

European Covered Bond Outlook 2016

Same procedure as last year?



Scope
Ratings

For 2016, Scope's base case scenario is a continuation of a credit-positive development for covered bonds, their issuers, and the sovereigns in which they operate. However, positive fundamentals will not be strong enough to sustain stronger growth, and about EUR 150bn of benchmark redemptions in 2016 will leave investors the challenge of finding enough supply to reinvest the maturing covered bonds.

We expect covered bond issuance volumes to remain at similar levels as in 2015. Slow GDP growth in the eurozone, and moderate production of new mortgage collateral to feed covered bonds, will leave new issuances either anaemic or only slightly positive in countries that have used covered bonds in the past. Banks will prefer non-covered bond issuances for ramping up more capital or increasing bail-in-able debt levels.

In 2016, private sector investors will again compete with the ongoing siphoning that is the ECB's third covered bond purchase programme (CBPP3), which will only end in September 2016. Ultra-low yields and spreads continue to leave no room for credit differentiation. As a result, investors might be willing to look into new countries, structures or collateral – often for covered bonds ineligible for CBPP3; otherwise, they will likely be crowded out.

We argue that covered bond investors will need to intensify their credit work in 2016 to take part in new covered bond trends:

- Non-EU countries, such as Poland, will likely see inaugural benchmark transactions.
- Existing trends in 'soft bullet' and conditional pass-through structures will amplify.
- More non-standard asset types, or even new dual-recourse structures, are likely to appear.
- Amendments to covered bond frameworks could arise in 2016 after the consultation period for the proposed covered bond harmonisation ends.

Calm sailing should continue for most of 2016, as all these themes have existed over the past months, of which we do not expect any to disrupt covered bond markets.

Positive credit fundamentals in 2016, but...

For 2016, we expect credit conditions across most asset classes to improve – albeit from low levels. Liquidity will remain ample as it is highly likely quantitative easing will continue, and consensus estimates support a mildly positive development for eurozone GDP growth. The credit strength of the banking sector is expected to remain stable to mildly positive thanks to stronger balance sheets, regulations and supervision; while low rates and a flat yield curve will continue to pressure profitability and put pressure on traditional bank business models. With existing overcapacity, smaller banks in particular (private, cooperative and savings banks) will have to cope with rising expenses owing to tighter regulatory requirements and changes needed to adapt retail business models to the digital age (see Scope's 'European Banking Outlook 2016', published 30 November 2015).

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Related Research

European Harmonisation:
Covered Bond Market Benefits –
if Standardisation Stays
Balanced, 20 October 2015

Covered bond framework
Analysis – Analytical
Considerations, 31. July 2015

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Credit-positive developments for banks in 2015

Positive rating changes for banks rated by Scope (see Figure 1) have outpaced negative rating developments in 2015. Rating changes reflect the positive impact of receding macroeconomic stresses in banks' financials, adjustments of business models gaining traction, as well as improved capitalisation.

Figure 1: Rating movements for Scope rated banks (Long-Term Rating)

Country	Issuer	Date	To	Rating development	From
Spain	Santander	24.02.2015	A+/Stable	+	A/Stable
Switzerland	Credit Suisse	10.04.2015	A/Stable	-	A+/Negative
Germany	Deutsche Bank AG	30.04.2015	A-/Stable	-	A-/Positive
Germany	Commerzbank AG	06.07.2015	A-/Stable	+	BBB+/Positive
France	BNP Paribas	04.10.2015	A+/Stable	+	A+/Negative
Netherlands	ING Bank NV	05.10.2015	A/Positive	+	A/Stable
Italy	Intesa Sanpaolo SpA	20.10.2015	A-/Stable	+	BBB+/Positive
Italy	Unicredit SpA	20.10.2015	BBB+/Stable	+	BBB/Positive
Denmark	Danske Bank	24.10.2015	A-/Positive	+	A-/Stable

Scope assigns first covered bond ratings using new methodology

In 2015 we assigned AAA Long-Term Ratings with Stable Outlooks to 21 covered bond programmes maintained by 12 Scope-rated banks¹. Scope currently rates EUR 355bn of covered bonds, spread across 535 issuances. (For the full list of covered bond programmes rated by Scope see [Appendix I](#)).

