Landkreditt Bank AS
Issuer Rating Report

A- [STABLE]

Overview

Scope assigns a first-time Issuer Rating of A- to Landkreditt Bank AS with a Stable Outlook. The rating agency also assigns a first-time rating of BBB+ to senior unsecured debt.

As Norway is part of the EEA, its banks are also expected to comply with BRRD, including MREL requirements. In line with our bank rating methodology (May 2017) and when the Norwegian FSA clarifies which debt is MREL-eligible, we would expect to rate senior unsecured MREL-eligible debt one notch below the Issuer Rating and senior unsecured non-MREL-eligible debt at the same level as the Issuer Rating.

The Issuer Rating of A- with Stable Outlook also applies to Landkreditt Boligkreditt, a wholly-owned subsidiary of Landkreditt Bank. Landkreditt Boligkreditt provides secured funding for its parent, through the issuance of covered bonds.

Highlights

- The ratings on Landkreditt Bank are based on the strength of the group, Landkreditt SA. Landkreditt Bank maintains a leading position in serving agricultural customers in Norway. In recent years, management has pursued a growth strategy in the agricultural segment as well as with retail customers to achieve greater scale and to diversify the business. The aim is to have an equal balance between agricultural and retail customers; currently the mix is 60% / 40%.
- At the same time, the bank has maintained a low risk profile. Over 99% of lending is secured by residential property or agricultural property and land, and credit losses have remained minimal. The bank's cooperative ownership structure further reinforces a fairly low risk business, with members understanding the need to ensure the solidity of the group. We expect the operating environment to remain supportive as Norway benefits from solid economic growth, low unemployment and high wealth levels.
- As an on-line bank, Landkreditt Bank is already comparatively efficient and continues to make investments to further digitalize and improve customer service.
- Like with other Norwegian banks, there is a reliance on market funding. However, the bank maintains comfortable liquidity buffers and successfully accesses the domestic unsecured and secured debt markets regularly. The bank's reassuring solvency metrics are in line with Norwegian regulatory requirements which we consider to be relatively rigorous.

Ratings & Outlook

Issuer Rating	A-
Outlook	Stable
Senior unsecured debt	BBB+
Covered bond ratings (Landkreditt Boligkreditt)	AAA
Covered bond outlook	Stable

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Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Ownership structure and strategic purpose support a relatively low risk business generating reasonable returns.
- Management's continued focus on high efficiency underpinned by a digital distribution model.
- Reliance on market funding.
- Reassuring solvency metrics driven by regulatory demands.

Rating change drivers

A decline in the operating environment which materially impacts profitability. A correction in property prices poses a risk as the central bank's 2017 Financial Stability Report continues to highlight high household debt and elevated property prices as significant vulnerabilities for the Norwegian financial system. Positively, regulators have been implementing measures to manage this risk such as a maximum debt-to-income ratio requirement of five times gross annual income and a requirement that borrowers must be able to service debt in the event of a five percent rise in mortgage rates**.**

Business expansion which increases the risk profile of the group. Over the next few years, management intends to further grow the business. Aggressive growth and/or expansion into new markets or businesses which increases the risk profile of the group would be viewed negatively. The group's expected increased ownership stake in the insurance business brings opportunities to further strengthen relationships with agricultural customers.

Track record of managing profitable growth. Proven ability to grow the business while keeping risks under control and sustainably increasing returns.

Rating drivers (details)

Ownership structure and strategic purpose support a relatively low risk business generating reasonable returns

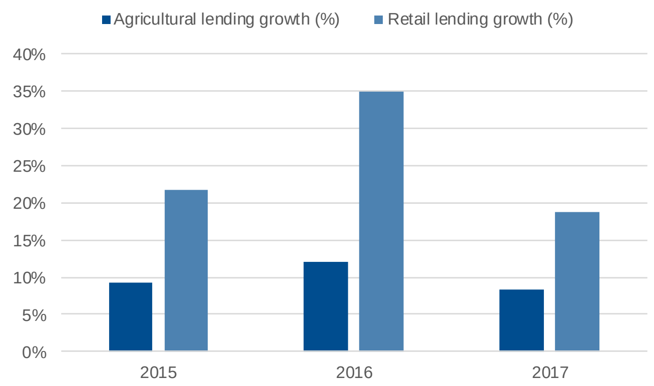
Landkreditt Bank is the main operating company of the Landkreditt SA group, a credit association founded in 1915. The group is a leading provider of financial services to Norway's agricultural sector and its activities also include insurance and asset management. Landkreditt Bank customers with a loan secured by agricultural property or with an agricultural production operating credit become members of the cooperative, Landkreditt SA. While profit optimization is not the goal, earnings are used to ensure the solidity of the group and to provide customers with attractive prices on financial products.

