffers and demonstrates good market access. The bank's reassuring solvency metrics are in line with Norwegian regulatory requirements which the agency considers to be relatively rigorous.
LKBol is a wholly-owned, specialised credit institution, with the dedicated role of providing secured covered bond funding for its parent. Scope's issuer rating on LKBol is based on its full ownership by LKB and on its specific purpose.
Among potential negative change drivers, Scope highlights a decline in the operating environment with a material impact on profitability, or expansion into new markets or businesses thus increasing the risk profile of the group. A continued track record of profitable business growth while keeping risks under control would be a potential positive change driver.

For the Landkreditt Bank rating report please click HERE.

Covered bond ratings rationale

The AAA ratings with a Stable Outlook assigned to LKBol's covered bonds reflect the A- rating of the issuer further enhanced by:

- fundamental credit support factors that provide five notches of uplift above the bank's rating and also provide a rating floor against a cover pool deterioration; and
- the further enhancement by one notch from a cover pool with sound credit quality and a sufficient level

of overcollateralisation which mitigates credit and market risks, in particular the covered bond programme's high asset liability mismatch risks. The cover pool on its own provides a at least six notch credit differentiation to LKBol's rating.

Key rating drivers for the covered bond ratings

- Sound issuer credit rating (positive)
- Fundamental credit support resulting from the strength of the Norwegian legal and BRRD framework, which supports a five notch uplift to the issuer rating (positive)
- Cover pool support: Low expected losses even for the highest rating stress (positive)
- Substantial asset liability mismatch (negative) reflecting slow scheduled amortisation of cover assets which also comprise of interest only mortgage secured credit lines. Repayment is reliant on the sale of cover assets. Almost 80% of the rating supporting overcollateralisation is needed to mitigate ALMM risk.
- Overcollateralisation (positive): available overcollateralisation has historically remained well above the regulatory minimum and above the rating supporting overcollateralisation determined by Scope.

Fundamental credit support: benefits from the Norwegian legal framework and resolution regime assessment

Fundamental credit support factors provide the covered bond rating with a five-notch uplift above the issuer rating on LKBol. Two notches of uplift are driven by the agency's analysis of the Norwegian covered bond legal framework. In addition, three additional notches of uplift are driven by its positive view on the support by the resolution regime and systemic importance of LKBol's covered bonds.
Fundamental credit support effectively provides a rating floor for the covered bonds five notches above the issuer rating, mitigating the impact of an adverse cover pool risk management.

Analysis of the Norwegian covered bond legal framework

In Scope's view, the Norwegian framework is currently one of the stronger European covered bond frameworks. It meets the rating agency's criteria for protecting covered bond investors and allows to assign the highest credit differentiation.
Norway is not part of the European Union and formally it will not need to comply with the covered bond harmonisation proposed by the European Commission in March 2018. However, once it has been formally approved, Norwegian stakeholders are likely to closely align the Norwegian covered bond framework with relevant changes to ensure continued alignment and the ability to maintain regulatory benefits for their investors.

The Norwegian legal covered bond framework is mainly based on the relevant section on covered bonds in the Financial Institutions Act, as well a related regulation on mortgage credit institutions, both introduced in 2007. The framework provides for:

- The use of a specialist, independently licensed mortgage bank facilitates the segregation and isolation of the cover assets from the general insolvency estate of the originating, typical parent bank.
- Covered bond holders benefit from a senior claim on the eligible cover pool assets.
- The definition of eligible assets follows European standards with a maximum 75% loan-to-value (LTV) limit for LKBol's main collateral type, residential mortgages.
- By law, non-performing loans do not need to be removed from the cover pool but will not be included in cover pool tests.

- As the specialist mortgage bank is a non-deposit taking institution, the covered bonds are not exposed to set-off risk.
- Market risks must be actively managed and the impact of pre-defined market risk stresses has to be limited by the issuer based on 'prudent' guidelines and with regard to its capital.
- Derivatives can be used to mitigate market risks and there are no limits on the issuer's ability to further buffer risk with overcollateralisation. The latter generally remains available in the event of a parent bank default which would not trigger a cross default for the issuer.
- Norwegian covered bonds benefit from ongoing regulatory oversight allowing them to meet both the UCITS and the CRR definition.

Resolution regime and systemic importance considerations for LKBol's covered bond programme

The agency has provided LKBol's covered bonds with three additional notches of uplift to reflect the advantages provided by the resolution regime as well as the systemic importance of covered bonds. Scope believes that, in general, Norwegian covered bonds of resolvable and very visible issuers could benefit from four additional notches of support.

One notch uplift reflects the highly likely exclusion of Norwegian covered bonds from a bail-in. Norway is an EEA country and has not yet translated the EU's Bank Recovery and Resolution Directive (2014/58/EU – BRRD) into local law. However, the October 2016 draft for the BRRD implementation in the Norwegian Financial Institutions Act confirms the agency's assumptions that regulators will exempt covered bonds and related derivatives from write-downs applicable to other debt instruments.

