Landkreditt Bank AS Issuer Rating Report

SCOPE

STABLE

A-

Overview

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

When there is further clarity about the implementation of the 2017/2399/EU Directive in Norway establishing the ability of banks to issue non-preferred senior debt for MREL purposes, Scope intends to adjust its senior unsecured debt ratings on Norwegian banks. In accordance with our rating methodology, Scope will rate senior preferred debt at the same level as the Issuer Rating while non-preferred senior debt or debt meant for MREL will be rated one notch below 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 of Landkreditt Bank are based on the credit fundamentals 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 for an equal balance between the two customer segments; currently the mix is slightly more skewed to farmers.
- Meanwhile, 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 online 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 rating	BBB+
Covered bond rating (Landkreditt Boligkreditt)	AAA
Covered bond outlook	Stable

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Dierk Brandenburg
d.brandenburg@scoperatings.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

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 2018 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 acquisition of the insurance business provides a means to further strengthen relationships with agricultural customers. Moreover, as there is currently little overlap between customers of the insurance company and the bank, management sees growth opportunities.

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

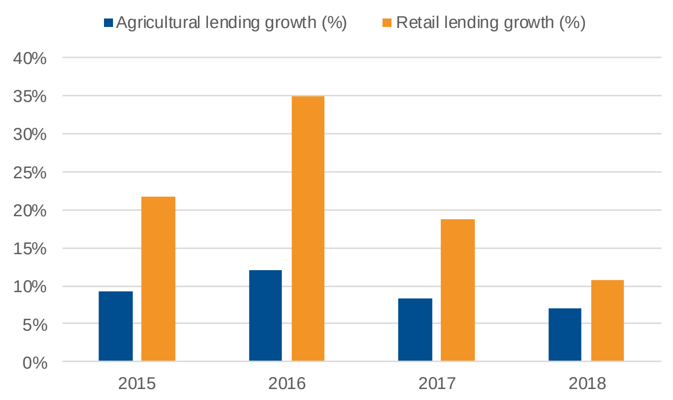
Landkreditt Bank is the main operating company of the Landkreditt SA group which was founded in 1915. The group is a leading provider of financial services to Norway's agricultural sector and its activities also include insurance and asset management. Customers of Landkreditt Bank with a loan secured 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. At YE 2018, there were almost 9,200 cooperative members from 16 regions. Representatives are elected to annual general meetings with voting done by electronic means to encourage wide participation. The 2019 annual general meeting will include 30 representatives who are responsible for selecting five of seven board members.

As detailed in the 2019-2022 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. In 2018, the group increased its ownership stake in Landbruksforsikring (insurance) to nearly 93% and sold its 56% stake in Landkreditt Finans (leasing) to BNP Paribas. The insurance business has been renamed to Landkreditt Forsikring and has been consolidated as a subsidiary since 1 June 2018. Originally established to provide insurance to agricultural cooperatives, Landkreditt Forsikring now also provides insurance to farmers, individuals and selected companies.

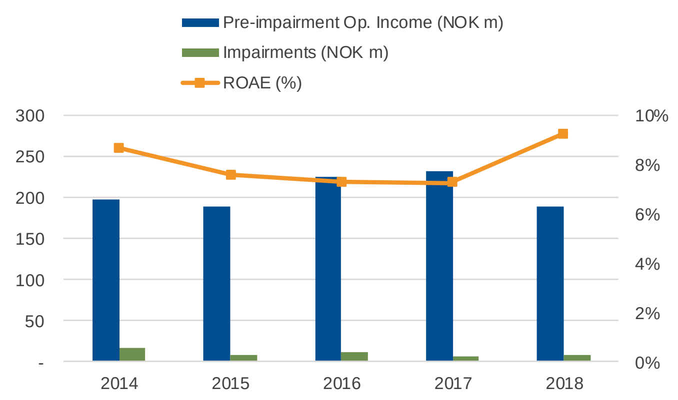
Over the last few years, the bank has determinedly grown its retail volume to achieve greater scale and a more diversified business. In 2018, lending growth in agriculture was 7% (on underlying basis excluding Landkreditt Finans) while in the retail market it was nearly 11%. The retail business is essentially mortgage lending. Currently, non-agricultural customers account for over 40% of credit exposure. While the goal is to achieve a roughly 50/50 balance, management recognizes the increasingly competitive conditions in the retail market and the group's core client base of farmers.

