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Aktia Bank p.l.c. - Mortgage Covered Bonds

Cover pool credit quality remains strong after Aktia's addition of low-risk housing company loans

Summary

The cover pool credit quality of Aktia Bank p.l.c's (A1 Stable, Aa3(cr), a3)[1] mortgage covered bonds remains strong after the Finnish bank added housing company (HC) loans to the pool.

» **Cover pool credit quality remains strong.** Most of the HC loans Aktia added to the cover pool of its mortgage covered bonds are low-risk loans to well-established HCs for renovation purposes. The loans' loan-to-value (LTV) ratios are low and seasoning is high. Furthermore, most loans are from regions in Finland with dynamic housing markets.

» **HC loans for renovation purposes are low-risk.** HC loans for renovations purposes are usually low-risk, because of low leverage for both HCs and shareholders. In addition, HC shareholders are in effect jointly liable for HC loans, which supports credit quality.

» **HC loans financing new buildings are riskier.** In recent years, property developers have used HC loans to fund 70%-80% of new residential buildings in Finland. HC loans financing new building are riskier than those for renovations, because of higher leverage for both HCs and shareholders, the potential for repayment shocks at the end of interest-only periods and possible ownership concentration.

Cover pool credit quality remains strong

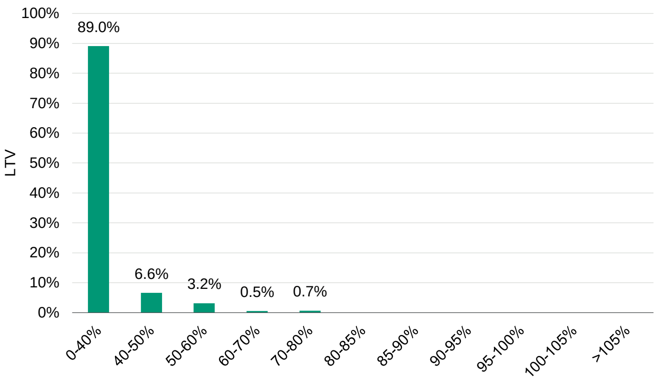
Aktia has added €133 million of HC loans (5.8% of the total assets) to the cover pool of its mortgage covered bonds in Q2 2020. The development is credit neutral for Aktia's covered bonds, because most of the HC loans in the cover pool are low-risk loans to well-established HCs for renovation purposes, which means the credit quality of the cover pool remains strong.

The WA LTV ratio of the HC loans Aktia added to the cover pools is low at 17.8%, with LTV ratios below 40% for around 90% of the loans (Exhibit 1), highlighting the loans' low-risk nature. In addition, the WA seasoning of the loans is relatively high at 58 months, with seasoning above 60 months for 31.8% of the loans (Exhibit 2).

Exhibit 1

LTV ratio is low for HC loans in Aktia cover pool

LTV distribution for HC loans in Aktia cover pool

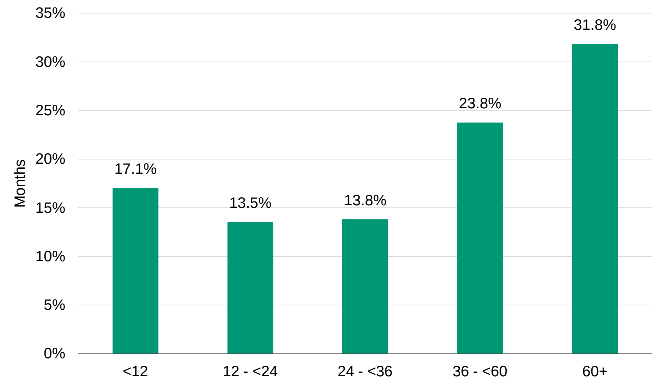


Source: Moody's Investors Service

Exhibit 2

Seasoning is high for HC loans in Aktia cover pool

Months of seasoning for HC loans in Aktia cover pool



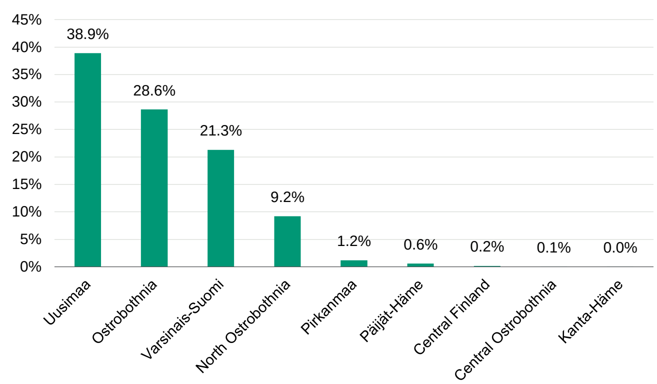
Source: Moody's Investors Service

Furthermore, 90.0% of the HC loans Aktia added to the cover pool are from regions with increasing populations, growing dwelling numbers and rising house prices over the past decade (Exhibit 3 and 4). These dynamic housing market characteristics mitigate the risk of adverse economic and demographic developments, which are the key credit risk for loans to well-established HCs.

