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SECTOR COMMENT

# Norwegian Covered Bonds: Banks' Strengthened Underwriting Criteria Improve Mortgage Loan Credit Quality

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Norwegian banks have strengthened their credit underwriting standards, according to the lending survey[1] published on 5 November 2013 by the Financial Supervisory Authority of Norway (FSA). The results of the survey show that banks have reduced the proportion of the riskiest loans they originate, thereby improving the credit quality of the cover pools that back the covered bonds. The proportion of interest-only loans is reducing, as well as the proportion of high loan-to-value (LTV) ratio loans, in particular to first-time buyer borrowers. The vast majority of borrowers show resilience to an interest-rate rise. Finally, while the share of flexible loans (FlexLoans)[2] is also decreasing, the proportion of FlexLoans granted to young borrowers, which makes up a relatively small portion of most cover pools, at higher LTV levels is increasing, which partly offsets the overall improvement of the underwriting quality.

**The proportion of loans with interest-only (IO) payments has halved within two years to a low of 11.7% (Exhibit 1)**. In addition, for IO loans, the average length of interest-only periods has shortened to three years, from approximately four years. The decrease in the proportion of IO loans and the shortening of IO periods are credit positive for the collateral quality as it requires borrowers to better adjust their spending habits to suit their loan repayment requirements. It also helps to reduce losses if a borrower defaults, which is important considering that the LTVs of these loans are often as high as 85% at origination in an environment where house price growth is abating.[3]

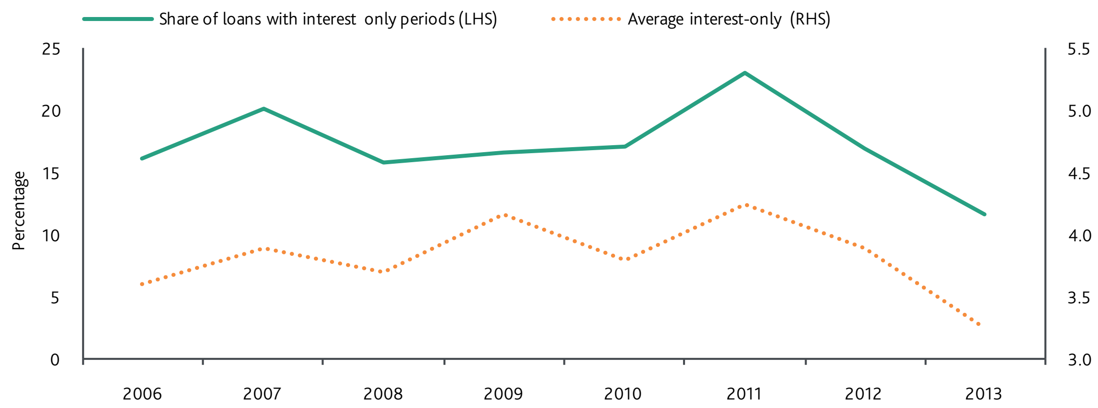
1 The lending survey covers 7000 loans originated by the 30 biggest banks (reflecting 88% market share) in August and September 2013. For details, see Financial Trends, November 2013. The Finanstilsynet's (the Norwegian Financial Supervisory Authority) lending guidelines primarily stipulate that (1) a loan may normally not exceed 85% of the value of the property; (2) the LTV should include all loans on a property; (3) the rules for deviations must be set by the board of the bank; (4) loans with an LTV of 70% or higher must be amortising from the first interest payment; (5) loans with variable amounts should not exceed a 70% LTV; and (6) the household budget has to withstand an interest-rate increase of 5 percentage points. See Finanstilsynet's press releases 9/2010 (3 March 2010), 44/2011 (1 December 2011) and 524 (7 May 2012) (in Norwegian).

2 FlexLoans are common in the Norwegian market. This loan product is similar to a credit line, in that the borrower can redraw amounts of the mortgage that he/she has repaid, thereby offering additional borrower flexibility.

3 According to the Eiendomsverdi October2013 market update, house prices have decreased in September and October 2013, slowing down the continued house price growth that has been observed in Norway. Prices for detached houses have grown 5.2% year to date and 34.4% over the last five years.