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



Source: Company data, Scope Ratings

Figure 2: Reasonable returns and low credit losses



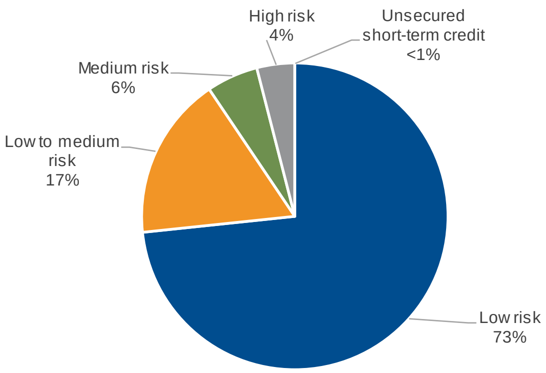
Source: Company data, Scope Ratings

The bank has demonstrated its ability to manage growth while maintaining low credit losses (Figure 2). Problems loans were less than 1% at YE 2018. Over 99% of credit exposure is secured via residential property or agricultural buildings and land. The average LTV is about 45%. Meanwhile, over 90% of loans have LTVs 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 26.8bn of credit exposure to agricultural and retail customers shown in Figures 3 and 4, the bank has another NOK 0.8bn in exposure to SME customers with a comparable risk profile. Management has decided to focus only on farmers and retail customers; and has been gradually discontinuing SME lending.

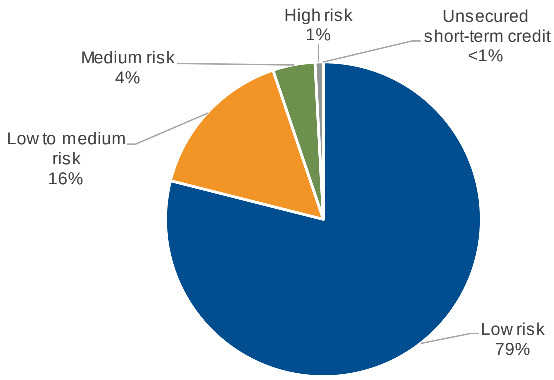
The bank's internal risk classification is determined by an assessment of the customer's ability to pay and the LTV. With agricultural customers, credit decisions benefit from the bank's in-depth knowledge and expertise in the sector.

Figure 3: Risk profile of agricultural exposures



Source: Data as of YE 2018. Agricultural exposures of NOK 15.9bn
Source: Company data, Scope Ratings

Figure 4: Risk profile of retail exposures



Source: Data as of YE 2018. Retail exposures of NOK 10.9bn
Source: Company data, Scope Ratings

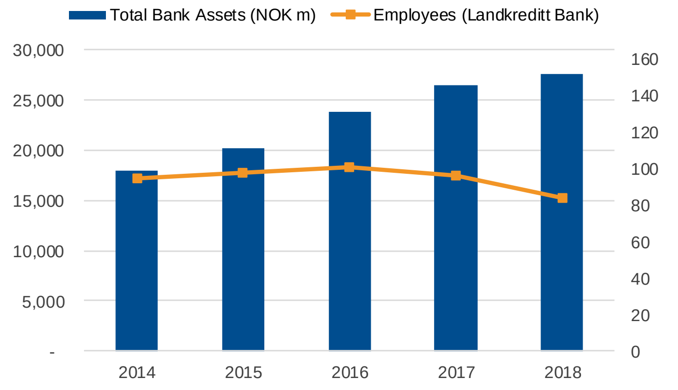
Management's continued focus on high efficiency underpinned by a digital distribution model

Since its establishment in 2002, Landkreditt Bank has been an online bank and therefore is not burdened by a legacy branch network. The bank has invested in established IT infrastructure, and systems are essentially outsourced. Furthermore, 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 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.

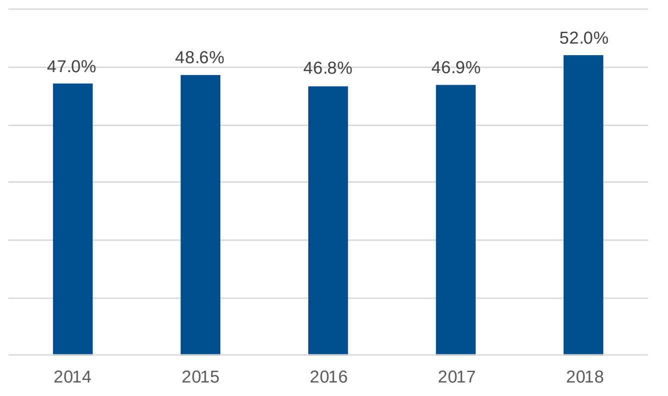
Nearly all the bank's employees operate out of a single building in Oslo. With the addition of the insurance business to the group, the bank plans to add a small number of insurance representatives to increase cross-selling opportunities. As shown in Figure 5, the volume of bank assets has outpaced the growth in employees over the last five years.

