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Transaction Update: Bank of Aland PLC Category FIN Covered Bonds

Category FIN Mortgage Covered Bonds

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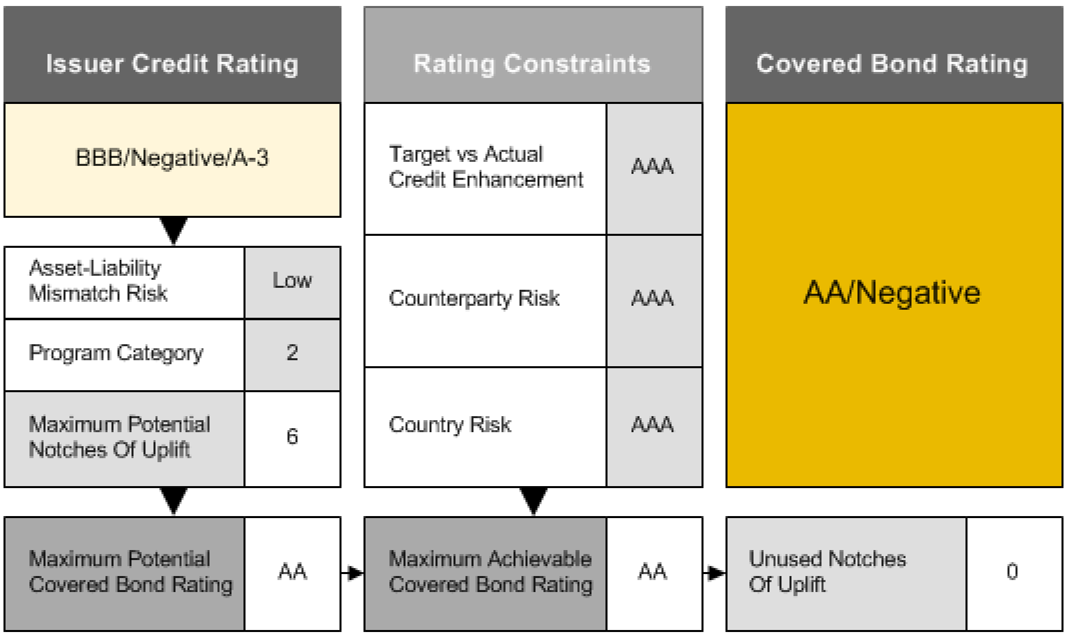
Ratings Detail



Program Overview

Table 1

Bank of Aland PLC Category FIN Covered Bonds	
Based On Data As Of March 31, 2014	
Jurisdiction	Finland
Type of covered bonds	Legislation-enabled
Underlying assets	Residential mortgage loans
Outstanding covered bonds (bil. €)	0.67
Year of first issuance	2012
Rating at closing/year	AA/2012
Extendible maturities	No
Target credit enhancement (%)	19.12
Available credit enhancement (%)	52.2

Major Factors

Strengths

- High level of available credit enhancement compared with target credit enhancement.
- Low risk of asset-liability mismatch (ALMM).

Weaknesses

- Commingling and bank account risk that is not addressed either structurally or by the legal framework.

Outlook: Negative

The outlook on the covered bonds is negative, reflecting the outlook on Bank of Aland PLC. If we were to downgrade the issuer, we would consequently downgrade the covered bonds, all else being equal.

Rationale

We assess the ALMM risk of the covered bonds as "low" and categorize the program in Category 2 in accordance with our ALMM criteria for rating covered bonds (see "Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds," published Dec. 16, 2009, on RatingsDirect). This allows the rating on the program to be up to six notches higher than the long-term issuer credit rating (ICR) on Bank of Aland. The available overcollateralization is commensurate with the highest achievable rating: 'AA'.

There are no constraints based on legal, counterparty, or country risk.

Our methodology and assumptions for rating covered bonds are outlined in "Covered Bond Ratings Framework: Methodology And Assumptions," published June 26, 2012.

Program Description

Bank of Aland is a relatively small bank with a strong presence in the Finnish region of the Aland Islands. The bank's operations in Finland are concentrated in the Aland Islands and a branch network in southern and western Finland. The bank focuses on offering private banking to high-net-worth clients, complemented by operations in Sweden.