Covered bond credit quality expected to benefit from the more benign environment

We expect the credit quality of European cover pools to develop favourably: core credit indicators for the collateral analysis (such as lower unemployment or house price indices for mortgage-backed cover pools) are expected to continue their turnaround, impacting positively on credit quality, and thereby reducing the protection needed to cover credit risk. Tightened refinancing spreads for covered bonds will also be a positive factor as lower discounts are accordingly applied when Scope models the refinancing risk.

.... another year of supply-demand imbalances likely

In 2015, we have observed that the covered bond net new issuance for European issuers is again slightly negative. From 2016 onward, the covered bond market is again expected to grow, starting with a mild increase in 2016 that will only become more sustained from 2017.

Silver lining on the horizon for increased covered bond issuance

We believe the ECB's purchase programme will remain the most significant factor in the market – continuing to influence spreads, and putting pressure on the supply-demand imbalance. Spreads in 2016 also will not reflect the intrinsic differences in the credit quality of covered bonds (see Figure 2), but rather the CBPP3's siphoning effect and the bonds' limited supply. These factors, combined with ultra-low yields, will likely continue to crowd out covered bond investors.

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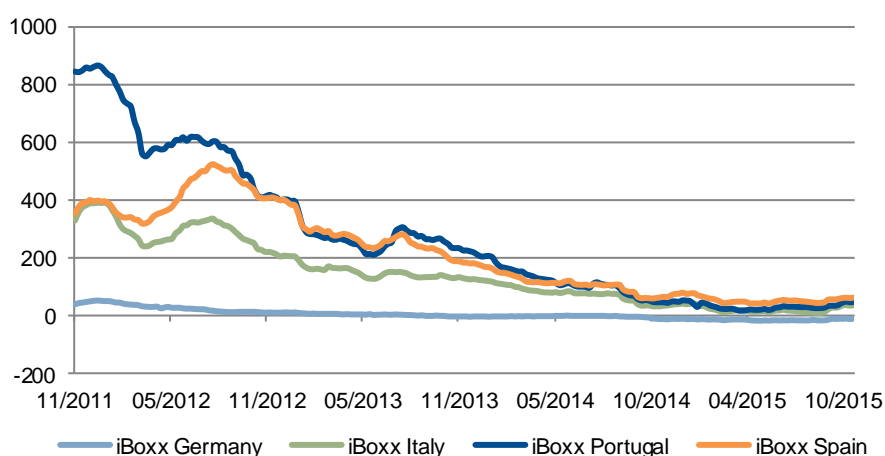
¹ 'Scope assigns AAA Long-Term Ratings to 340 European covered bonds totalling EUR 220bn', published 30 September 2015 and 'Scope expands coverage and assigns AAA/Stable ratings to EUR 130bn Swedish covered bonds', published 26 November 2015

Spread compression mainly reflects ECB's third covered bond purchase program

Covered bond redemptions to peak in 2016....

... but new covered bond issuances will only support a mildly positive net new supply