EXHIBIT 1

**The proportion of loans with IO payments has reduced and for IO loans the length of the interest-only period has shortened**

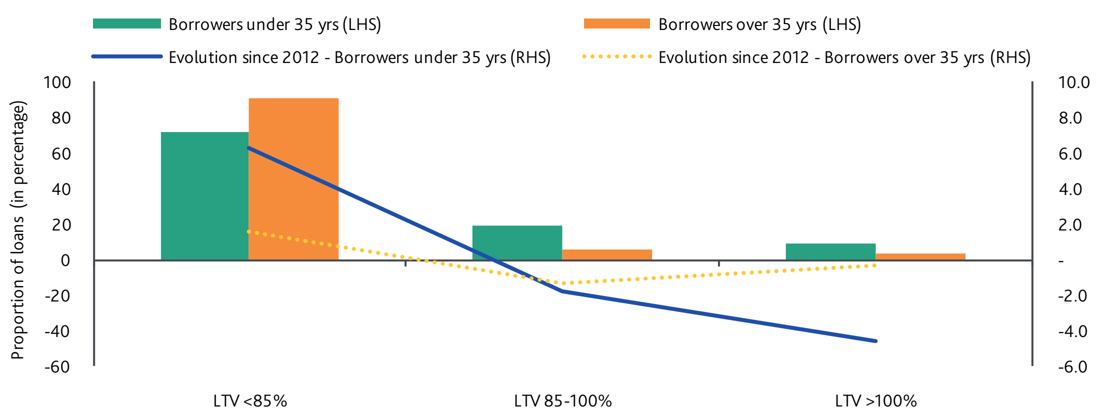



*Source: FSA's Financial Trends, November 2013*

**The proportion of high-LTV loans to young borrowers has reduced**. Loans with an LTV exceeding 85% now represent 15% of the new production down from 17% last year. The FSA guidelines require banks to grant high LTV loans only when mitigating risk factors exist, such as additional collateral. Of these high LTV loans, 60% benefit from additional collateral pledged in favour of the lender. Taking pledged additional collateral into account in calculating the LTV ratio, the share of loans with LTVs exceeding 85% falls to 8%. More importantly, the share of high-LTV loans to borrowers under 35 years, typically first-time buyers and with a higher risk to become delinquent, has reduced to 27.7% from 34.0% last year. We see this reduction in the proportion of high LTV loans as a positive development as the LTV is a key driver of the collateral credit risk.

EXHIBIT 2

**The proportion of high LTV loans has decreased and so has the proportion of high LTV loans to young borrowers**



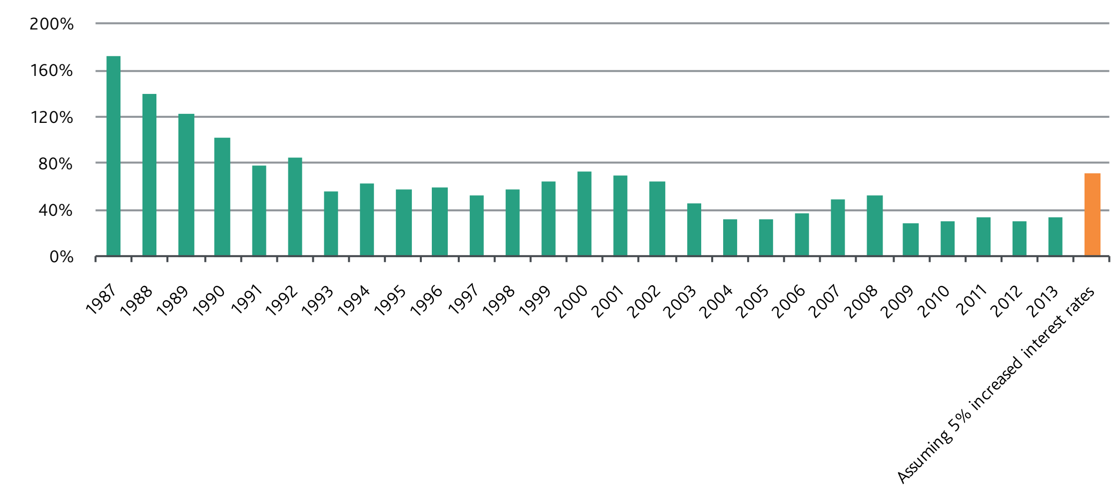

*Source: FSA's Financial Trends, November 2013*

**Most borrowers would be resilient to an interest-rate rise**. Because most Norwegian loans are floating rate, the FSA lending guidelines require banks to test borrowers' affordability if interest rates rise by 5 percentage points (pps). The survey results show that 6% of borrowers would have insufficient income to meet their debt-service obligations if interest rates were to increase by 5 pps. When focusing on loans with an LTV ratio exceeding 85%, the survey shows that only approximately 3% of borrowers would not be able to repay.

Projections show that an interest-rate rise of 5 pps would likely affect borrowers' spending habits, but not lead to a dramatic deterioration of borrowers' interest payments affordability. Exhibit 3 shows the proportion of a borrower's freely available income[4] dedicated to mortgage interest payments, assuming an LTV of 70%[5]. Currently, the median household spends around 1/3 of its disposable income for interest service, leaving the reminder for discretionary spending, mortgage principal repayment and saving. Assuming a 5 pps interest-rate increase, this ratio would increase significantly and may lead consumers to tighten their discretionary spending However, the interest burden would then be at a level last seen around 15 years ago and remain significantly lower than what was observed in the early 1990s when Norway experienced a severe economic downturn.