Exhibit 3

Most HC loans in Aktia cover pool are from four regions

Regional distribution for HC loans in Aktia cover pool

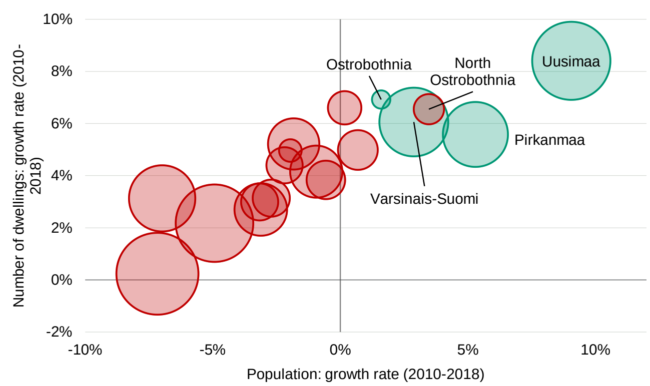


Source: Moody's Investors Service

Exhibit 4

Housing market is dynamic in regions with most Aktia HC loans

Population, dwelling number and house price growth rates, by region



Note: Each bubble represents a Finnish region. Bubble size indicates nominal house prices changes between 2010 and 2018. Red means declining house prices and green means increasing house prices.

Sources: Statistics of Finland, Moody's Investors Service

HC loans for renovation purposes are low-risk

HC loans for renovations purposes are usually low-risk, because of low leverage both at the HC and shareholder level, as well as the fact that HC shareholders are in effect jointly liable for the loans.

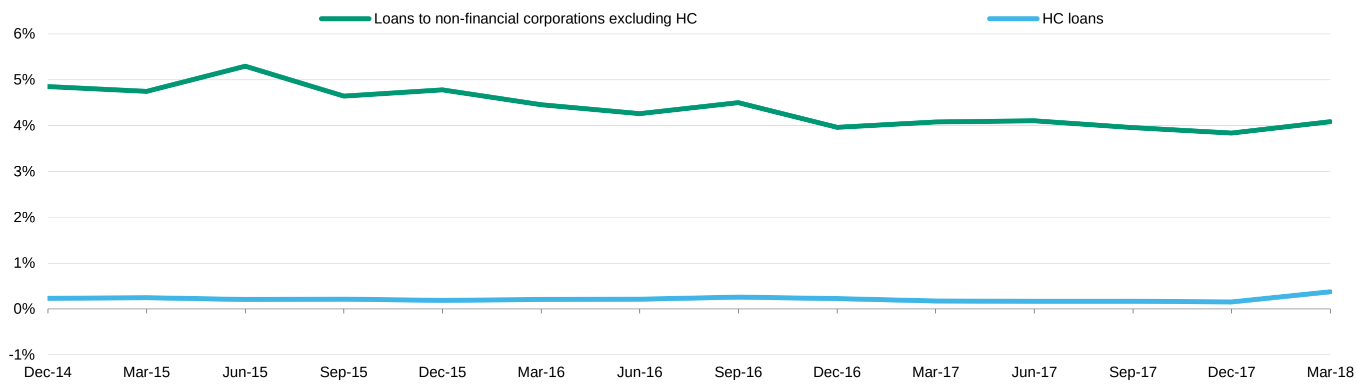
In most cases, HC estates that borrow to conduct renovations are several decades old. Most Finnish HCs do not build up reserves for future maintenance work but instead borrow from banks when they need to renovate. The amounts HCs borrow for renovations are relatively small compared with the value of the apartment complex backing the loan, which usually translates to low LTV ratios of around 30%-40% at origination.

In addition, the people living in these long-established HC complexes are more likely to have substantially repaid their retail mortgages compared with people in new HC estates. Consequently, shareholder equity is usually high in well-established HCs.

Furthermore, HC shareholders are in effect jointly liable for HC loans, which further supports the credit quality of these loans. If a HC shareholder defaults on HC fees, the HC may take control of the shareholder's apartment for up to three years at a time and raise funds against it by renting it out. The HC would use the rental proceeds to pay the late fees. However, even if the HC assumes control of the property, the shareholder retains their shareholding in the HC. The HC law[2] does not contemplate the forced sale of shareholdings, but the HC has the option of a forced sale of the shares following the standard enforcement process against a delinquent shareholder. If a HC's enforcement actions against a shareholder for non-payment of HC fees is insufficient to raise the required liquidity in a timely fashion, then the HC can raise additional liquidity via HC fees from other shareholders to repay the HC loan.[3]

Loans to well-established HCs have caused very low credit losses for banks historically and nonperforming loans rates for HC debt are extremely low, as Exhibit 5 shows.