One additional notch of uplift to reflect the combination of: i) a moderate to high likelihood that the covered bond issuer will be maintained in a resolution scenario; and ii) the high systemic importance of covered bonds in Norway. We however recognise a low visibility and importance of LKBol as a covered bond issuer.

The rating agency believes that the current capital structure will allow regulators to restructure the group using available resolution tools. However, given its core focus on agricultural related business, residential mortgage lending could possibly appear as a non-critical business which either would be subject to an orderly wind-down or transferred to another bank in a resolution scenario. As a result, the current covered bond issuer structure might not be maintained as a going concern.

Scope considers LKBol's covered bond issuing activities and market share to only result in a low to moderate systemic importance. LKBol is only issuing into the domestic market which likely reduces negative repercussions on other issuers in the event of a failure. The low to moderate systemic importance also reflects that most of the 25 covered bond issuers are similarly subsidiaries of small to midsize banks. A failure of a covered bond issuer with the size and setup of LKBol could thus result in contagion, effectively creating systemic problems for issuers reliant on this refinancing channel for their core product, residential mortgage lending.
We generally classify Norwegian covered bonds as a systemic refinancing product, in particular for the refinancing of residential mortgages. On average, the combined outstanding covered bond volume has accounted for more than 25% of GDP since 2011, achieving 33.2% at the end of 2016. Annual issuance hovers around EUR 20bn and reached EUR 23.8bn in 2016. At present, 25 specialised covered bond issuers are active in the market, issuing residential, commercial and public sector-backed covered bonds.

A third additional notch of uplift reflects the existence of a cohesive and supportive domestic stakeholder group. Covered bond issuers actively work together under the umbrella of the Norwegian covered bond council, promoting the product and initiating changes to the framework if needed (such as the March 2017 increase in minimum overcollateralisation to 2% to avoid potential challenges for cover pool derivatives as a result of the EMIR regulation). Domestic covered bond investors such as banks and insurers actively use covered bonds as a substitute for long-dated, NOK-denominated government debt as well as for liquidity management purposes. Moreover, the central bank has demonstrated support by allowing the use of covered bonds in its repo operations and running a covered bond for government debt swap programme between 2008 and 2014. The Norwegian FSA (Finanstilsynet) is also an active stakeholder given the widespread use of covered bonds as a refinancing tool for residential mortgage lending.

Cover pool supports highest rating achievable

At 28 February 2018 LKBol's NOK 3.6bn cover pool supports a rating uplift of six notches to the NOK 3.16bn of covered bonds outstanding. Based on issued covered bonds, the available overcollateralization is 13.5%.

Assets in the fully domestic, NOK-denominated and floating rate cover pool exhibit a sound credit quality characterised by a low LTV. The credit quality of the cover pool does not introduce a significant risk contribution to the 11% of supporting overcollateralisation which Scope considers commensurate with a six-notch cover pool uplift. The covered bond programme is not materially exposed to market risk as covered bonds are in line with the cover assets which are fully denominated in NOK and interest referenced to floating rates.

However, risks resulting from the programme's high asset liability mismatch (ALMM) explain the majority of the overcollateralisation needed to support the rating. The mismatch is approximately 12.7 years, resulting from a weighted average life of the cover pool (approx. 16.5 years, based on the legal maturities of the mortgage loans and mortgage-secured credit lines), and the weighted average life of the outstanding covered bonds (3.7 years, taking into account the soft-bullet structure). ALMM risk is mitigated by the soft-bullet structure (contractual 12-month maturity extension if the issuer is unable to service a maturing covered bond) coupled with sufficiently high overcollateralisation and transparent and granular cover pools of low LTV mortgage loans facilitating a potential sale. The standard practice of the issuer to regularly repurchase upcoming maturities in advance reduces the impact of liquidity requirements upon an upcoming scheduled maturity, even though this practice is not contractually committed.

Cover pool composition

As of 31 December 2017, the NOK 3.6bn cover pool comprises 2,561 loans with an average size of NOK 1.7m. The current indexed LTV of the cover pool (which is almost fully focussed on domestic, residential properties) stands at 47.5% and has a weighted average seasoning of 4.2 years. The two main product types are amortising mortgage loans with an original legal maturity of 25 years (69.2%) as well as interest-only loans with an embedded credit line and standard maturity of 15 years (30.8%). In Scope's loss given default analysis the rating agency assumed that the credit lines (NOK 1.1bn) were fully drawn to the maximum exposure of NOK 1.8bn, significantly increasing the LTV and lowering recovery expectations.

The collateral is primarily located in Oslo and the Akershus region, which together make up 63.9%. The next largest regional concentration is in the oil regions around Bergen (8.6%) with the remainder well distributed throughout Norway. The combination of sound cover pool credit quality, prudent underwriting criteria and very benign house price development in Norway have provided the bank with a decidedly negligible loss history in this segment.