Figure 2: Selected covered bond spreads by country

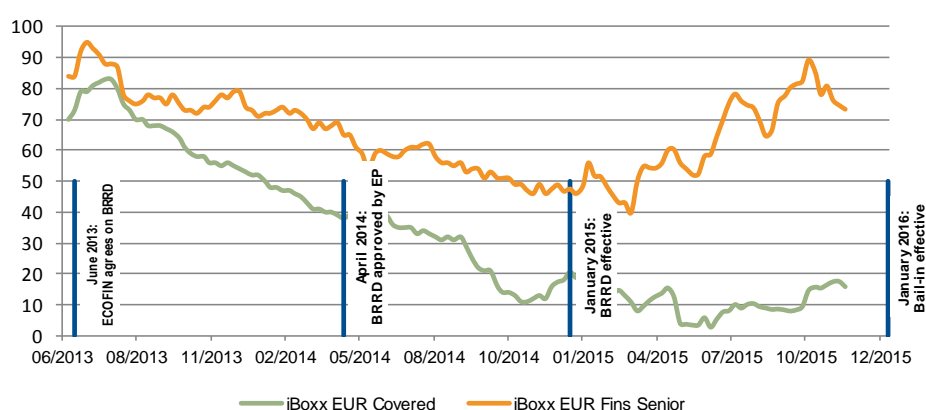


In retrospect, new issuance activity has held up remarkably well during 2015, taking into account that markets were impacted (and even closed) by uncertainty emanating from the Greek crisis and changed growth expectations of China.

Impressive issuance activity has been recorded in the second half of 2015. (The EUR 23.5bn of issuances in September was the highest monthly volume since January 2012.) However, net supply for 2015 remains slightly negative, driven primarily by still increasing redemptions that are expected to peak in 2016. The ever-increasing redemption wave from last year reflects the typical maturity of 5-7 years for benchmark-sized covered bonds; and the Lehmann crisis and sovereign crises that followed created a surge of covered bond issuances which are now set to mature.

Covered bond issuances remain an attractive funding instrument (see Figure 3) as investors increasingly factor in the likelihood of an eventual bail-in. We believe unsecured issuances are likely to increase in 2016 so that banks can meet sufficient bail-in-able debt levels – and some banks might even need to increase their capital base to comply with increased regulatory requirements.

Figure 3: Covered bond vs. senior unsecured bank spreads



Source: Markit

In our view, lower redemptions from 2017, and the ongoing increase in GDP growth, will lead to sustainable growth for covered bonds from 2017.

Repayment risk for covered bonds addressed structurally

Bullet repayment risk to soften further?

We expect the trend towards 'soft bullet'² covered bond structures to gain pace and, over time, to become the 'new normal'. We also expect conditional pass-through structures to make further inroads, and become the preference for non-standard asset types and issuers with weaker credit profiles.

For years, repaying covered bonds in full at maturity (bullet) has been the norm in the covered bond market. Bullet repayment risk has been the most prominent driver for overcollateralisation levels needed for a rating uplift based on a cover pool analysis. Splitting overcollateralisation into the share, in order to address repayment risk versus credit risk, often results in relationships as high as 3:1.

Mitigating the risk by adding 'substitute' assets of high credit quality has been the preferred choice. Therefore the provision to introduce a 180-day liquidity coverage requirement, which mitigates repayment risk for upcoming covered bond redemptions under French or German laws, has to be seen in this context.

As issuers avoid too-high asset encumbrances of their balance sheet, and increasingly focus on the efficiency of their covered bond transaction (mainly by trying to reduce overcollateralisation), addressing repayment risks using structural amendments, and not by adding more collateral, increasingly takes centre stage.

'Soft bullets' no longer an option solely for SPV-based structures

'Soft bullet' structures to become the new normal?

Soft bullet structures have, particularly in 2015, become popular in the market (see Figure 4). Initially, soft bullet structures were only present for covered bonds with SPV structures. Today, banks operating with an 'on-balance sheet' setup are also seeing the merits, and have issued covered bonds as 'soft bullets', or have started converting large-sized benchmark issuances, in particular, into this form. We also expect that, in some countries, the covered bond legal framework will likely open up for soft bullets, which will allow issuers to more efficiently manage supporting overcollateralisation.

Figure 4: Covered bond programmes with partial conversion to soft bullets

Date	Issuer country	Issuer	Full program
Sep. 14	Sweden	Swedish Covered Bond Corporation (SCBC)	Added soft bullet issuances
Nov. 14	France	Credit Agricole Home Loan SFH	Added soft bullet issuances
Dec. 14	Switzerland	Credit Suisse AG EUR 15bn covered bond programme	Active selective switch
Apr. 15	Netherlands	ABN Amro Bank N.V. EUR 30bn covered bond programme	Active selective switch
Aug. 15	UK	Bank of Scotland plc EUR 60bn covered bond programme (HBOS)	Active selective switch
Sep. 15	Australia	Commonwealth Bank of Australia	Active selective switch
Sep. 15	Netherlands	ING Bank EUR 35bn hard and soft bullet covered bond programme	Active selective switch
Nov. 15	UK	Barclays Bank plc EUR 35bn global covered bond programme	Active selective switch