Figure 5: Faster asset growth than employee growth



Source: Company data, Scope Ratings

Figure 6: Landkreditt Bank - Costs % Income



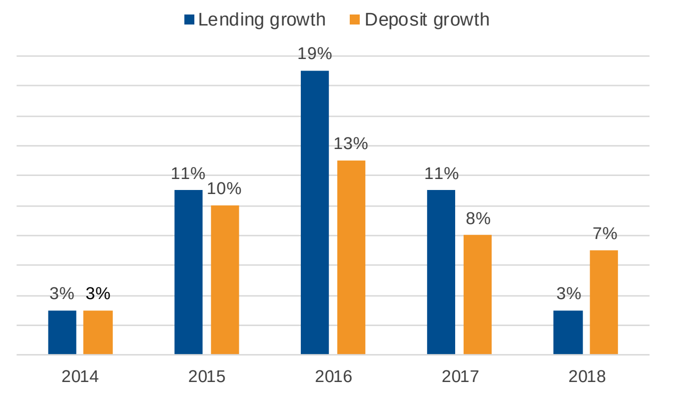
Source: SNL, Scope Ratings

Reliance on market funding

Landkreditt Bank continues to be in an expansion phase with strong lending and deposit growth. Until last year, the pace of lending outstripped deposit growth, with deposits being insufficient to support lending activities. The deposit-to-loan ratio was 73% in 2018, down from above 80% in 2012. Positively, management targets a minimum deposit-to-loan ratio of 70% which is above the level of larger Norwegian peers.

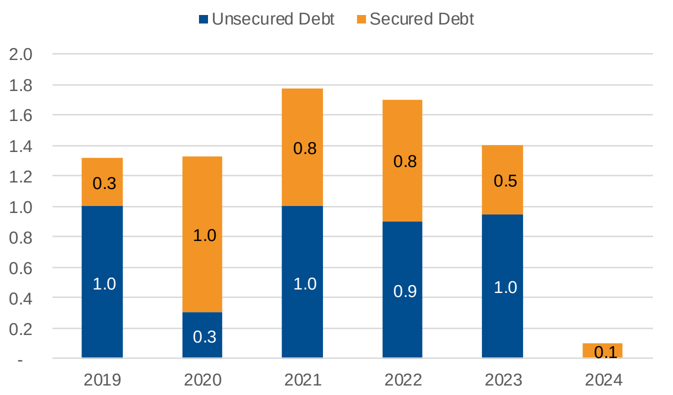
To diversify funding sources, a fully-owned covered bond issuer, Landkreditt Boligkreditt, was established in 2010. As of YE 2018, NOK 4.0bn in loans have been sold to Landkreditt Boligkreditt, accounting for approximately 17% of the banking group's total loans. Covered bonds account for about 45% of 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 2018
Source: Company data, Scope Ratings

Both Landkreditt Bank and Landkreditt Boligkreditt are regular issuers in the domestic bond market, issuing secured, senior and subordinated debt. In 2018, the two entities tapped the markets six times, raising NOK 1.5bn in total. Investors include Norwegian pension funds, asset managers and insurance companies. As of YE 2018, the average maturity of outstanding debt was about three years while the average interest rate was 1.88%.

Primarily to meet LCR requirements, the bank held a liquidity buffer of NOK 2.2bn in government bonds and covered bonds as of YE 2018. Meanwhile, the LCR and NSFR were reassuring at 207% and 144%, respectively as of YE 2018.