In addition, the group acts as a center of expertise and advocates for financial support of the agricultural sector in Norway. As of YE 2017, there were over 9,300 cooperative members from 16 regions. Representatives are elected to annual general meetings with voting done by electronic means to encourage wide participation. The 2018 annual meeting included 30 elected representatives and members of the board.

In its 2018-2021 strategic plan, the group aims to further strengthen its position in the agricultural sector and to reinforce customer relationships, particularly in light of developments such as PSD2. Subject to regulatory approval, the group will increase its current approximate 46% stake in Landbruksforsikring (insurance) to about 75% and sell the bank's 56% stake in Landkreditt Finans (leasing) to BNP Paribas. These strategic actions are expected to free up capital for business growth and further digital investments.

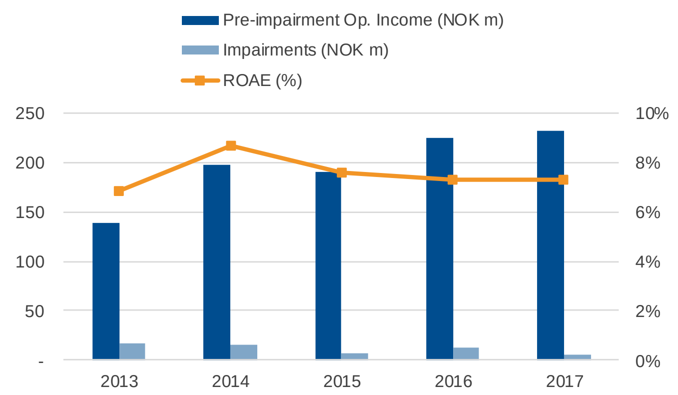
Over the last few years, the group has been determinedly growing its retail volume to achieve greater scale and a more diversified business. In 2017, lending growth in agriculture was 9% while in the retail market it was nearly 20% (Figure 1). Currently, retail customers account for about 40% (2013: about 30%) of credit exposure and agricultural customers about 60%. The goal is to achieve a 50/50 balance. The retail business is essentially mortgage lending. Expansion into the retail market started unintentionally 20 years ago, sparked by the bank's attractive rates on mortgages.

Figure 1: Agricultural vs. retail lending growth (%)



Source: Company data, Scope Ratings

Figure 2: Reasonable returns and low credit losses



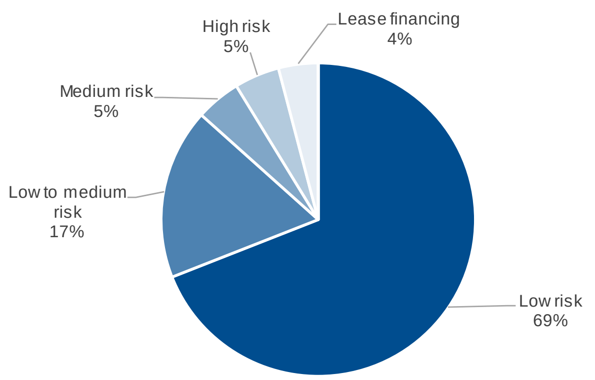
Source: Company data, Scope Ratings

The bank has demonstrated its ability to manage this growth while maintaining low credit losses (Figure 2). The non-performing loan ratio was less than 1% at YE 2017. Over 99% of credit exposure is secured via residential property or agricultural buildings and land. The average LTV is about 45%. Ninety percent of agricultural loans and 99% of retail loans have a LTV below 80%. Nearly 50% of the credit exposure is in the Oslo-fjord area with the remainder spread throughout the country.

In addition to the NOK 25.3bn of credit exposure to agricultural and retail customers shown in Figures 3 and 4, the bank has another NOK 1.3bn in exposure to SME customers with a comparable risk profile. Management has decided to focus only on farmers and retail customers; and is slowly discontinuing SME lending.

