Landkreditt Boligkreditt AS

Norwegian Covered Bonds – Performance Update

The AAA rating with a Stable Outlook assigned to the Norwegian mortgage-covered bonds issued out of Landkreditt Boligkreditt AS (LKBol) is based on the bank's A- issuer rating, enhanced by six notches of cover pool support. Five notches thereof reflect our assessment of the strong fundamental credit support provided by the Norwegian legal covered bond and resolution frameworks.

Rating rationale (summary)

Cut-off date	Cover pool	Cover asset type	Covered bonds*	Rating/Outlook
31 Dec 2018	NOK 4.03bn	Mortgage loans	NOK 3.47bn	AAA/Stable

* Obligasjoner med fortrinnsrett (Norwegian mortgage-covered bonds) [2]

The AAA covered bond ratings benefit from a two-notch buffer against an issuer downgrade assuming an unchanged covered bond risk profile. This buffer reflects a cover pool uplift of up to three notches on top of the fundamental credit support (altogether up to eight notches for LKBol's covered bonds). Fundamental credit support provides a backstop against a deterioration of the credit quality of the cover pool.

Fundamental credit support	Distance	Ratings	Cover pool analysis
	D8	(Unused)	Cover pool support +8
	D7	(Unused)	Cover pool support +7
	D6	AAA	Cover pool support +6
Resolution regime +3	D5	AA+	Cover pool support +5
Resolution regime +2	D4	AA	Cover pool support +4
Resolution regime +1	D3	AA-	Cover pool support +3
Legal framework +2	D2	A+	Cover pool support +2
Legal framework +1	D1	A	Cover pool support +1
Issuer rating	D0	A-	Issuer rating

Covered bond uplift

Adequate overcollateralisation supporting the rating

The programme's AAA rating is cover pool supported. To provide a six-notch uplift, 7.0% of overcollateralisation (oc) are sufficient to mitigate credit and market risks. The supporting oc is well below the current level of 16.1% provided by the bank and lower than last year. Maturity mismatches from residential mortgage loans with an average remaining life of 11.0 years, compared to only 3.7 years for the covered bonds, are the main contributor to the supporting oc. Credit risk contributes only 1.4 pp to the supporting oc and remains a secondary risk driver for the programme.

Stable Outlook

The Stable Outlook on the covered bond rating reflects our expectations that: i) the credit performance of Landkreditt Bank, LKBol and its mortgage borrowers will continue to be stable; ii) the issuer will maintain its covered bond programme's prudent risk profile; and iii) both the parent and direct issuer will remain willing and able to provide sufficient oc to support the covered bonds' very high credit quality.

The two-notch buffer against an issuer downgrade also supports the Stable Outlook on the covered bonds, provided the programme's risk structure does not change materially.

1 The issuer has solicited the assigned rating and participated in the rating process.
2 Scope's covered bond ratings constitute an opinion about the relative credit risks and reflect the expected loss associated with the payments contractually promised by an instrument on a particular payment date or by its legal maturity. See Scope's website for the covered bond rating definitions.

Ratings & Outlook[1]

Issuer rating	**A-**
Outlook	Stable
Last rating action	New
Last rating action date	**04.04.2018**
Covered bond rating	**AAA**
Outlook	Stable
Rating action	Affirmation
Last rating action date	02.04.2019

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Related Research

Scope affirms at AAA/Stable mortgage-covered bonds issued by Landkreditt Boligkreditt AS, 1 April 2019

Landkreditt Bank AS Issuer Rating Report, 4 April 2018

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The issuer

Landkreditt Boligkreditt AS (LKBol) ratings reflect those of its parent bank, Landkreditt Bank (LKB).

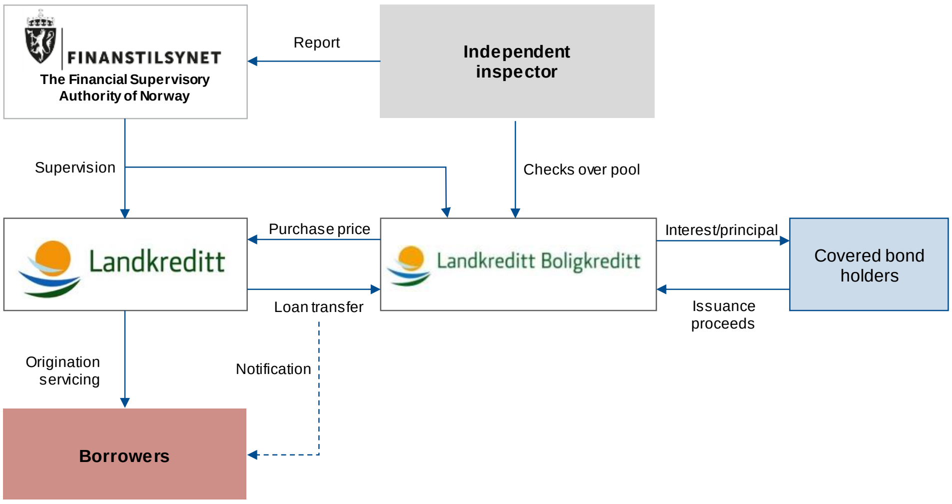
LKB is a leader in financial services for agricultural customers in Norway. The bank also focuses on retail customers as part its strategy to achieve greater scale and business diversification. LKB aims to establish a customer base balanced equally on the agricultural and retail sectors. As an online bank, LKB has an efficient structure and continues to invest further in digitalisation and improving customer service.