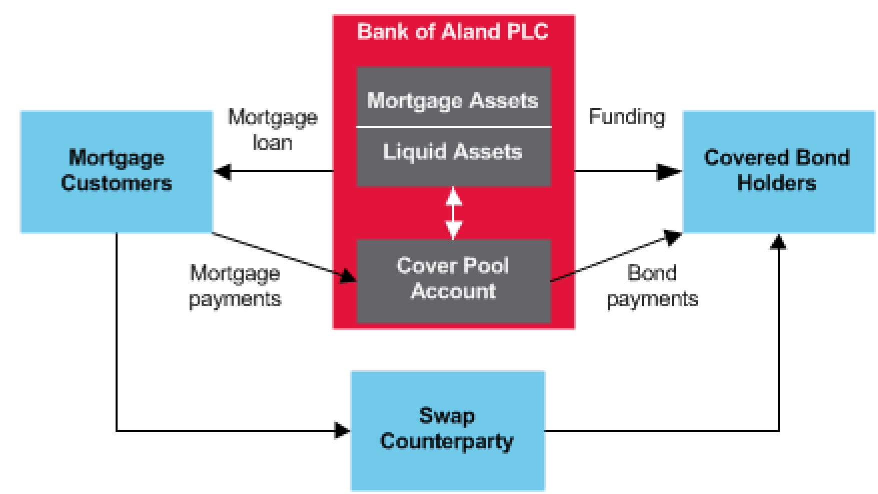
Under its €2 billion covered bond program, Bank of Aland will maintain two separate cover pools, each backing a separate set of covered bonds. The "Category FIN Covered Bonds" have a preferential claim on a separate pool of Finnish mortgage assets, while the "Category SWE" covered bonds are collateralized by a pool of Swedish mortgages. Both sets of covered bonds are issued under the terms of Finnish Covered Bond Act. This transaction update covers the "Category FIN" covered bonds only.

The covered bonds constitute a senior-secured unsubordinated obligation and rank pari passu with other obligations secured by the same cover register. In the event of bankruptcy, the pools would be separate and independent of each other.

Cash in the European Central Bank account is currently not required for the highest achievable rating. Accordingly, we have not taken such cash into consideration in our cash flow analysis and our target credit enhancement calculation. Moreover, the issuer intends to replace such cash with liquid assets similar to those initially registered in the cover pool.

Chart 1

Bank of Aland PLC Category FIN Covered Bonds
Transaction Structure



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Program Participants

Table 2

Bank of Aland PLC Category FIN Covered Bonds

Role	Name	Rating	Rating dependency
Issuer	Bank of Aland PLC	BBB/Negative/A-3	Y
Bank account provider	Bank of Aland PLC	BBB/Negative/A-3	N
Bank account provider	Nordea Bank PLC	AA-/Negative/A-1+	N
Bank account provider	European Central Bank	AAA/Stable/ A-1+	N
Swap account provider	Skandinaviska Enskilda Banken AB	A+/Negative/A-1	Y
Swap account provider	Swedbank Mortgage AB	A+/Negative/A-1	Y

Issuer-Specific Factors

Legal and regulatory risk

In our opinion, the Finnish covered bond legal framework satisfies the relevant legal requirements of our covered bond criteria. This enables us to rate the covered bonds above the long-term ICR.

The Finnish Covered Bond Act of 2010 sets out the legal framework for issuing Finnish covered bonds.

If the issuer defaults, covered 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.

The cover pool's assets must be registered in either the issuer's Finnish or Swedish 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 were to become 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 payment of the covered bonds if it considers this to be in the bondholders' best interests, subject to Finnish regulatory approval. The administrator's fundraising options under the legislative framework is a major factor in our classification of the program in "Category 2" under our ALMM criteria.

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 covered bondholders. Accordingly, we rate the covered bonds on the basis of their final legal maturity.

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

Operational and administrative risk

Following a meeting with the issuer, we conducted a review of Bank of Aland's origination, underwriting, collection, and default management procedures for the program's cover pool assets.