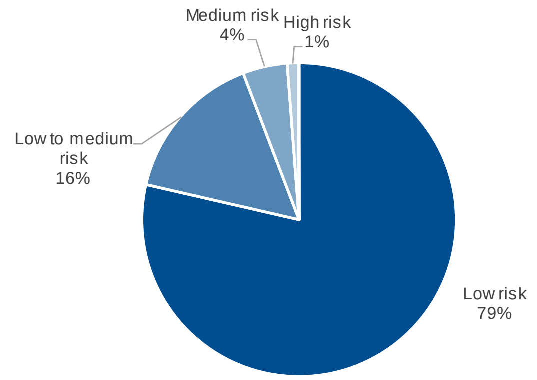
The bank's internal risk classification is determined by an assessment of the customer's ability to pay and the LTV. With agricultural customers, credit decisions benefit from the bank's in-depth knowledge and expertise in the sector.

Figure 3: Risk profile of agricultural exposures



Source: Data as of YE 2017. Agricultural exposures of NOK 15.5bn. Unsecured short-term credit accounts for less than 1% of these exposures.
Source: Company data, Scope Ratings.

Figure 4: Risk profile of retail exposures



Source: Data as of YE 2017. Retail exposures of NOK 9.8bn. Unsecured short-term credit accounts for less than 1% of these exposures.
Source: Company data, Scope Ratings

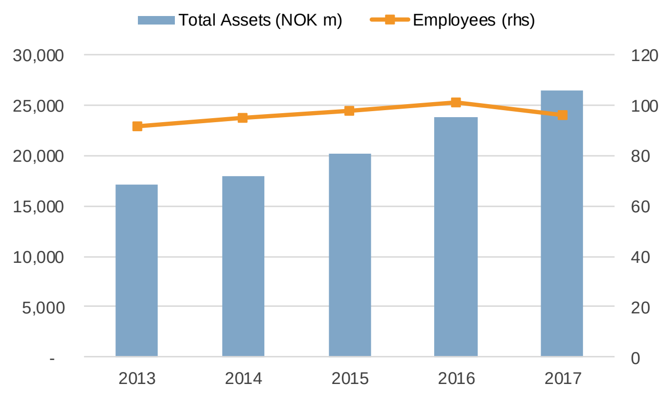
Management's continued focus on high efficiency underpinned by a digital distribution model

Since its establishment in 2002, Landkreditt Bank has been an on-line bank and therefore is not burdened by a legacy branch network. The bank has invested in established IT infrastructure and systems are essentially outsourced. As well, the bank offers relatively simple products, reducing operational complexity.

A key part of the bank's strategy is further digitalisation to increase efficiency. In February 2018, the bank entered into a new NOK 150m five-year agreement with EVRY, a leading Nordic IT services and software provider. Under the agreement, EVRY is expected to deliver next-generation core banking and payment solutions, including further improvements in respect of self-service and automation in the loan and credit area.

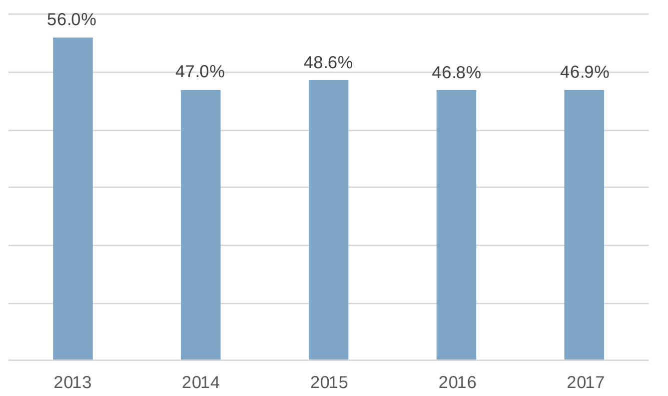
Nearly all the bank's employees operate out of a single building in Oslo, with fewer than five employees located elsewhere in the country. As shown in Figure 5, the volume of bank assets has outpaced the growth in employees over the last five years.