Increased transparency needed for mixed repayment pools

For high credit quality issuances in particular, we view positively all efforts that help to reduce risk in covered bond structures. From an investor's point of view, however, transparency on the repayment profile is important, but still underdeveloped. Some cover pools comprise a combination of soft and hard bullets, and identifying the promised

² Covered bonds issued as a 'soft bullet' have a scheduled maturity date that, upon meeting certain conditions, can typically be extended by additional 12 months.

CPT structures gained traction in 2015

Poland covered bonds to combine soft bullet and CPT from 2016

Despite low likelihood investors need to be able to size extension risk to avoid market disruptions

repayment structure can be a challenge for investor – particularly when investing in the secondary market. Triggers for the typical 12-month extension can also differ, supporting our argument that either more credit diligence for investors or stronger harmonisation of structures across Europe is needed.

...Or will conditional pass-through structures take centre stage?

Following the inaugural issuance of a 'conditional pass through'³ (CPT) covered bond by Dutch bank NIBC in 2013, it took another year before Italy's Unicredit SpA appeared as the second CPT issuer in 2015. Some investors still prefer hard-bullet covered bonds, but Unicredit's successful conversion encouraged successful placements of more CPT structures. The issuers in Figure 5 have either converted existing covered bond programmes (Italian Banca Monte die Paschi di Siena) or established programmes in CPT format from the very beginning.

Figure 5: Recent CPT covered bond programme structures

Date	Issuer country	Issuer	Conversion/ New programme
Feb. 15	Italy	Unicredit EUR 25bn OBG SRL CPT programme (OBG 2)	Full conversion
Apr. 15	Netherlands	F van Lanschot Bankier NV EUR 5bn CPT covered bond programme	New programme
Jun. 15	Italy	Banca Monte die Paschi di Siena SpA CPT covered bond programme	Full conversion
Oct. 15	Portugal	Novo Banco S.A. EUR 10bn CPT covered bond programme	New programme
Nov. 15	Netherlands	Aegon Bank EUR 5bn CPT covered bond programme	New programme
2016	Poland	Covered bond law introduces CPT for all covered bonds	New programme

CPT structures to date result from issuer-specific considerations on efficiency, rating stability or asset type. We understand these aspects were also considered in Poland. On 5 August 2015, the Polish parliament approved amendments to Poland's covered bond law, introducing a structure that combines soft bullet and CPT features. All Polish covered bond structures will benefit from these amendments once the new covered bond law is enacted in January 2016.

From a credit point of view, soft bullet or CPT structures address the risks to which covered bonds are mostly exposed: maturity mismatch and the resulting repayment risk. The presence of these CPT structures allows a significant reduction in the protection needed for a covered bond structure. Structurally eliminating repayment risk and the presence of high credit quality collateral allows to sustain a very high credit differential to its issuer's credit strength – even with lower overcollateralisation.

We view these changes to the repayment structure as credit-positive and expect the trend to continue. The embedded option that the expected cash flow profile could significantly extend, can introduce unintended stresses for the covered bond market.

Better regulation of issuers generally strengthens their credit profile; and the BRRD further pushes the likelihood of a covered bond investor having to rely solely on the cover pool's cash flows – extended by a year or as a pass-through.

³ The repayment profile of covered bonds issued as a 'conditional pass-through' also feature a scheduled maturity at which the bonds would be paid back as bullet. If certain conditions are met (typically the issuer's insolvency), the repayment profile of such covered bonds will become amortising.

Ability to model CPT structures the key to benefitting from lower repayment risks and higher recoveries

Transparency on amortisation profiles is an important element for CPT structures

Novel dual recourse structures without preferential risk weighting but bail-in protection

New European SME covered bonds?

