MOODY'S
INVESTORS SERVICE

Credit Opinion: Pohjola Bank plc

Global Credit Research - 23 Jul 2015

Helsinki, Finland

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Aa3/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	a3
Issuer Rating	Aa3
Senior Unsecured	Aa3
Subordinate	Baa1
Pref. Stock Non-cumulative	Baa3
Commercial Paper -Dom Curr	P-1
Other Short Term -Fgn Curr	P-1
Other Short Term -Dom Curr	(P)P-1
Parent: OP Financial Group	
Outlook	Stable
Baseline Credit Assessment	a3
Adjusted Baseline Credit Assessment	a3
Pohjola Insurance Ltd	
Outlook	Stable
Insurance Financial Strength	A3

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Key Indicators

Pohjola Bank plc (Consolidated Financials)[1]

	[2]3-15	[2]12-14	[3]12-13	[3]12-12	[3]12-11	Avg.
Total Assets (EUR million)	47,603.0	45,111.0	40,664.0	44,623.0	41,069.0	[4]3.8
Total Assets (USD million)	51,125.6	54,586.7	56,032.6	58,830.6	53,313.5	[4]-1.0
Tangible Common Equity (EUR million)	2,276.0	2,300.0	1,970.0	1,680.0	1,510.6	[4]10.8
Tangible Common Equity (USD million)	2,444.4	2,783.1	2,714.5	2,214.9	1,961.0	[4]5.7
Problem Loans / Gross Loans (%)	3.1	3.1	3.3	2.4	2.5	[5]2.9
Tangible Common Equity / Risk Weighted Assets (%)	10.9	10.5	12.3	11.0	10.5	[6]10.7
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	19.7	19.3	22.2	17.4	18.6	[5]19.4
Net Interest Margin (%)	0.5	0.6	0.6	0.6	0.8	[5]0.6
PPI / Average RWA (%)	3.1	2.9	3.2	2.8	2.2	[6]3.0
Net Income / Tangible Assets (%)	1.1	1.1	1.1	0.7	0.5	[5]0.9
Cost / Income Ratio (%)	41.8	49.8	52.5	57.4	62.8	[5]52.9
Market Funds / Tangible Banking Assets (%)	60.0	58.9	59.3	60.2	66.6	[5]61.0
Liquid Banking Assets / Tangible Banking Assets (%)	56.3	55.0	54.2	49.2	49.8	[5]52.9
Gross Loans / Total Deposits (%)	136.6	104.3	105.1	95.4	105.4	[5]109.4

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 29 June we affirmed Pohjola Bank Plc's baa2 baseline credit assessment (BCA), affirmed its a3 adjusted BCA and affirmed the bank's Aa3 long-term senior unsecured and deposit ratings. Furthermore, we assigned a Counterparty Risk Assessment (CR Assessment) of Aa2(cr) / P-1(cr).

The affirmation of Pohjola Bank's stand-alone baa2 BCA reflects the bank's strong national franchise, focused mainly on corporate lending, stable asset quality and improving capitalisation. The BCA is constrained by sector concentration and reliance on market funding.

Pohjola Bank is the main subsidiary in OP Financial Group (a3 BCA). Entities in the group (with exceptions for some group companies and insurance companies) guarantee each other's' liabilities. Consequently, Pohjola Bank's a3 adjusted BCA (BCA + affiliate support) is aligned with OP Financial Group's a3 BCA.

The affirmation of Pohjola Bank's Aa3 long-term senior unsecured debt and deposit ratings takes into account the bank's a3 adjusted BCA, in conjunction with our view of a very low loss given failure based on the protection provided to creditors by OP Financial Group's bail-in-able liabilities and a moderate likelihood of government support.

RECENT EVENTS

In 2014 OP Financial Group acquired all Pohjola Bank shares held by external investors. The transactions did in our view not have immediate material implications for Pohjola Bank although a less diverse ownership structure will speed up decision making. More negatively, the absence of institutional equity investors as shareholders will limit the bank's ability to attract equity capital.