Figure 5: Faster asset growth than employee growth



Source: Company data, Scope Ratings

Figure 6: Costs % Income



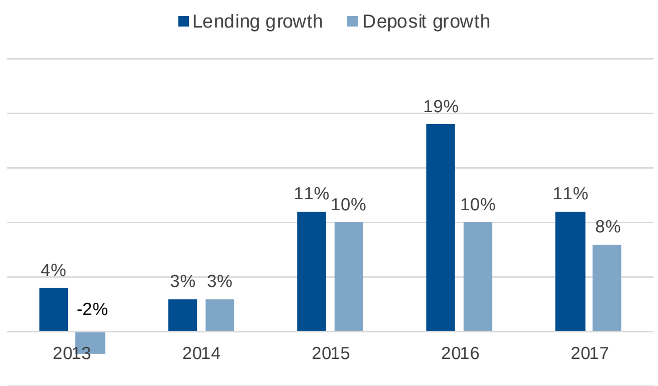
Source: SNL

Reliance on market funding

Landkreditt Bank continues to be in an expansion phase with strong lending and deposit growth. However, the pace of lending has outstripped deposit growth over the last few years and consequently, customer deposits are increasingly insufficient to support lending activities. The deposit-to-loan ratio has declined to 70% in 2017 from above 80% in 2012. Positively, management targets a minimum deposit-to-loan ratio of 70% which is higher than for larger Norwegian peers.

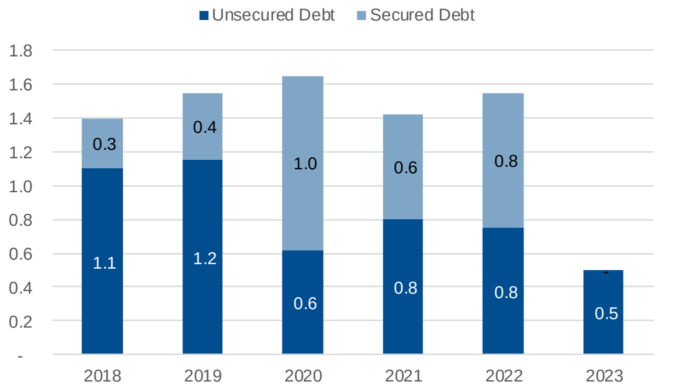
To diversify funding sources, a fully-owned covered bond issuer, Landkreditt Boligkreditt, was established in 2010. As of YE 2017, NOK 3.6bn in loans have been sold to Landkreditt Boligkreditt, accounting for approximately 15% of the banking group's total loans. Covered bonds account for about 40% of outstanding debt.

Figure 7: Lending and deposit growth (%)



Source: Company data, Scope Ratings

Figure 8: Funding maturity profile (NOK bn)



Note: Data as of 31 December 2017.
Source: Company data, Scope Ratings

The various entities of the banking group are regular issuers in the domestic bond market, issuing secured, senior and subordinated debt. In 2017, the various entities tapped the markets eight times, raising NOK 2bn in total. Investors include Norwegian pension funds, asset managers and insurance companies. As of YE 2017, the average maturity of outstanding debt was about three years while the average interest rate was 1.16%.

Primarily to meet LCR requirements, the bank held a liquidity buffer of NOK 1.9bn in government bonds and covered bonds as of YE 2017. Meanwhile, the LCR and NSFR were reassuring at 243% and 143%, respectively as of YE 2017.

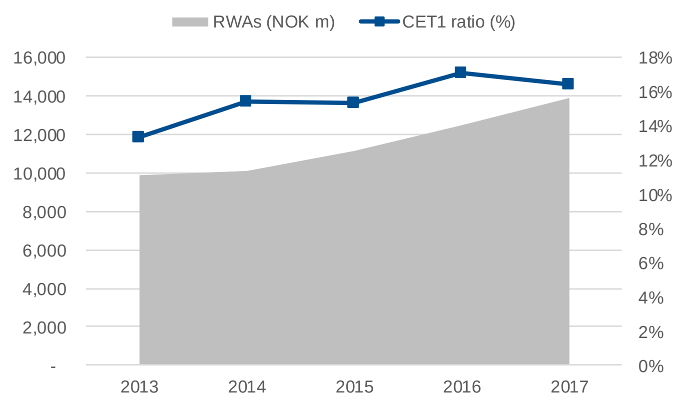
Reassuring solvency metrics driven by regulatory demands

In line with increasing regulatory demands, Landkreditt Bank has been bolstering its solvency position through retained earnings and capital contributions from its parent (NOK 130m in 2014, NOK 300m in 2016). According to management, members of the cooperative understand the need to grow and solidify the bank's position and have not asked for earnings distributions. We view this positively considering the bank's ownership structure. If further capital were needed, management has said that growth could be managed downwards.