As a result, investors do not factor the option of CPT amortisation in their investment decisions. Transparency on the amortisation profile of cover pools, and the covered bonds issued against them, is very limited; and we understand most investors are currently unable to 'model' cash flows on their own. An issuer's significant credit deterioration could therefore trigger considerable market distress, in our view. When the likelihood of being exposed to the extension or pass-through becomes more tangible, we believe that less sophisticated investors could start selling such bonds, rather than face the uncertainty of when their investment will repay – even with the higher expectations of recovery for these than for hard bullet structures.

Therefore, Scope views that in particular programmes with CPT structures should improve the transparency on the amortisation profiles of their cover pools.

Low spreads increase issuer's appeal for dual-recourse structures

Preferential treatment of covered bonds increasingly needs to be justified, and policymakers actually have to consider expanding this treatment to other collateral types. With investors crowded out by the ECB, or no longer able to achieve positive yields when investing in traditional covered bonds, we expect more 'covered bond alike' structures, such as dual-recourse forms, to appear and gain investor interest.

In 2015, we observed novel and bespoke dual-recourse structures, such as SumitG (discussed later in this report), to become established. We expect novel structures to be driven by the aim for efficient funding. Collateral will be bespoke reflecting diverging bank business models and thus balance sheets, differ and issuers need. They can offer investors extra security and higher recoveries than on senior unsecured issuances. Also, it is our understanding that such secured bonds are not exposed to a potential bail-in, which also adds to their attractiveness.

However, compared to traditional covered bonds, we do not envisage such bespoke 'covered bond alike' structures to become as widely established. The pool of eligible cover assets with which investors will need to become familiar will differ deal by deal; and even though they can potentially get a better credit assessment than the issuer, we currently do not expect such bespoke transactions to benefit from preferential risk weights or the ability to 'repo' these with a central bank.

European secured notes will come eventually...

To date, non-covered bond dual-recourse structures are rare, and options already available in securitisation or covered bond frameworks⁴ were generally one-offs⁵.

We anticipate that the lack of SME collateral standardisation will prevent the establishment of a functional market for dual-recourse structures (backed by SMEs) in 2016, despite support from policymakers for SME funding to use such instruments. In addition, covered bond market stakeholders are keen to avoid a commingling of asset classes; and in March 2015, the European Covered Bond council (ECBC) proposed the creation of European Secured Notes (ESNs). One of the proposed ESN options mirrors a structured covered bond structure with SME collateral, whereas the second would be more akin to a securitisation with a tranching risk structure.

From a bank rating perspective, we believe the more robust a financial institution's funding options, the more resilient the funding becomes. Scope thus does not prefer any of the two options as long as the credit risk is mitigated adequately.

⁴ The Spanish securitisation framework – amended in 2015 – allows an SPV to provide a guarantee, thereby opening up the way for structured covered bond structures with SME collateral. In 2014 the Italian covered bond act was amended and has allowed for a new Italian covered bond that can be backed by SMEs. In contrast to existing Italian covered bonds (OBGs), it lacks specific supervision from the Bank of Italy. Neither Spanish nor Italian SME covered bonds have been issued to date.

⁵ E.g. the Commerzbank SME-backed structured covered bonds issued in 2013.

Standardisation and harmonisation of SME definitions key to investor acceptance

The main difference between Commerzbank's existing SME covered bond and potential ESNs is the preferential regulatory treatment investors could apply when investing in such structures. Issuances would be governed by a legal framework and subjected to special supervision.

However, the high heterogeneity of SME debt across regions and issuers may hamper the emergence of an appealing product, if the market fails to achieve sufficient standardisation in eligibility criteria. A common definition of an SME and comparable credit measures across banks currently do not exist. SME lending standards also cannot be generalised: SME loans can be collateralised by mortgages or with working capital; can be plain vanilla or use covenants; and SME loans can benefit from additional guarantees by parent companies or their owners.