Reassuring solvency metrics driven by regulatory demands

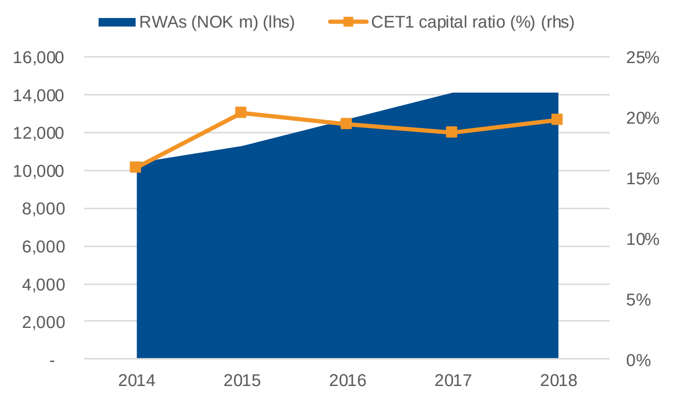
In line with increasing regulatory demands, Landkreditt Bank has been bolstering its solvency position through retained earnings and capital contributions from its parent (NOK 130m in 2014, NOK 300m in 2016). According to management, members of the cooperative understand the need to grow and solidify 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 2019, the group targets a CET1 capital ratio of at least 15.8% which includes a 0.5% management buffer above the requirement of 15.3%. The requirement incorporates a 3% systemic risk buffer and a 2.8% Pillar 2 requirement. In addition, the countercyclical capital buffer is increasing to 2.5% from 2% by YE 2019 (Figure 10).

At the level of the bank, CET1 capital requirements are nearly the same. The sole difference is the Pillar 2 requirement which stands at 2.7% vs. 2.8% for the group. As with the group, management aims for a buffer of 0.5% above requirements at the bank.

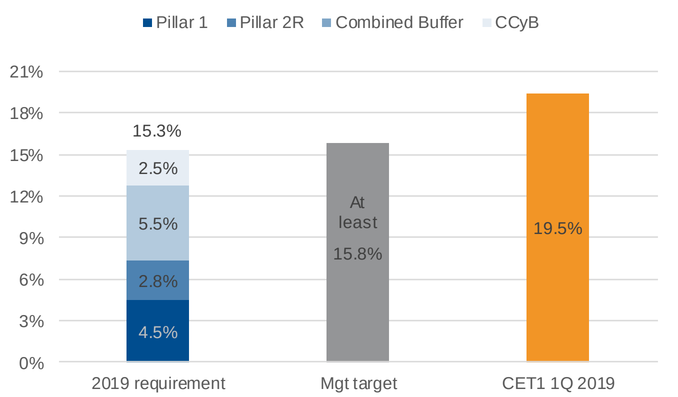
As of 1Q 2019, the bank's leverage ratio was 8.9% which compares well to both domestic and international peers. All Norwegian banks must hold a buffer of at least 2% above the minimum requirement of 3%. In addition, management intends to maintain a further buffer of 1%.

Figure 9: Landkreditt group – development of capital and RWAs



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

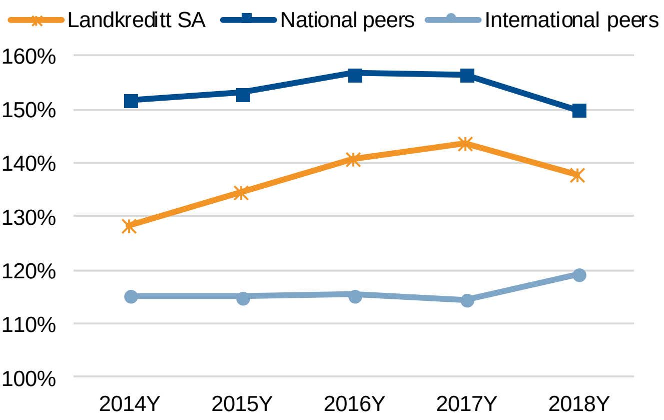
Figure 10: Landkreditt group - actual CET1 vs management target and requirements



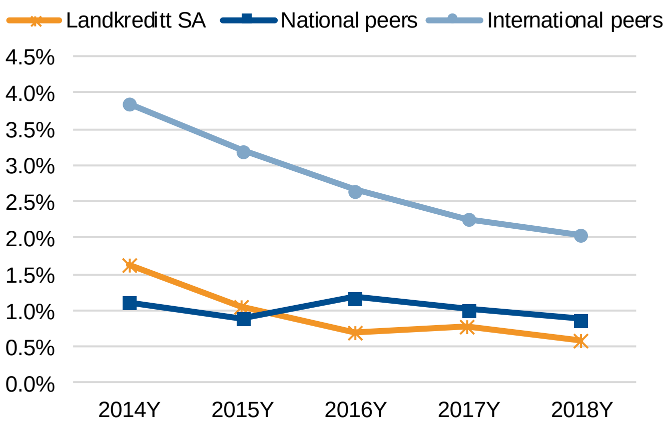
Notes: Combined buffer comprises 2.5% capital conservation buffer and a 3% systemic risk buffer. CCyB = countercyclical capital buffer
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