For 2018, the bank targets a CET1 ratio of at least 15.2% which includes a 0.5% management buffer above the requirement of 14.7%. The requirement incorporates a 3% systemic risk buffer and a 2.7% Pillar 2 requirement. While the countercyclical capital buffer currently stands at 2%, management expects this to increase to 2.5% in the future.

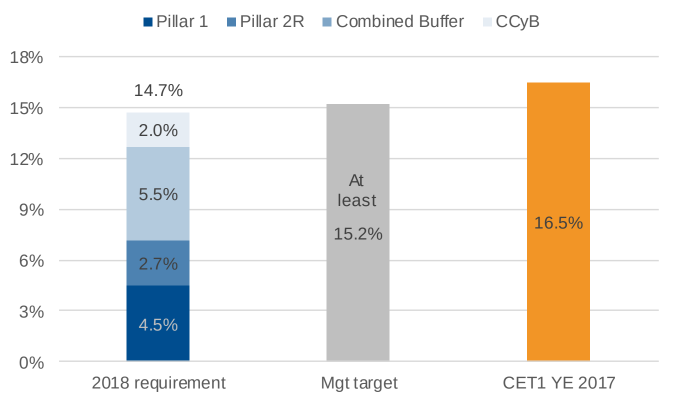
As of YE 2017, the bank's leverage ratio stood at 9% which compares well to both domestic and international peers. All Norwegian banks must hold a buffer of at least 2% above the minimum requirement of 3%. In addition, management intends to maintain a further buffer of 1%.

Figure 9: Improving capitalization



Note: Figures are on a transitional basis.
Source: SNL, Scope Ratings

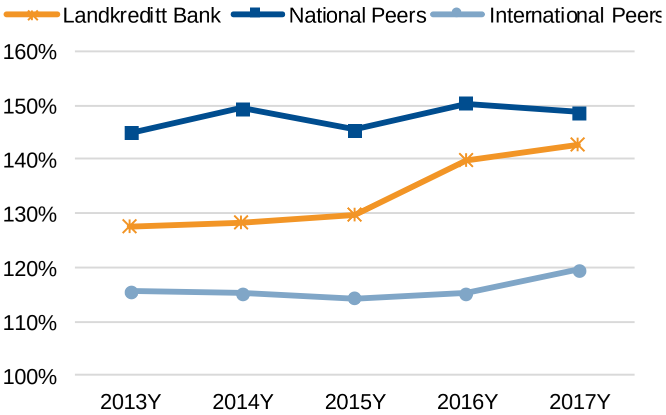
Figure 10: Actual CET1 vs management target and requirements



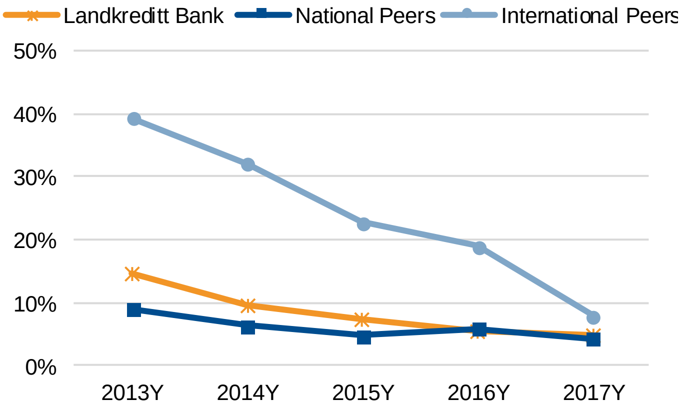
Notes: Combined buffer comprises 2.5% capital conservation buffer and a 3% systemic risk buffer. CCyB = countercyclical capital buffer.
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