Standardisation and comparability of collateral is one of the cornerstones giving investors comfort in the covered bond market. We believe policymakers' success in striking a balance between sufficiently clear and comparable eligibility criteria, as well as the comparability of the individual banks' underwriting criteria, is the key to establishing ESNs as a valid funding alternative between traditional bank lending and bespoke SME securitisations.

Transparency on the current and potential future composition of cover pools is important for such ESNs. The maturity of SME loans is significantly shorter than for mortgage loans, resulting in a higher turnover in the cover pool. Such ESNs would require much more attention from investors and, depending on the eligibility criteria, could potentially have a higher volatility of credit measures. The maturity of issued ESNs in relation to turnover will require a much stronger linkage to the issuer's ability to constantly replenish the cover pool with collateral of similar credit quality.

The share of SME loans in European banks' balance sheets is significant. Using them for a new form of secured funding, at a time when the credit quality of both issuers and collateral is improving, is credible. We do not, however, expect such a new framework to be established in 2015 and see the first issuances. Similar to the harmonisation of existing covered bond frameworks, establishing and maintaining a new asset class is a multi-year process – which needs constant work.

... but bespoke novel covered bonds are already here

Dual recourse – the recourse to a cover pool and a dedicated pool of assets – is one of the core defining elements for a covered bond. In some countries the structure of the banking market or specific covered bond laws has, in the past, already resulted in joint issuance vehicles that effectively provide (indirect) recourse to more than one issuer⁶. In October 2015 we observed another novel structure, which also took recourse to this defining element: SumitG⁷.

Similar to structured covered bonds, SumitG features an SPV but, in contrast, its obligations are joint and severally guaranteed by two banks – Goldman Sachs Group and Sumitomo Mitsui Trust Bank Ltd. Also, in contrast to traditional covered bonds, it is not the mortgage loans themselves but the senior notes of prime European and Japanese RMBS that comprise the collateral pool. Another similar feature to traditional covered bonds is the obligation to maintain a defined minimum overcollateralisation and asset value of the collateral pool, which, for SumitG, the two guarantors are obliged to maintain.

Secured funding for banks to increase

⁶ In Switzerland, for example, the covered bond act only allows domestic covered bond issuance using joint issuance vehicles – one for banks in the public sector and the one for the private. In other countries such as Norway, Denmark, Finland, smaller issuers – typically belonging to the same cooperative banking group – have established joint issuance vehicles to allow for larger, benchmark-sized issues that more easily allow the raising international funding. These jointly owned covered bond issuers are typically established to source ongoing funding in order to allow their owners to provide low-cost and long-term mortgage finance to their customers.

⁷ SumitG: SumitG Guaranteed Secured Obligation Issuer DAC (Series 2015-1). Issuance benefits from a joint and several guarantee of two banks.

Covered bond harmonisation continues

To promote the European Capital Markets Union and to reduce existing fragmentation in the covered bond market, the European Commission published in September 2015 a consultation to enhance comparability (see '[European Harmonisation: Covered Bond Market Benefits – if Standardisation Stays Balanced](#)', published 8 October 2015).

European Commission solicits comments

The proposal suggests two options for harmonising the fragmentation:

1) Indirect harmonisation: Based on EBA best practice, eligibility criteria for the preferential treatment of covered bonds will be amended. Member states would have discretion to adapt their current frameworks and to include national peculiarities.

2) Direct product regulation (29th regime): The EC is also considering a specific covered bond regulation. This product regulation would provide a pan-European covered bond law that is optional for issuers, and to which they could eventually migrate.

Scope's view:

We believe that improved harmonisation and standardisation will help maintain the preferential regulatory treatment of covered bonds in a potential bail-in scenario of its issuer. Even though the sole reliance on the cover pool becomes very remote as a result of the preferential treatment, credit quality of covered bonds will continue to differ – even with increased harmonisation. The issuing banks' credit strength will still vary, the macro environment they operate in will differ and a cover pool's quality will remain a dynamic source of risk – even when complying with improved regulations.