OP Financial Group is planning to carry out structural changes, involving, among other things, the transfer of certain businesses away from Pohjola Bank. We are assessing the longer term impact of these changes as they are announced and implemented.

POHJOLA BANK'S BCA IS SUPPORTED BY ITS STRONG+ MACRO PROFILE

Finland is one of only five Aaa-rated countries in the euro region, underpinned by an innovation-driven economy, high living standards and a predictable economic policy framework. Post- crisis, the country's public finances are in much better shape than those of many other advanced economies despite similar struggles to revive economic growth. While this stable framework supports the Finnish banking sector, we note that the banks exhibit significant reliance on wholesale funding, exposing them to swings in investor sentiment. This risk is more pronounced in Finland compared to Nordic peers, because the country benefits to a lesser extent from an established, captive, investor community like countries like Sweden and Denmark.

Although the Finnish economy remains stagnant (putting pressure on government finances - a key driver behind the outlook change for the sovereign rating to Aaa negative from Aaa stable in June), the banking sector remains stable, showing relatively stable problem loans and earnings. It is unlikely that even a continued prolonged stagnation would create any significant rating pressure points in the near term.

Rating Drivers

- Strong domestic franchise in corporate banking although some functions are transferred away from the bank

- Improving profitability trend could reverse as functions are transferred away from the bank

- High reliance on short-term wholesale funding mitigated by liquidity buffer

- Asset quality is stable in spite of some sector concentration

- Good capital position likely to strengthen further

- A cushion of liabilities eligible for bail-in compensates for lower government support

RATING OUTLOOK

The outlook on Pohjola Bank's deposit and senior unsecured ratings is stable.

What Could Change the Rating - Up

Upward pressure on the ratings could develop as a result of: (1) stronger profitability; (2) reduced reliance on market funding and a longer debt maturity profile; and (3) a sustained reduction in sector concentration risks, particularly related to real estate.

What Could Change the Rating - Down

Pohjola Bank's ratings could be downgraded as a result of weaker asset quality, capitalization or a downgrade of OP Financial Group. A smaller cushion of bail-in eligible liabilities (on OP Financial Group level) or less likely government support would also result in downward rating pressure.

DETAILED RATING CONSIDERATIONS

The financial data in the following sections are sourced from Pohjola Bank's financial statements unless otherwise stated.

- STRONG DOMESTIC FRANCHISE IN CORPORATE BANKING ALTHOUGH SOME FUNCTIONS ARE TRANSFERRED AWAY FROM THE BANK

Pohjola Bank's asset quality and profitability are supported by its strong franchise, which is underpinned by its strong domestic market position in corporate banking, having reported a market share of around 21% at end-February 2015. It is also a leading player in non-life insurance, with a market share of around 31.5% (of written premiums) at year end-2014. In addition, the bank benefits from being part of OP Financial Group, a leading financial services group in Finland, thus laying ground for cross-selling of insurance products to banking customers and vice versa.

Pohjola bank as a company will in the future play a lesser role within OP Financial Group, thus negatively impacting the bank's franchise. According to current plans, central and corporate bank activities, equities and non-life insurance will remain with Pohjola Bank plc. All other operations of Pohjola Bank plc will be transferred to a new company to be established. The business transferred to the new company includes wealth management as well as card and property management functions. In addition, OP Financial Group is assessing whether the bank should continue to play the role of central bank for the group or whether the central banking operations should be separated as a detached subsidiary wholly owned by OP Cooperative. Since a more specific plan or schedule for the structural change of the Non-life Insurance segment (transfer from Pohjola Bank to direct ownership of OP Cooperative) has not yet been decided, it is reported as continuing operations together with Banking and Other Operations in Pohjola Bank's financial reporting.

As OP Financial Group's businesses (except for the insurance companies and some other group companies), including Pohjola Bank and the member cooperative banks, are responsible for each other's liabilities as outlined in the Cooperative Bank Act, Pohjola Bank can issue debt at more advantageous interest rates, a positive.