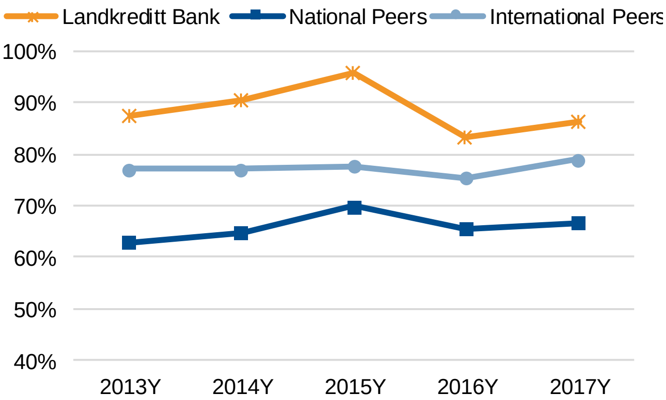
Amortised loans % Deposits



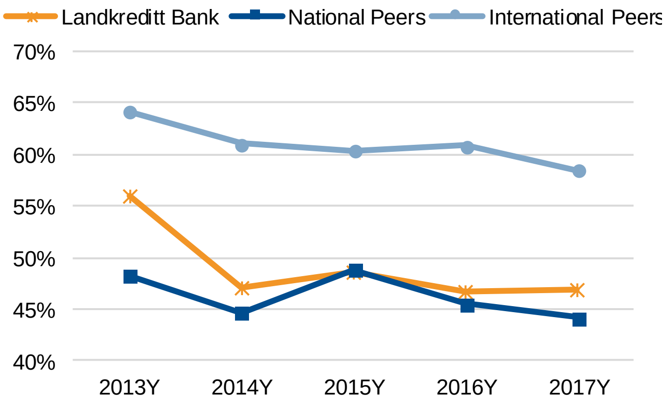
Impaired loans % Tangible equity and reserves



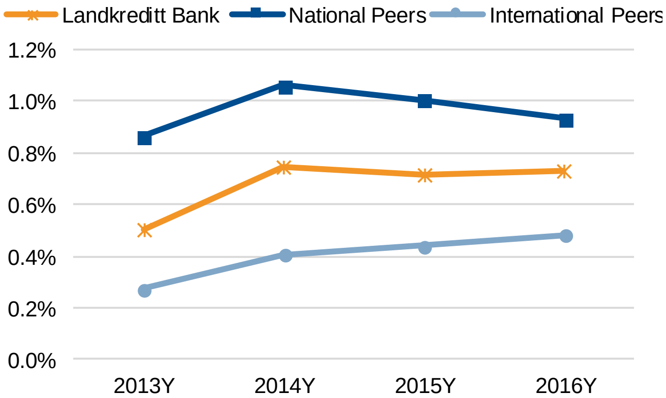
Net interest income % Operating income



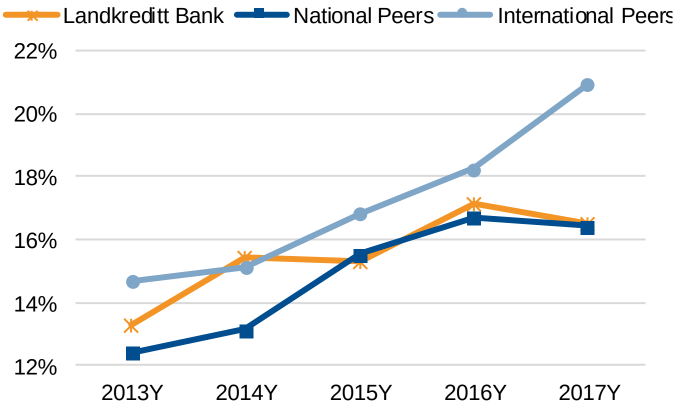
Costs % Income



Return on average assets (%)



CET1 capital ratio (transitional) (%)



National peers: Landkreditt Bank, SpareBank 1 SMN, SpareBank 1 SR-Bank, DNB, Jaeren Sparebank, Totens Sparebank.
International peers: Landkreditt Bank, Nationwide Building Society, Coventry Building Society, Santander UK, Kutxabank, Rabobank, Bausparkasse Wustenrot AG.
Source: SNL