LKB has a low-risk profile with minimal credit losses, as most of its loans are secured by residential, agricultural or land properties.

The bank's cooperative ownership further reinforces its low-risk business, as members have a stake in the group's success. We expect the bank's operating environment to remain supportive: Norway, its main market, continues to benefit from solid economic growth, low unemployment and high wealth levels.

Covered bond structure

Figure 1: Transaction structure



Under Norway's covered bond framework, issuance is only permitted through specialist covered bond issuers. LKBol is a specialised residential mortgage institution and like most issuers of covered bonds (called Boligkreditt) are subsidiaries that rely on loans originated by their respective parent banks. The parent banks generally also provide most of the services for these subsidiaries, allowing the latter to keep staff numbers low.

Like other Norwegian covered bond issuers, LKBol is supervised by both an independent inspector and the Financial Supervisory Authority of Norway (Finanstilsynet).

A Boligkreditt issues covered bonds whose proceeds are used to purchase mortgage assets from its parent bank, thereby financing the latter's lending business. The scheduled interest and principal proceeds from the cover pool are used to pay covered bond investors.

Upon solvency or liquidity problems for the issuer, a public administrator would take control to ensure timely payment to the covered bond holders.

Fundamental credit support

Fundamental credit support factors enhance the covered bond rating by five notches above LKBol's issuer rating. The maximum uplift is currently constrained by the issuer's low to moderate visibility as a covered bond issuer, resulting in a lower likelihood of continuation should the issuer default

Two notches of fundamental uplift are driven by our positive view of the Norwegian legal covered bond framework. We believe that Norway has one of the strongest covered bond frameworks in Europe. It meets our criteria for the protection of covered bond investors in a going or gone concern of a bank and allows us to assign the highest credit differentiation.

Three additional notches of uplift for the covered bonds reflect a 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 recognise the low visibility and limited importance of LKBol as a covered bond issuer. In general, Norwegian covered bonds from resolvable and very visible issuers can benefit from up to four additional notches of support.

Cover pool composition

Pool characteristics (NOK bn)	
Total balance	4.0
Residential assets	4.0
Substitute assets	0.0

General information	
Number of borrowers	2,607
Avg exposure ('000)	1,545
Top 1 (%)	0.5
Top 10 (%)	2.7
Seasoning (y)	3.8
LTV (%)	45.4

Interest rate type (%)	
Floating	100
Fixed	0

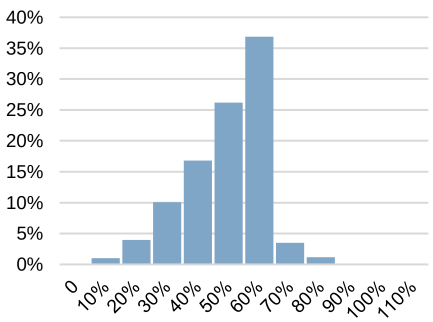
Repayment type (%)	
French	51
Flexible	32
Interest only (IO)	17

The cover pool comprises Norwegian granular, first-lien residential mortgage loans denominated in Norwegian kroner. As of December 2018, the loans were granted to 2,607 obligor groups. We assess the cover pool as granular, with an average loan size of NOK 1,545,000 (around EUR 158,000). The top 10 largest obligors account for 2.7%.

The weighted average whole loan to value (LTV) is 45%. This LTV is calculated based on the maximum drawable amount for re-drawable loans (flexible loans) which make up 32% of the cover pool. These loans have an embedded credit line which can be redrawn without new credit approval. Flexible loans will only be granted if the loan's LTV does not exceed 60%. Existing flexible loans may only draw up to a level of 60%. Another 17% of the mortgage loans have an interest-only period. The remaining loans are normal amortising loans.