We also reviewed the cover pool's management and administration. We concluded that the issuer manages the cover pool prudently and that it follows strict underwriting and loan management policies.

We analysed operational and administrative risk by applying our covered bond criteria. We have identified no operational or administrative risk that would affect our assessment of the program. We consider the servicing and origination procedures to be in line with those of other European covered bond issuers and we have applied no adjustments to reflect concerns about the originator in our credit analysis.

Our analysis of operational risk is consistent with our ALMM criteria.

Cover-Pool Specific Factors

Asset credit quality

All of the mortgage assets in the cover pool are currently Finnish private residential mortgage loans.

The issuer continues to add new mortgage loans to the cover pool and we expect many of the new loans registered in the "Category FIN" program to be originated on the Finnish mainland. Accordingly, while we expect the percentage of mortgage loans on the Aland islands in the cover pool to decrease, we consider the pool itself an established one and do not expect the issuer to materially change its current credit composition.

We have analysed loan-by-loan data from the issuer as of March 2014 and applied stresses commensurate with a 'AAA' rating scenario to estimate the levels of default (the weighted-average foreclosure frequency, WAFF; and our corresponding loss estimate measure, the weighted-average loss severity, WALS).

The WAFF was lower than at our last analysis, mainly driven by a reduction of loans with loan-to-value (LTV) ratios above 80%, higher seasoning, and a lower proportion of interest only loans. This was partly offset by a higher proportion of Jumbo loans and higher levels of loans in arrears. The WALS was higher, mainly driven by a higher percentage of Jumbo valuations and partly offset by lower cover pool LTV ratios.

As cash in the European Central Bank account is currently not required for the highest achievable rating, we have not taken such cash into consideration in our cash flow analysis and our target credit enhancement calculation. Moreover, the issuer intends to replace such cash with liquid assets similar to those initially registered in the cover pool.

Our analysis of the Finnish assets' credit quality follows the principles laid out in "Principles Of Credit Ratings," published Feb. 16, 2011.

Table 3

Bank of Aland PLC Category FIN Covered Bonds Cover Pool Composition				
	--Current period, March 31, 2014--		--Previous period, Jan. 31, 2013--	
Asset type	**Value (mil. €)**	**Percentage of cover pool (%)**	**Value (mil. €)**	**Percentage of cover pool (%)**
Mortgage type 1 (e.g., residential)	894,124,283.00	87.99	771,440,904.00	83.72
Mortgage type 2 (e.g., commercial)	0.00	0.00	0.00	0.00
Substitute assets	122,000,000.00	12.01	150,000,000.00	16.28
Other asset type	0.00	0.00	0.00	0.00
Total cover pool assets	1,016,124,284.00	100.00	921,440,904.00	100.00

Table 4

Bank of Aland Category FIN Covered Bonds Key Credit Metrics		
	Current period, March 31, 2014	**Previous period, Jan. 31, 2013**
Average loan size (€)	114,832	107,548
Weighted-average LTV ratio (%)	60.69	61.04
Weighted-average loan seasoning (months)*	3779.00	3519.00
Balance of loans in arrears (%)	1.47	1.32
Buy-to-let loans (%)	9.17	8.82
Credit analysis results		
Weighted-average foreclosure frequency (WAFF; %)	19.25	20.62
Weighted-average loss severity (WALS; %)	11.26	9.85

Table 4

Bank of Aland Category FIN Covered Bonds Key Credit Metrics (cont.)		
Asset default risk (%)	10.5	16.14
Country average metrics		
WAFF (%)	11.4	11.04
WALS (%)	6.04	4.99
Asset default risk (%)	2.86	4

*Seasoning refers to the elapsed loan term. LTV--Loan to value.