- IMPROVING PROFITABILITY TREND COULD REVERSE AS FUNCTIONS ARE TRANSFERRED AWAY FROM THE BANK

We expect Pohjola Bank's profitability to remain strong, owing to the bank's corporate banking focus which is a higher return/risk business compared to household mortgage lending. Moody's calculated return on equity was 14.8% in Q12015 compared to 9.6% in 2011. That said, we expect profits, in absolute terms, to drop as the asset management and other businesses are transferred away from the bank. This drop would be significant if non-life operations eventually are moved out of the bank as they accounted for 44% of Pohjola Bank's earnings before tax in Q1, 2015.

Pohjola Bank has a track-record of strengthening its efficiency over many years. Its Moody's calculated cost-to-income ratio was 41.8% in Q12015 down from 57.4% three years earlier. It is unlikely that this ratio will decrease much further, based on our experience with other Nordic banks. That said, in 2012 the bank launched a cost-savings program, aiming to save EUR50 million by the end of 2015. 75% of the savings target had been reached by year end-2014, and the bank expects to reach the EUR 50million goal before 2016.

Although we forecast only a 0.3% real GDP growth in Finland for 2015, we do not expect loan impairment charges to increase substantially. This assessment is based on historical performance; impairment charges have remained very low although the economy has contracted for three years. Even after the 2008/09 crisis Finnish banks recorded low impairment charges.

- HIGH RELIANCE ON SHORT-TERM WHOLESALE FUNDING MITIGATED BY LIQUIDITY BUFFER

Pohjola Bank currently plays the role of central bank for OP Financial Group. Among other things, the bank is responsible for issuing senior unsecured debt and managing the group's liquidity portfolio.

The bank is reliant on market funding, which exposes it to swings in investor sentiment. Market funds accounted for almost half of total liabilities (at 31 March 2015). More than half, or around 25% of total liabilities, were short-term in nature, including for example commercial paper. Whilst reliance on market funding is a credit weakness, we positively note that the bank has taken steps to lengthen its debt maturity profile. However, the current reorganization of functions within OP Financial Group could result in the bank losing its central bank role, and may therefor change the bank's funding profile. A decision to strip Pohjola Bank of its central bank role has not been taken nor has another suitable entity been identified by the group.

The bank maintains a large liquidity buffer which is of high quality, which is common for Nordic banks. The buffer amounted to EUR17.8 billion, around 68% of market funding per Moody's calculations, at 31 march 2015. Most securities are eligible for Central Bank repo transactions which gives the bank some flexibility in a currently unlikely stress scenario.

- ASSET QUALITY IS STABLE IN SPITE OF SOME SECTOR CONCENTRATION

Pohjola Bank has a track record of strong asset quality for a corporate bank: its Moody's calculated problem loans ratio stood at 3.1% at the end-March 2015. This ratio is slightly higher compared to large Swedish banks and mainly explained by the fact that Pohjola Bank is focused more exclusively on corporate lending. Nordic banks with a high share of household mortgage lending tend to benefit from a lower level of problem loans.

Pohjola Bank's asset quality is constrained by its high sector concentration. At end-March 2015, the most significant industries included Energy 11%, Wholesale and Retail Trade 10% and Renting and Operating of Residential Real Estate representing 10%. In mitigation, a total of 45% of exposures within Renting and Operating of Residential Real Estate were guaranteed by general government. More widely, Pohjola Bank's corporate exposures are stable according to the bank's internal risk classification system when comparing to 2013.

- GOOD CAPITAL POSITION LIKELY TO STRENGTHEN FURTHER

We consider Pohjola Bank to be well capitalized. The bank reported a CET1 ratio of 13.5% at Q12015 compared to 12.4% at year-end 2014. During Q1 the bank updated its probability of default assumptions for corporate exposures which had a 0.7 percentage point positive impact on the bank's CET1 ratio.