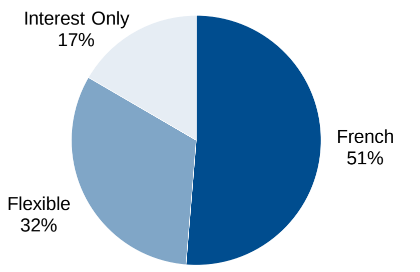
Figure 2: Key pool characteristics

LTV distribution



Source: LKBol, Scope

Repayment type



Source: LKBol, Scope

The collateral is primarily located in the Oslo and Akershus regions, together accounting for around 63%. The rest of the portfolio is spread across Norway, supported by LKB's online distribution channel. Norway's oil regions (Rogaland, Hordaland and Vest Agder) are less represented, accounting for 7.9% compared to the country average of 22%.

Around two third of the portfolio is made up of single-family houses and another quarter of flats or apartments. Holiday homes account for only 0.6% and agricultural property for another 0.3%.

Regional distribution (%)	
Oslo	32.2
Akershus	31.7
Buskerud	5.2
Østfold	4.5
Rogaland	4.2
Rest	22.1

Scope regional mapping (%)	
Oslo and Akershus	63.4
Oil regions	7.9
Rest of Norway	28.8

Property type (%)	
Houses	69.5
Flats	24.8
Other	5.7

Currency breakdown (%)

	Assets	Bonds
NOK	100	100

Interest type (%)

	Assets	Bonds
Fixed	0	0
Floating	100	100
Hedged	No	No

Supporting oc breakdown (%)

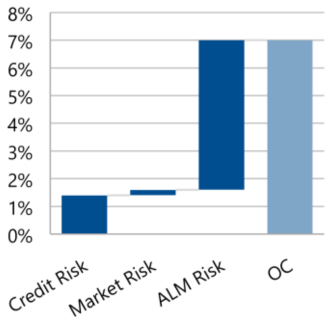
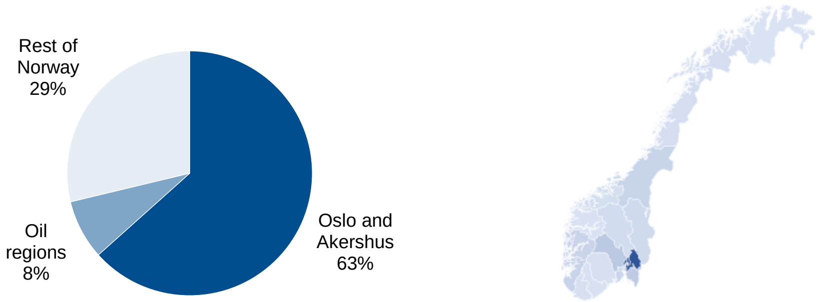


Figure 3: Regional distribution of collateral



Source: LKBol, Scope

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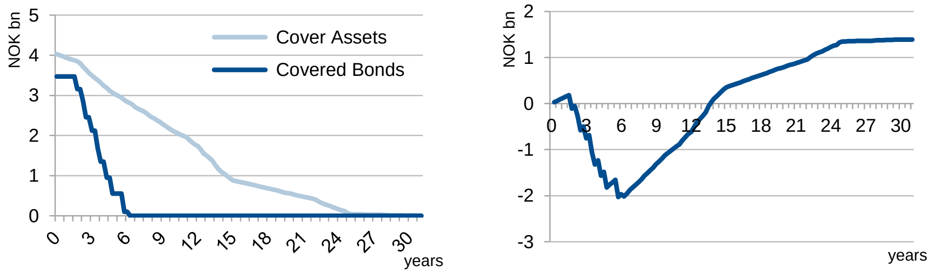
Asset and cash flow analysis (Cover pool support)

In order to determine the cover pool-supported rating uplift, we performed a cash flow analysis to establish an expected loss for the covered bonds. The programme's AAA ratings are tested against a 6-notch uplift. The programmes maximum uplift of 8 notches provides a two-notch buffer against an issuer downgrade.

Maturity mismatches (ALM risk), accounting for 5.4 pp of the 7% supporting oc, are the main risk contributor. They arise from the gap between the asset's weighted average life (WAL) of 11 years and the bonds' WAL of only 3.7 years[3] as we assume that assets are sold under a discount when asset amortisation is insufficient to pay timely interest and principle on the covered bonds.

Figure 4: Scheduled amortisaton profile[3] and cash account (NOK bn)



Source: LKBol, Scope

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Credit risk remains relatively low which is reflected by an annual term default probability of 62 bps, a stressed recovery rate of 88.5% and a coefficient of variation of 50%. Credit risk accounts for 1.4 pp and is not a major driver for the supporting oc. Market risk is minimal as all bonds and assets are floating and denominated in NOK.

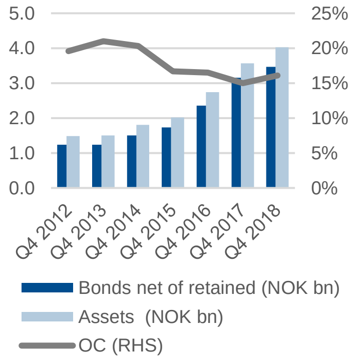
The programme's supporting oc is most vulnerable to low prepayments (0%) in combination with rising interest rates (rising after 6 years non-converting).