We believe that harmonising and standardising covered bond frameworks will raise the minimum credit quality for most European covered bonds. To fully appreciate the envisaged changes and assess whether they are stringent enough to result in the desired benefits policymakers should provide answers on:

- What is the minimum credit quality that a covered bond framework should support;
- Whether this quality should also be supportable under stressed scenarios and,
- Whether the framework should ensure timely and/or full repayment of covered bonds.

Covered bonds predominantly reflect their issuers' credit strength and ability to maintain continuously high credit quality in the cover pool. Raising the bar too high via a pan-European 29th regime could even curtail the ability of covered bond issuers to provide low-cost homeowner financing and prevent individual banks market access needed to raise long-term stable funding.






An envisaged standardisation can only provide the desired benefits if it allows to embed elements such as local market specificities of housing finance, the condition of housing markets, and insolvency regimes.

Harmonisation should not
reduce investors' diligence...

... as credit quality will continue
to differ

I. Appendix



Country	Covered bond issuer (or parent)	ICSR (Long term/Outlook/ Short term)	Covered bond programme/ Covered bond type	Primary collateral type	Fundamental uplift (notches)	Cover Pool uplift (notches)	Combined CB uplift (notches)	CB Rating (Long term/ Outlook)
 Denmark	Danske Bank A/S	A- /Stable /S-1	Pool C – SDO	Mortgages	6	N/A	6	AAA/ Stable
			Pool D – SDO			N/A		AAA/ Stable
			Pool I – SDO			N/A		AAA/ Stable
 France	BNP Paribas SA	A+ /Negative /S-1	BNP Paribas Home Loan SFH (Obligation d'habitat)	Mortgages	6	N/A	6	AAA/ Stable
			BNP Paribas Public Sector SCF (Obligation foncières)	Public Sector	6	N/A	6	AAA/ Stable
	BPCE SA	A+ /Stable /S-1	BPCE SFH	Mortgages	6	N/A	6	AAA/ Stable
			(Obligation d'habitat)					
	Credit Agricole Group	A /Positive /S-1	Credit Agricole Home Loan SFH (Obligation d'habitat)	Mortgages	6	N/A	6	AAA/ Stable
			Credit Agricole Public Sector SCF (Obligation foncières)	Public Sector	6	N/A	6	AAA/ Stable
	Societe Generale SA	A /Stable /S-1	Société Générale SFH (Obligation d'habitat)	Mortgages	6	N/A	6	AAA/ Stable
			Société Générale SCF (Obligation foncières)	Public Sector	6	N/A	6	AAA/ Stable
 Germany	Commerzbank AG	A- /Stable /S-1	Öffentliche Pfandbriefe	Public Sector	6	N/A	6	AAA/ Stable
			Hypothekenpfandbriefe	Mortgages	6	N/A	6	AAA/ Stable
	Deutsche Bank AG	A- /Stable /S-1	Hypothekenpfandbriefe	Mortgages	6	N/A	6	AAA/ Stable
 Spain	Banco Santander SA	A+ /Stable /S-1	Cédulas Hipotecarias	Mortgages	6	N/A	6	AAA/ Stable
			Cédulas Territoriales	Public Sector	5	N/A	5	AAA/ Stable
	BBVA SA	A /Stable /S-1	Cédulas Hipotecarias	Mortgages	6	N/A	6	AAA/ Stable
			Cédulas Territoriales	Public Sector	5	N/A	5	AAA/ Stable
 Sweden	Nordea Bank AB	A+ /Stable /S-1	Nordea Hypotek AB/ Säkerställda obligationer	Swedish Mortgages	6	N/A	6	AAA/ Stable
	Svenska Handelsbanken AB	A /Stable /S-1	Stadshypotek AB/ Säkerställda obligationer	Swedish Mortgages	6	N/A	6	AAA/ Stable
			Stadshypotek AB/ Säkerställda obligationer	Norwegian Mortgages	6	N/A	6	AAA/ Stable
	Sw edbank AB	A- /Stable /S-1	Sw edbank Mortgage AB/ Säkerställda obligationer	Swedish Mortgages	6	N/A	6	AAA/ Stable



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