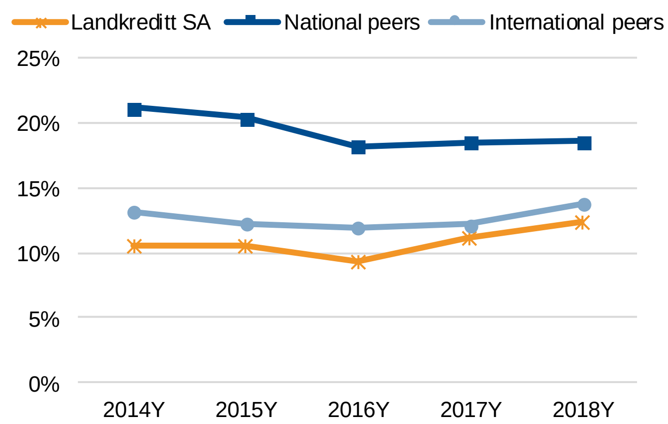
Amortised loans % Deposits



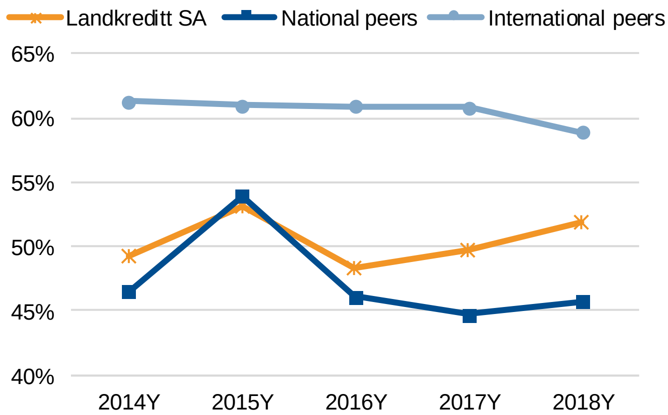
Problem loans % Gross customer loans



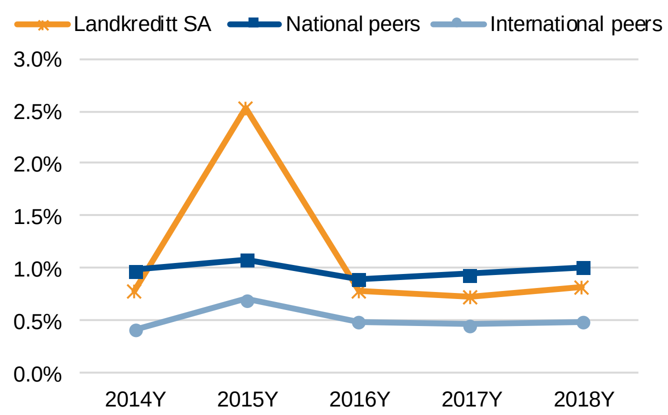
Net fee and commission income % Operating income



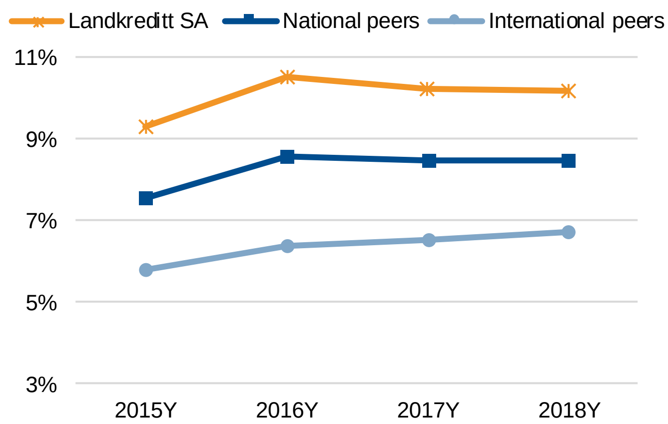
Costs % Income



Return on average assets (%)



Leverage ratio (%)