EXHIBIT 3

**An interest rate rise of 5 percentage points would not dramatically affect borrowers' affordability**



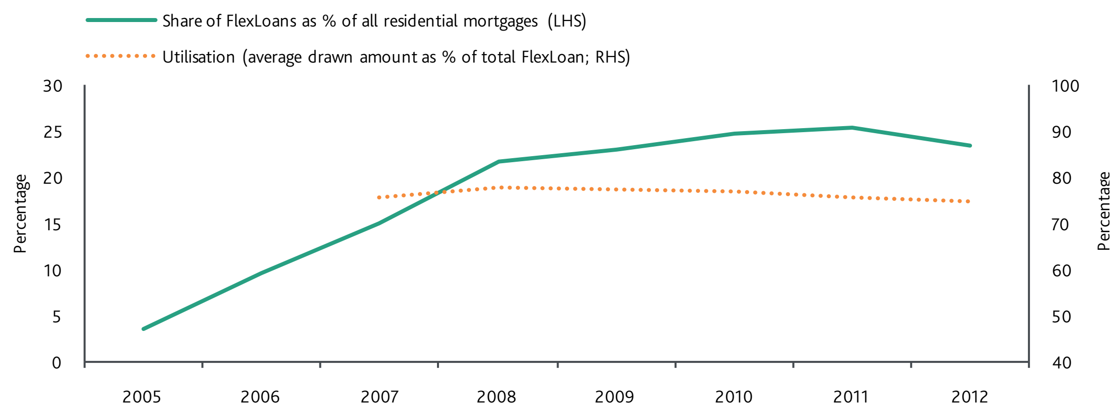

*Source: Chart developed by Eiendomsverdi using assumptions, based on Statistics Norway, Eiendomsmeglerforetakernes forening EFF, Finanstilsynet, Norges Bank data*

**However, although banks originate fewer FlexLoans, more of these loans are originated to young borrowers at high LTV levels.** As a proportion of all residential loans, the origination of FlexLoans has marginally decreased to 23.5% from 25.5% (Exhibit 4) after years of increases. This decrease in the proportion of FlexLoans is credit positive as these loans are riskier than fully amortizing loans because their principal can increase over time through additional loan draws, and such draws are likely to occur in an economic downturn. However, banks grant more FlexLoans with high LTV ratios to young borrowers than before, which is credit negative. The share of loans above 70% LTV to younger borrowers has increased to 20.7% from 14.5% last year (compare Exhibit 5).

[4] The income is net of tax and net of necessary consumption. Necessary consumption includes the following items: Food and non-alcoholic beverages, clothes and shoes, furniture and other household goods, healthcare, transportation, mail and phone services.

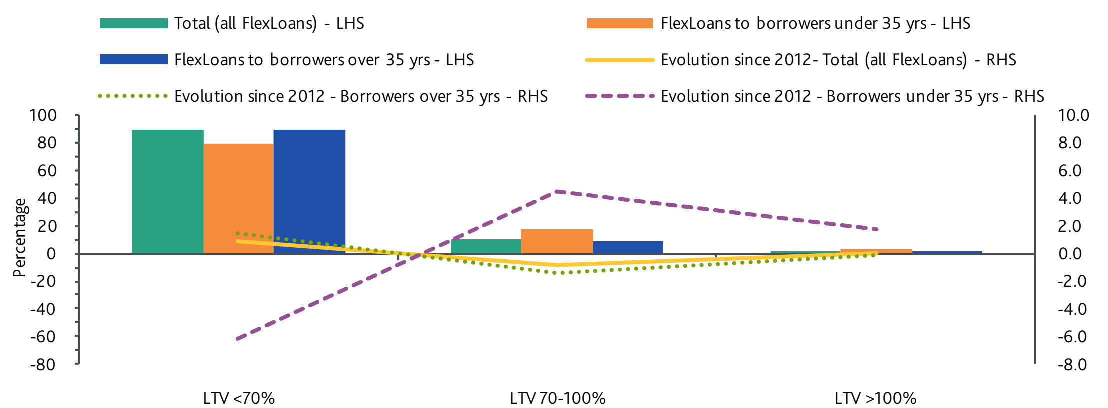
[5] We note that the debt burden is not distributed equally among the population with borrowers under 40years of age being more affected in case interest rates rise.

EXHIBIT 4
### The proportion of FlexLoans has slightly decreased




Source: FSA's Financial Trends, November 2013

EXHIBIT 5
### The proportion of high LTV FlexLoans to young borrowers has increased




Source: FSA's Financial Trends, November 2013

Report Number: SF350348

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