Table 5

Bank of Aland Category FIN Covered Bonds Cover Assets By Loan Size

(€)	Current period, March 31, 2014	Previous period, Jan. 31, 2013
0 - 10,0000	24.23	26.86
10,0000 to 20,0000	31.69	33.74
20,0000 to 30,0000	17.57	15.40
30,0000 to 40,0000	7.73	7.17
40,0000 to 50,0000	4.28	3.65
50,0000 to 60,0000	1.84	1.68
60,0000 to 70,0000	1.51	1.77
More than 70,0000	11.16	9.73

Table 6

Loan-To-value Ratios

(%)	Current period, March 31, 2014	Previous period, Jan. 31, 2013
0-60	44.29	43.57
60-70	21.71	21.6
70-80	17.14	16.54
80-90	10.47	11.47
90-100	6.38	6.82
Above 100	0.00	0.00
Weighted-average loan-to-value ratio	60.69	61.04

Table 7

Bank of Aland PLC Category FIN Covered Bonds Loan Seasoning Distribution

Remaining term to maturity (months)	Current period, March 31, 2014	Previous period, Jan. 31, 2013
Less than 18 months	35.58	38.75
18 to 60	43.12	41.32
Above 60 months	21.30	19.93
Weighted-average seasoning*	37	35

*Seasoning refers to the elapsed loan term.

Table 8

Bank of Aland PLC Category FIN Covered Bonds Geographic Distribution Of Mortgage Loans

	Current period, March 31, 2014	Previous period, Jan. 31, 2013
Southern Finland	51.30	53.49

Table 8

Bank of Aland PLC Category FIN Covered Bonds Geographic Distribution Of Mortgage Loans (cont.)		
Eastern Finland	0.11	0.15
Western Finland	29.08	28.85
Oulu (A)	0.06	0.07
Oulu (B)	0.00	0.00
Lapland	0.12	0.14
Aland	19.32	17.31
Total	100.00	100.00

Payment structure and cash flow mechanics

Our analysis of the covered bonds' payment structure indicates that cash flows from the cover pool assets would be sufficient at the current rating to make timely payments of interest and principal to bond holders. The program is exposed to ALMM risk because the mismatches in its asset-liability profile are not addressed by structural features.

We determine the maximum potential rating uplift on a program by combining our assessment of its ALMM risk and program categorization. We classify the covered bond program in Category 2, which indicates our view of the issuing bank's ability to obtain third-party liquidity or sell assets to fund any mismatch in the event that the bank fails, while ALMM risk indicates the scale and urgency of any asset-liability mismatches in the program. We consider the program to be a typical Finnish covered bond program.

To assess ALMM risk, we calculate the percentage of the cover pool that shows a mismatch between the maturities of the assets and the liabilities.

According to our ALMM criteria, the maximum potential rating on covered bonds in Category 2, with "low" ALMM risk, is six notches above the ICR. This means that Bank of Aland's Category FIN covered bonds can achieve a maximum rating of 'AA' if the available credit enhancement is at least equal to the target credit enhancement, and if other factors (such as counterparty or country risk) do not constrain the rating.

The available credit enhancement as of March 31, 2014 was 52.20%. After applying our credit and cash flow stresses, we calculated a target credit enhancement of 19.12%. This is lower than the available credit enhancement, allowing for a covered bond rating that is six notches higher than our long-term ICR on Bank of Aland.

We analysed the program's cash flows under 'AAA' credit stresses, as well as under liquidity and interest rate stresses. We also ran different default timing and prepayment patterns.

We modeled market value risk by discounting the cover pool assets' stressed cash flows with a modeled interest rate curve and a "spread shock" (an additional discount margin). We calculated the net present value of the assets' projected cash flows using a discount rate, which we base on the pool-specific asset spreads over the relevant funding rates. The current stressed target asset spread that we use for the cover pool is 425 basis points. We combined this with our assumptions of prepayment rates at 0.5% and 24.0% for low and high prepayment scenarios, respectively (based on the criteria below).

We analysed the cash flows according to our criteria as set out in "Revised Methodology And Assumptions For

Assessing Asset-Liability Mismatch Risk In Covered Bonds," published Dec. 16, 2009, "Assessing Asset-Liability Mismatch Risk In Covered Bonds: Revised Methodology And Assumptions For Target Asset Spreads," published April 24, 2012, "Update To The Cash Flow Criteria For European RMBS Transactions," published Jan. 6, 2009, and "Cash Flow Criteria For European RMBS Transactions," published Nov. 20, 2003.