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

Source: SNL

II. Appendix: Selected Financial Information – Landkreditt group

	2015Y	2016Y	2017Y	2018Y	2019Q1
Balance sheet summary (NOK m)					
Assets					
Cash and interbank assets	970	977	759	993	746
Total securities	1,456	1,786	2,453	3,391	4,030
of which, derivatives	0	0	0	0	0
Net loans to customers	17,762	21,076	23,293	24,054	23,598
Other assets	125	183	227	500	611
Total assets	**20,313**	**24,022**	**26,732**	**28,938**	**28,985**
Liabilities					
Interbank liabilities	0	0	15	16	18
Senior debt	4,266	6,021	7,272	7,069	6,103
Derivatives	0	0	0	0	0
Deposits from customers	13,208	14,963	16,208	17,443	18,286
Subordinated debt	175	175	175	331	331
Other liabilities	NA	NA	NA	NA	NA
Total liabilities	**17,821**	**21,337**	**23,840**	**25,925**	**25,918**
Ordinary equity	2,255	2,437	2,599	2,795	2,849
Equity hybrids	149	149	199	199	199
Minority interests	88	98	94	19	20
Total liabilities and equity	**20,313**	**24,022**	**26,732**	**28,938**	**28,985**
Core tier 1/Common equity tier 1 capital	2,294	2,487	2,651	2,795	2,748
Income statement summary (NOK m)					
Net interest income	347	355	379	380	93
Net fee & commission income	42	43	53	72	32
Net trading income	-15	32	28	92	25
Other income	25	30	16	40	8
Operating income	**400**	**459**	**476**	**585**	**157**
Operating expense	212	221	237	303	88
Pre-provision income	**188**	**237**	**239**	**281**	**70**
Credit and other financial impairments	7	12	6	8	-1
Other impairments	0	0	0	0	0
Non-recurring items	359	NA	NA	NA	NA
Pre-tax profit	**536**	**225**	**234**	**274**	**71**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	46	48	46	40	14
Net profit attributable to minority interests	11	12	10	5	1
Net profit attributable to parent	**478**	**165**	**178**	**229**	**56**

Source: SNL

III. Appendix: Selected Financial Information – Landkreditt group

	2015Y	2016Y	2017Y	2018Y	2019Q1
Funding and liquidity					
Net loans/ Deposits (%)	134.5%	140.9%	143.7%	137.9%	129.1%
Liquidity coverage ratio (%)	351.0%	294.0%	248.0%	238.0%	161.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/ Assets (%)	87.4%	87.7%	87.1%	83.1%	81.4%
Problem Loans/ Gross Customer Loans (%)	1.0%	0.7%	0.8%	0.6%	0.6%
Loan Loss Reserves/ Problem Loans (%)	24.2%	32.4%	27.8%	52.6%	52.6%
Net loan growth (%)	11.4%	18.7%	10.5%	3.3%	-7.6%
Problem Loans/ Tangible Equity & Reserves (%)	7.4%	5.4%	6.1%	4.7%	4.7%
Asset growth (%)	11.1%	18.0%	11.3%	8.3%	0.6%
Earnings and profitability					
Net interest margin (%)	1.8%	1.6%	1.5%	1.4%	1.3%
Net interest income/ Average RWAs (%)	3.1%	2.9%	2.8%	2.7%	2.6%
Net interest income/ Operating income (%)	86.8%	77.3%	79.6%	65.0%	58.9%
Net fees & commissions/ Operating income (%)	10.6%	9.3%	11.2%	12.4%	20.1%
Cost/ Income ratio (%)	53.1%	48.3%	49.7%	51.9%	55.8%
Operating expenses/ Average RWAs (%)	1.9%	1.8%	1.8%	2.1%	2.5%
Pre-impairment operating profit/ Average RWAs (%)	1.7%	2.0%	1.8%	2.0%	2.0%
Impairment on financial assets / Pre-impairment income (%)	0.0%	0.1%	0.0%	0.0%	0.0%
Loan Loss Provision/ Avg Gross Loans (%)	0.0%	0.1%	0.0%	0.0%	0.0%
Pre-tax profit/ Average RWAs (%)	4.8%	1.8%	1.7%	1.9%	2.0%
Return on average assets (%)	2.5%	0.8%	0.7%	0.8%	0.8%
Return on average RWAs (%)	4.4%	1.5%	1.4%	1.6%	1.6%
Return on average equity (%)	24.2%	6.8%	6.7%	7.9%	7.4%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	20.3%	19.5%	18.7%	19.8%	19.4%
Tier 1 capital ratio (%, transitional)	21.7%	20.7%	20.1%	21.2%	20.9%
Total capital ratio (%, transitional)	23.2%	22.1%	21.4%	23.0%	22.6%
Leverage ratio (%)	9.3%	10.5%	10.2%	10.2%	9.7%
Asset risk intensity (RWAs/ Total assets, %)	55.5%	53.0%	53.0%	48.8%	48.8%

Source: SNL

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com