In March 2014 the bank announced a CET1 ratio target of 15% which it intends to reach by year end-2016. On top of this, the bank is subject to a 13% return on equity target. Pohjola Bank will not pay out more than 30% of profits in dividends before the CET1 target is reached. The payout ratio target will be at least 50% once the bank has achieved a 15% CET1 ratio.

NOTCHING CONSIDERATIONS

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

Finland is subject to the EU Bank Resolution and Recovery Directive (BRRD), which we consider to be an Operational Resolution Regime. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. In line with large European banks, we assume 26% of deposits are junior. These are in line with our standard assumptions.

The confirmation of Pohjola Bank's Aa3 deposit and senior unsecured debt ratings considers (i) Pohjola Bank's a3 adjusted BCA; (ii) a very low loss given failure for these instruments under our advanced LGF framework, resulting in a two-notch advanced LGF uplift; and (iii) a moderate probability of government support, translating into an additional notch of uplift. The reduction of our government support assumptions, reflecting the introduction of an operational resolution regime in Finland, is balanced by the two-notches benefit that deposit and senior unsecured ratings receive as a result of our advanced LGF analysis.

Our advanced LGF analysis is based on the balance sheet of the entire OP Financial Group (including Pohjola Bank), because all entities in OP Financial Group (excluding insurance companies and some other group companies) guarantee each other's' liabilities, in accordance with the Amalgamations Act.

For junior securities issued by Pohjola Bank, our advanced LGF analysis confirms a high loss-given-failure, given the small volume of debt and limited protection from more subordinated instruments and residual equity. We also incorporate additional notching for junior subordinated and preference share instruments reflecting the coupon features.

GOVERNMENT SUPPORT

The implementation of an operational resolution regime in Finland has caused us to reconsider the potential for government support to benefit certain creditors. Following the introduction of BRRD, we believe the probability of government support for Pohjola Bank's long-term and deposits ratings to be moderate, translating into one notch of uplift from its unsupported rating level. This reflects Pohjola Bank's profile as one of the leading financial institutions in Finland. For other junior securities, we continue to believe that potential government support is low and these ratings do not include any related uplift.

COUNTERPARTY RISK ASSESSMENT

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

Pohjola Bank's CR Assessment is positioned at Aa2(cr)/Prime-1(cr). The CR Assessment takes into account three notches of uplift on the Adjusted BCA of a3, based on the substantial cushion against default provided to the senior obligations represented by the CR Assessment by subordinated instruments. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

The CR Assessment also benefits from a low assessment of government support, translating into an additional notch of uplift. This reflects our view that any support provided by governmental authorities to a bank which benefits senior unsecured debt or deposits is very likely to benefit operating activities and obligations reflected by the CR Assessment as well, consistent with our belief that governments are likely to maintain such operations as a going-concern in order to reduce contagion and preserve a bank's critical functions.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Pohjola Bank plc

Macro Factors	
Weighted Macro Profile	**Strong +**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	3.1%	a3	←→	baa2	Single name concentration	Sector concentration
Capital						
TCE / RWA	10.9%	baa2	←→	baa2	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	1.0%	baa1	←→	baa2	Earnings quality	
Combined Solvency Score		baa1		baa2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	58.9%	b3	←→	ba3	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	55.0%	aa2	←→	aa2	Stock of liquid assets	
Combined Liquidity Score		baa3		baa2		

Financial Profile	**baa2**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	Aaa
Scorecard Calculated BCA range	**baa1 - baa3**
Assigned BCA	**baa2**
Affiliate Support notching	**2**
Adjusted BCA	**a3**

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	2	0	a1	1	Aa3	Aa3
Senior unsecured bank debt	2	0	a1	1	Aa3	Aa3

Dated subordinated bank debt	-1	0	baa1	0	Baa1	Baa1
Non-cumulative bank preference shares	-1	-2	baa3	0	Baa3(hyb)	Baa3(hyb)

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