Quantitative analysis and assumptions for the cover pool analysis

Scope performed a cash flow analysis and projected the cover pool defaults assuming a normal inverse distribution. Based on available credit performance data provided by the bank, loss data for the market as well as benchmarking, the agency derived a lifetime mean default rate of 10%, a coefficient of variation of 50%. We also assumed a 73% asset recovery rate, after incorporating a stress commensurate to the highest uplift above the issuer rating.
For the recovery rates Scope applies rating distance-dependent market value declines. Assumptions are based on an analysis of Norwegian housing market developments and their unique characteristics. Scope established market value declines for the properties securing the mortgage loans of 52.5-60% (depending on the location of the property). In addition to a correction of the indexed LTV to a sustainable level, this market value decline incorporates a general fire sale discount as well as additional property size-dependent haircuts.

Scope used the resulting loss distribution and default timing to project the covered bond programme's losses and reflect the programme's amortisation structure. The rating agency also incorporated the impact of rating distance-dependent interest rate stresses in its analysis. The covered bond programme was most sensitive to a scenario in which interest rates decreased after two years, plateaued and then started rising to a sustainable average of 5%. If available proceeds were unable to service the bonds at their extended legal maturity date Scope assumed an asset sale. In order to calculate net present value in the event of an asset sale, a liquidity premium for Norwegian residential mortgage loans of 150bps was added to the rating distance and scenario-dependent discount curve. Scope derived this liquidity premium by analysing the long-term development of trading spreads for Norwegian and other 'core country' covered bond spreads. The agency generally uses 150 bps as the lowest liquidity premium even though Norwegian covered bond spreads are often negative at present, and did not even exceed 70 bps during the last crisis.

Stable Outlook assigned to the covered bonds

The Stable Outlook on the covered bonds reflects the expected stable credit performance of LKB, LKBol as well as its mortgage borrowers. Scope's covered bond outlook also reflects its expectation that the issuer will maintain its prudent covered bond programme risk profile. The agency expects that both the parent and the direct issuer will remain willing and able to continuously provide the overcollateralisation needed to support the very strong credit quality of the covered bonds.

Provided that the covered bond programme risk structure does not change materially, current covered bond ratings supported by the cover pool could remain unchanged up to a two-notch downgrade of the issuer – also supporting the Stable Outlook on the covered bonds.

Covered bond rating-change drivers

The covered bond ratings are already at the highest level. Covered bond ratings could be negatively affected by a more than two-notch downgrade of the issuer, a changed view on the issuer's resolvability and lower cover pool support, but Scope does not expect such an outcome at present. Fundamental credit support factors effectively provide a floor for the covered bond rating.

A detailed rating report with the agency's assessment of credit factors for Landkreditt Bank and Landkreditt Boligkreditt is available on www.scoperatings.com or under the following link: Landkreditt Bank rating report.
The detailed rating report on the covered bonds will be published later.

Stress testing
No stress testing was performed for the bank or covered bond rating.

Cash flow analysis

No cash flow analysis was performed for the bank ratings. In order to determine the cover pool supported rating uplift Scope performed a cash flow analysis to establish an expected loss for the covered bonds. The cash flow analysis uses the scheduled cash flows of the cover assets and covered bonds as a starting point. Scope applies rating distance-dependant stresses to simulate the impact of increasing credit and market risks on these cash flows. The cash flow analysis also includes the impact of stressed asset sales or other variables such as changing prepayment speeds or servicing costs.

Methodology

The methodology used for the bank ratings and outlook is the Rating Methodology Bank Ratings. For the covered bond ratings and outlook the Covered Bonds Rating Methdology and the General Structured Finance Rating Methodology were used. The methodologies are available on www.scoperatings.com.
Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.
The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rated entity participated in the rating process.
The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources.
Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the rating or outlook action, the rated entity was given the opportunity to review the rating and outlook and the principal grounds on which the credit rating and outlook is based. Following that review, the rating was not amended before being issued.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.
Lead analyst: Pauline Lambert, Executive Director (Bank ratings); Karlo Fuchs, Executive Director (Covered bond ratings)
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The ratings/outlooks were first released by Scope on 4 April 2018.

Potential conflicts

Please see www.scoperatings.com. for a list of potential conflicts of interest related to the issuance of credit ratings.

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About Scope Ratings GmbH

Scope Ratings GmbH is part of the Scope Group with headquarters in Berlin and offices in Frankfurt, London, Madrid, Milan, Oslo and Paris. As the leading European credit rating agency, the company specialises in the analysis and ratings of financial institutions, corporates, structured finance, project finance and public finance. Scope Ratings offers a credit risk analysis that is opinion-driven, forward-looking and non-mechanistic, an approach which adds to a greater diversity of opinions for institutional investors. Scope Ratings is a credit rating agency registered in accordance with the EU rating regulation and operating in the European Union with ECAI status.

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