The supporting oc reflects the results of further sensitivity tests including a liquidity premium of up to 200 bps, considering the less liquid nature of the flexible loans. In addition, we also tested sensitivity to a margin compression down to 40 bps and frontloaded defaults.

The decrease in supporting oc since our last analysis is predominantly driven by less conservative assumption on the loans' repayments. Further we updated assumptions for Norway resulting in higher recoveries compared to our last analysis.

[3] Bond cash flows were calculated assuming the 12 months extension was triggered

Overcollateralisation



Summary of covered bond characteristics

Reporting date	Dec 2017	Dec 2018
Issuer name	Landkreditt Boligkreditt AS	
Country	Norway	
Type of covered bond	Obligasjoner med fortrinnsrett (OMF)	
Legal framework	Norwegian legal covered bond framework	
Cover pool type	Residential mortgages	
Covered bond maturity type	Soft bullet (one-year extension)	
Issuer rating / Outlook	A- / Stable	A- / Stable
Covered bond rating / Outlook	AAA / Stable	AAA / Stable
Fundamental support (notches)	5	5
Cover pool support	3	3
Downgrade buffer	2	2
Cover assets (NOK bn)	3.58	4.03
thereof substitute	0	0
Covered bonds	3.20	3.47
Current oc (%)	13.5	16.1
Oc supporting the rating	11.0	7.0
Oc supporting the rating upon one-notch issuer downgrade	12.0	8.0
Avg. loan seasoning	3.5	3.8
WAL / duration of assets	16.5 / 13.0	11.0 / 10.3[4]
WAL / duration of bonds	3.7 / 3.6	3.7 / 3.6
WAL duration gap	12.7 / 9.4	7.3 / 6.5
Interest type assets	100% (floating)	100% (floating)
Interest type bonds	100% (floating)	100% (floating)
Number of borrowers	2.491	2.606
Avg loan size / borrower	1,437,037	1,544,921
Top 1	0.4	0.5
Top 10	2.5	2.7
Top 20	4.4	4.6
Weighted avg. LTV	42.1	45.4
Default measure	Inverse Gaussian	Inverse Gaussian
Cumulative term default rate[5]	10.0%	10.0%
Coefficient of variation	50%	50%
Avg. recovery rate (base/stressed)	98% / 73%	99% / 88.5%

[4] The decrease in asset WAL is driven by a different approach used to amortise the portfolio until the assets' final legal maturity date
[5] The term default rate does not constitute any amortization during the life of the loans and translates into an annual avg. default rate of 0.62%

Quantitative analysis and key assumptions

We projected default on mortgage loans using an inverse Gaussian distribution. This was based on credit performance data provided by the bank (historical delinquencies, portfolio loss rate) and benchmarking.

In our loss given default analysis, we assumed that the credit lines for flexible loans are fully drawn and pay interest only until their expected maturity, assuming a loan term of 15 years.

We established recovery rates by applying rating distance-dependent security value haircuts, reflecting market value declines and fire sale discounts. The assumptions used reflect our analysis of Norwegian housing market developments and their unique characteristics.

Security value haircuts (SVH)	Base SVH	Stressed SVH
Oslo and Akerhus	32.5%	57.5%
South West (oil)	20.0%	45.0%
Rest of Norway	27.5%	47.5%

We used the resulting loss distribution and default timing to project the covered bond programme's losses and reflect the programme's amortisation structure. We also incorporated the impact of rating distance-dependent interest rate stresses in our analysis. The covered bond programme is most sensitive to a scenario in which interest rates increase after six years and plateau at 10% thereafter.

In order to calculate a net present value for the cover pool in the event of an asset sale, we added a liquidity premium for Norwegian residential mortgage loans of 150 bps to the rating distance- and scenario-dependent discount curve. We derived this liquidity premium by analysing the long-term development of trading spreads for Norwegian and other 'core country' covered bonds.

We tested for low (0%) and high prepayments (up to 25%) to stress the programme's sensitivity to unscheduled repayments. The programme is most sensitive to low prepayments as the large maturity mismatch requires asset sales in order to make timely payments on the bonds.

We assumed a recovery lag of 18 months for residential loans originated by LKBol. The recovery timing for the mortgage loans was based on an analysis of Norwegian enforcement processes, bearing in mind that the collateral's regionality and strong dependencies on oil may temporarily lengthen the overall recovery process.

We applied country- and asset type-specific servicing fees which the cover pool needs to pay annually. For the residential mortgage loans, we assumed a servicing fee of 25 bps.

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