Table 9

Bank of Aland PLC Category FIN Covered Bonds ALMM Metrics

	Current period, March 31, 2014	Previous period, Jan. 31, 2013
Asset WAM (years)	6.85	5.97
Liability WAM (years)	3.96	4.69
Maturity gap (years)	2.89	1.28
ALMM (%)	0	0
ALMM classification	Low	Low
Maximum uplift above issuer rating (notches)	6	6
Target credit enhancement for maximum uplift (%)	19.12	20.35
Target credit enhancement for first notch of uplift (%)	10.74	16.14
Available credit enhancement (%)	52.2	60.58
Country average target credit enhancement (%)	13.44	15.45
Country average available credit enhancement (%)	52.2	41.32

ALMM--Asset-liability maturity mismatch. WAM--Weighted average maturity.

Additional Factors

Counterparty risk

We have identified several potential counterparty risks to which the covered bonds are exposed. However, these are either mitigated through structural mechanisms, or we have taken them into account in our modeling. Accordingly, we consider that they do not constrain our ratings on the covered bonds.

We have identified account bank and commingling risk as a relevant counterparty risk that is not addressed structurally or by law. We have considered the frequency of our access to information on the program's available credit enhancement to estimate the size of the account bank and commingling risk--currently 9.99% of the additional credit enhancement--and take the view that overcollateralization sufficiently mitigates this risk.

The swaps in place cover interest rate and currency mismatches between the mortgage loans in the cover pool and the payments due to covered bondholders. Swap agreements in line with our criteria govern the program's asset swaps and liability swaps, which provide various replacement options if the swap providers, are downgraded below 'A-'. We factor the remaining interest rate risk into our cash flow calculation.

Accordingly, counterparty risk does not constrain the maximum achievable ratings on the covered bonds.

Country risk

Sovereign risk does not constrain our ratings on the covered bonds because the mortgage assets are all located in Finland, which we rate 'AAA'. In addition, we consider that these assets have "low" sensitivity to country risk.

Accordingly, the covered bonds can be rated up to six notches above the sovereign according to our nonsvereign ratings criteria (see "Nonsovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published June 14, 2011).

Potential Effects Of Proposed Criteria Changes

Our ratings are based on our applicable criteria, including those set out in the criteria articles, "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 26, 2012, on RatingsDirect, and "Nonsovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published on June 14, 2011. However, please note that these criteria are under review (see "Advance Notice Of Proposed Criteria Change For Covered Bonds," published on April 29, 2014, and "Request For Comment On Proposed Methodology Change For Rating Structured Finance Above The Sovereign," published Oct. 14, 2013).

As a result of this review, our future criteria applicable to rating covered bonds may differ from our current criteria. These criteria changes may affect the ratings on the outstanding covered bonds. Until we adopt new criteria, we will continue to rate and surveil these covered bonds using our existing criteria (see Related Criteria And Research).

Related Criteria And Research

Related criteria

- Europe Asset Isolation And Special-Purpose Entity Criteria--Structured Finance, Sept. 13, 2013
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Covered Bond Ratings Framework: Methodology And Assumptions, June 26, 2012
- Covered Bonds Counterparty And Supporting Obligations Methodology And Assumptions, May 31 2012
- Assessing Asset-Liability Mismatch Risk In Covered Bonds: Revised Methodology And Assumptions For Target Asset Spreads, April 24, 2012
- Nonsovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions, June 14, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds, Dec. 16, 2009
- Update To The Cash Flow Criteria For European RMBS Transactions, Jan. 6 2009
- Cash Flow Criteria For European RMBS Transactions, Nov. 20 2003

Related research

- Advance Notice Of Proposed Criteria Change For Covered Bonds, April 29, 2014
- Outlook On Finland Revised To Negative On Subpar Growth Prospects; 'AAA/A-1+' Ratings Affirmed, April 11, 2014
- Request For Comment: Methodology And Assumptions For Ratings Above The Sovereign--Single Jurisdiction Structured Finance, Oct. 14, 2013
- Credit FAQ: What Factors Do We Consider When Analyzing Commingling And Account Bank Risk In Covered Bonds?, Nov. 26, 2012
- Covered Bond Monitor: Technical Note, Feb. 14, 2006

Appendix: Summary Of Adjustments In Our Credit Analysis

No specific covered bond criteria exist for Finland to determine asset credit risk. For this reason we apply the principles set out in "Principles Of Credit Ratings," published Feb. 16, 2011.