II. Appendix: Selected Financial Information – Landkreditt Bank

	2013Y	2014Y	2015Y	2016Y	2017Y
Balance sheet summary (NOK m)					
Assets					
Cash and interbank assets	315	683	970	976	758
Total securities	1,262	1,341	1,429	1,693	2,374
of which, derivatives	12	0	0	0	0
Net loans to customers	15,487	15,943	17,762	21,076	23,293
Other assets	75	76	57	63	74
Total assets	**17,139**	**18,043**	**20,218**	**23,808**	**26,499**
Liabilities					
Interbank liabilities	10	31	0	0	15
Senior debt	3,305	3,479	4,266	6,021	7,272
Derivatives	0	0	0	0	0
Deposits from customers	12,080	12,434	13,699	15,092	16,331
Subordinated debt	100	175	175	175	175
Other liabilities	141	168	175	179	171
Total liabilities	**15,626**	**16,287**	**18,315**	**21,467**	**23,964**
Ordinary equity	1,286	1,530	1,667	2,093	2,242
Equity hybrids	150	150	149	149	199
Minority interests	67	76	87	98	94
Total liabilities and equity	**17,139**	**18,043**	**20,218**	**23,808**	**26,499**
Core tier 1/Common equity tier 1 capital	1,314	1,561	1,706	2,143	2,294
Income statement summary (NOK m)					
Net interest income	276	335	354	352	377
Net fee & commission income	21	26	27	28	31
Net trading income	12	6	-15	30	24
Other income	6	4	3	13	4
Operating income	**315**	**372**	**369**	**423**	**437**
Operating expense	177	175	179	198	205
Pre-provision income	**138**	**197**	**190**	**225**	**232**
Credit and other financial impairments	17	16	7	12	6
Other impairments	0	0	0	0	0
Non-recurring items	NA	NA	NA	NA	NA
Pre-tax profit	**122**	**181**	**182**	**213**	**227**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	34	47	46	50	48
Net profit attributable to minority interests	8	9	11	12	10
Net profit attributable to parent	**80**	**124**	**126**	**151**	**168**

Source: Company data, SNL

III. Appendix: Ratios – Landkreditt Bank

	2013Y	2014Y	2015Y	2016Y	2017Y
Funding and liquidity					
Net loans/deposits (%)	127.5%	128.2%	129.7%	139.7%	142.6%
Liquidity coverage ratio (%)	NA	120.0%	338.0%	291.0%	243.0%
Net stable funding ratio (%)	NA	NA	142.0%	144.0%	143.0%
Asset mix, quality and growth					
Net loans/assets (%)	89.9%	88.4%	87.9%	88.5%	87.9%
Problem loans/gross loans (%)	1.5%	1.6%	1.0%	0.7%	0.8%
Loan-loss reserves/impaired loans (%)	18.6%	29.6%	32.1%	36.6%	39.5%
Net loan growth (%)	3.5%	2.9%	11.4%	18.7%	10.5%
Impaired loans/tangible equity & reserves (%)	14.7%	9.6%	7.3%	5.5%	4.9%
Asset growth (%)	-0.5%	5.3%	12.1%	17.8%	11.3%
Earnings and profitability					
Net interest margin (%)	1.6%	1.9%	1.9%	1.6%	1.5%
Net interest income/average RWAs (%)	2.8%	3.3%	3.3%	2.9%	2.9%
Net interest income/operating income (%)	87.6%	90.3%	95.9%	83.3%	86.2%
Net fees & commissions/operating income (%)	6.7%	7.0%	7.4%	6.6%	7.2%
Cost/income ratio (%)	56.0%	47.0%	48.6%	46.8%	46.9%
Operating expenses/average RWAs (%)	1.8%	1.7%	1.7%	1.7%	1.5%
Pre-impairment operating profit/average RWAs (%)	1.4%	1.9%	1.8%	1.9%	1.8%
Impairment on financial assets /pre-impairment income (%)	11.9%	8.1%	3.9%	5.5%	2.4%
Loan-loss provision charges/net loans (%)	0.1%	0.1%	0.0%	0.1%	0.0%
Pre-tax profit/average RWAs (%)	1.2%	1.8%	1.7%	1.8%	1.7%
Return on average assets (%)	0.5%	0.7%	0.7%	0.7%	0.7%
Return on average RWAs (%)	0.9%	1.3%	1.3%	1.4%	1.4%
Return on average equity (%)	6.8%	8.7%	7.6%	7.3%	7.3%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	13.3%	15.4%	15.3%	17.1%	16.5%
Tier 1 capital ratio (%, transitional)	14.7%	16.9%	16.7%	18.3%	17.9%
Total capital ratio (%, transitional)	15.7%	18.6%	18.2%	19.7%	19.2%
Leverage ratio (%)	NA	NA	NA	9.2%	9.0%
Asset risk intensity (RWAs/total assets, %)	57.6%	56.0%	55.0%	52.5%	52.5%

Source: Company data, SNL

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