Exhibit 5
HC nonperforming loan rate is very low
Banks' nonperforming loan rates, by borrower type



Note: Nonperforming loans include loans in arrears for more than 90 days, plus those loans that banks assess as unlikely to pay
Sources: Finnish Financial Supervisory Authority, Moody's Investors Service

Economic and demographic decline is main credit risk for well-established HCs

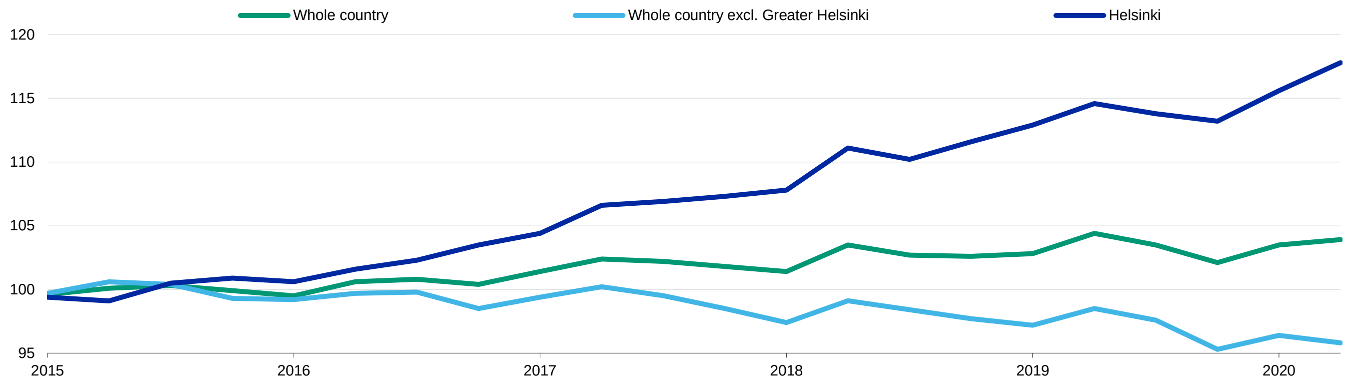
For loans to well-established HCs, the key credit risk is the possibility of structural deterioration in income and employment opportunities in the HC's region, because of demographic changes or economic circumstances in an area. In a worst-case scenario, it may be economically rational for HC shareholders to abandon their apartments depending on their equity value in the HC and personal circumstances, which might cause very high vacancy rates. In such a scenario, recovery prospects for defaulted HC loans would be severely limited.

As in other European countries, Finland's regional demographic and economic prospects differ. Outside of urban areas in Finland, house prices have been flat or even declining in the last five years, as Exhibit 6 shows.

Exhibit 6

House prices outside urban areas have been flat or even declining in the last five years

House price index of old dwellings in housing companies (2015 = 100)



Source: Statistics of Finland

HC loans financing new buildings are riskier

HC loans financing new building are riskier than those for renovations, because of higher leverage for both HCs and shareholders, the potential for repayment shocks at the end of interest-only periods and possible ownership concentration. Aktia has not added this type of HC loans to the cover pool backing its mortgage covered bonds.

In recent years, property developers have used HC loans to fund 70%-80% of new residential buildings in Finland. Developers lower the sales price of apartments in HCs in return for purchasers taking over the HC loan.

For HC loans funding new developments, leverage is higher than for loans for renovation purposes. Higher leverage means higher sensitivity to interest rate increases, which raises risks. If HC shareholders' retail mortgage interest rates were to increase at the same time as HC loan interest rates, this would exacerbate risks.

HC loans typically have interest-only periods of three to five years after building completion, which keeps initial debt service costs down. However, this also raises the risk of repayment shocks when the interest-only period ends, particularly if this occurs at a time when interest rates are higher than current low levels.

Furthermore, investors are more likely to buy into new buildings than well-established HC estates, potentially resulting in more concentrated HC ownership and higher-leveraged shareholders. This speculative element and ownership concentration means there could be fewer shareholders to in effect share in joint liability for the HC loans, though the Finnish Financial Supervisory Authority requires banks to assess significant ownership concentration as part of their underwriting process for HC loans.[4]

When HC debt is risky, this also weakens the collateral for retail mortgages. HC shareholdings, not apartments, secure retail mortgages financing apartment shares in HCs. If a HC is financially weak, this may impair the value of the HC shareholding, which would reduce the security of the retail mortgage and potentially increase credit losses on the retail mortgage.

Endnotes

1 The bank ratings shown in this report are the LT Bank Deposits (Domestic) rating, LT Counterparty Risk Assessment and Adjusted Baseline Credit Assessment.

2 Limited Liability Housing Companies Act.

3 HCs charge fees to shareholders. These fees cover interest and principal payments for HC loans, as well as other expenses such as management and maintenance costs.

4 See FIN-FSA - Risks increasing in construction-stage financing and housing corporation loans, 23 May 2018.

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