The base foreclosure frequencies and market value declines used for this credit analysis have been derived by comparing the base assumptions to levels in markets for which we have published criteria and which have similar credit characteristics and mortgage performances, namely Germany and Sweden. The mortgage market and system in Finland is standardized, and has substantial political support. We observe the following similarities to the German and Swedish mortgage markets:

- Lenders have full recourse to borrowers of residential mortgage loans. Lenders can pursue this right if necessary.
- The legal framework is creditor-friendly with strong enforcement.
- Underwriting practices are similar; they assessthe borrower's creditworthiness and the quality of the underlying property. For example, standardized valuation methods serve as a basis for loan origination.
- Finland has a long tradition of on-balance sheet refinancing of residential mortgage loans through deposits and covered bonds. The originate-to-distribute model is not a strong feature.

Base assumptions for the credit analysis of Finnish residential mortgage loans

This section provides additional detail on the adjustments taken in the credit analysis.

Adjustments to the WAFF. Our base foreclosure frequency at a 'AAA' rating level is 12%.

LTV ratios have historically been a key foreclosure predictor, with low LTV ratios associated with lower probabilities of loan default. For loans with LTV ratios above 80%, we apply an analytical adjustment to the base foreclosure frequency (see table 10). We derived the ratio brackets and base foreclosure frequency multipliers by comparing other jurisdictions with similar economic performances.

Table 10

Adjustments To Base FF: LTV Ratio

LTV ratio	
60% to 80%	1 x Base FF
81% to 90%	1.5 x Base FF
91% to 100%	3 x Base FF
100% and above	4 x Base FF

LTV--Loan-to-value. FF--Foreclosure frequency.

We applied a seasoning benefit to loans with a seasoning above 18 months, as loans with a performance history often perform better than newly originated loans. We based the applied limits on generally applied limits from comparable jurisdictions. We make no adjustments based on seasoning to loans in arrears.

Table 11

Adjustments To Base FF: Seasoning

Months	
18 to 60	0.9 x Base FF

Table 11

Adjustments To Base FF: Seasoning (cont.)	
60 and above	0.75 x Base FF

FF--Foreclosure frequency.

Generally, we consider residential mortgage loans with short interest-only payment maturities to be riskier than mortgage loans with longer maturities. This is because longer maturity interest-only loans allow the borrower to prepare better for potentially higher payments following the expiry of the interest-only period, for example through increased savings, or a refinancing plan. We consider interest-only loans with a maturity above 20 years to be exposed to similar risk as repayment loans.

Table 12

Adjustments to Base Foreclosure Frequency: Interest Only	
Interest-only period	
5-10 years	3 x Base FF
10-20 years	1.67 x Base FF

FF--Foreclosure frequency.

We increase the base foreclosure frequency for loan sizes exceeding the thresholds outlined in table 13 by a factor of 1% to 20%.

Table 13

Adjustments to Base Foreclosure Frequency: Jumbo Loans	
Region	**Jumbo Loan (EUR)**
South	300,000
Other	200,000

Arrears. All loans in arrears are automatically assigned a foreclosure frequency of 75%. We consider loans that are in arrears to have a much greater probability of default.

Adjustments to the WALS. Our base market value decline at a 'AAA' rating level is 40%.

Reduction of valuation. We can reduce the valuation before calculating the loss severity if we consider price volatility to be high. In our analysis, the valuations provided by the issuer were recent and therefore reflected recent house price index movements. Accordingly, we did not reduce valuations in our calculation of loss severity.

Table 14

Adjustments To Base Market Value Decline: Jumbo Valuation	
Region	**Jumbo Valuation (€)**
South	375,000
Other	250,000

We increased our base market value decline assumptions with a factor between 1% and 20% for loan valuations exceeding the thresholds outlined in table 14.

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