

MOODY'S

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Credit Opinion: Pohjola Bank plc

Global Credit Research - 02 Apr 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
Jr Subordinate MTN -Dom Curr	(P)Baa1
Pref. Stock Non-cumulative	Baa3 (hyb)
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

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Key Indicators

Pohjola Bank plc (Consolidated Financials)[1]

	[2]12-14	[3]12-13	[3]12-12	[3]12-11	[3]12-10	Avg.
Total Assets (EUR million)	45,111.0	40,664.0	44,623.0	41,069.0	36,149.0	[4]5.7
Total Assets (USD million)	54,586.7	56,032.6	58,830.6	53,313.5	48,495.5	[4]3.0
Tangible Common Equity (EUR million)	2,300.0	1,970.0	1,680.0	1,510.6	1,440.0	[4]12.4
Tangible Common Equity (USD million)	2,783.1	2,714.5	2,214.9	1,961.0	1,931.8	[4]9.6
Problem Loans / Gross Loans (%)	2.6	3.3	2.4	2.5	2.9	[5]2.7
Tangible Common Equity / Risk Weighted Assets (%)	10.5	12.3	11.0	10.5	10.7	[6]10.5
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	15.8	22.2	17.4	18.6	22.5	[5]19.3
Net Interest Margin (%)	0.6	0.6	0.6	0.8	0.8	[5]0.7
PPI / Average RWA (%)	2.9	3.2	2.9	2.3	3.2	[6]2.9
Net Income / Tangible Assets (%)	1.1	1.1	0.7	0.6	0.7	[5]0.8
Cost / Income Ratio (%)	49.7	52.4	57.1	62.4	55.2	[5]55.4
Market Funds / Tangible Banking Assets (%)	58.9	59.3	60.2	66.6	74.0	[5]63.8
Liquid Banking Assets / Tangible Banking Assets (%)	55.0	54.2	49.2	49.8	47.9	[5]51.2
Gross Loans / Total Deposits (%)	104.3	105.1	95.4	105.4	175.1	[5]117.1

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 March 17th we affirmed Pohjola Bank Plc's long-term deposit and senior unsecured debt ratings with a stable outlook. The forthcoming introduction of an operational resolution regime in Finland (as part of the EU) has reduced our assessment of the likelihood of government support for Pohjola Bank Plc. However, our advanced loss given failure analysis indicates that Pohjola Bank Plc's cushion of liabilities eligible for bail-in, assuming a currently unlikely failure scenario, is sufficient to compensate for less likely government support.

Pohjola Bank Plc's baa2 baseline credit assessment (BCA) reflects the bank's strong national franchise, its sound risk management as well as the good asset quality in its loan book. The BCA is constrained by the bank's credit concentration risks and high reliance on market funding.

Pohjola Bank Plc is the main subsidiary of the Finnish co-operative banking group, OP Financial Group, to which we assign an a3 BCA. Non-insurance companies in the group are jointly and severally liable for each others' obligations, hence Pohjola Bank Plc's adjusted BCA (BCA + affiliate support) is aligned with the group BCA at a3.

RECENT EVENTS

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

OP Financial group is planning to carry out structural changes, involving, among other things, the transfer of non-life insurance and asset management businesses from Pohjola Group to OP Cooperative. We are assessing the longer term impact of these changes as they are announced and implemented.

POHJOLA BANK PLC'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.

Rating Drivers

- Strong domestic franchise in corporate banking although some functions are transferred away from the bank
- High reliance on short-term wholesale funding mitigated by liquidity buffer
- Upward sloping profitability trend could reverse as functions are transferred away from the bank
- Asset quality is good in spite of moderate industry concentration
- Good capital position likely to strengthen further
- The bank's cushion of liabilities eligible for bail in compensates for lower government support

RATING OUTLOOK

The outlook on Pohjola Bank Plc's deposit and senior unsecured ratings is stable. Following the introduction of an operational resolution regime in Finland we have lowered our assessment of the likelihood of government support

for the bank. However, under our LGF analysis, Pohjola Bank Plc benefits from a sizable cushion of liabilities eligible for bail-in, assuming a currently unlikely failure scenario, which offsets the negative impact of less likely government support.

What Could Change the Rating - Up

Upward pressure on the ratings could develop following: (1) an improvement in the bank's profitability levels without increasing its risk profile; (2) a further sustained extension in its funding maturity profile combined with an increasing share of deposit funding; and/or (3) a sustained reduction in its concentration risk, particularly related to real estate.

What Could Change the Rating - Down

Pohjola Bank Plc's BCA could be lowered following: (1) weakening financing conditions and/or operating environment; (2) a material weakening of the bank's franchise, and/or; (3) weakening economic fundamentals, particularly with respect to the bank's profitability and capital position. The bank's adjusted BCA (BCA + group support) could come under pressure if the OP Financial Group's creditworthiness were to deteriorate.

Pohjola Bank Plc's senior unsecured debt and deposit ratings could come under pressure if (1) its cushion of liabilities eligible for bail-in were to shrink and/or (2) the likelihood of government support were to be reduced further.

DETAILED RATING CONSIDERATIONS

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

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

Pohjola Bank Plc's franchise value is underpinned by its strong domestic market position in corporate banking where it reports a market share of around 27% of lending. It is also a leading player in non-life insurance, with a market share of around 30%. The bank benefits from being part of OP Financial Group, a leading banking group in Finland, thus laying ground for cross-selling of insurance products to banking customers and vice versa.

Looking ahead, the bank will play a lesser role within the OP Financial Group, thus negatively impacting the bank's franchise value. Non-Life Insurance and Asset Management will be transferred to OP Cooperative from the bank. These two segments accounted for 44.7% of pre-tax profits and 11% of the bank's assets at year end-2014. Moreover, the OP Financial Group is assessing whether the bank should continue to play the role of central bank for the group.

Effectively all OP Financial Group's businesses (except for the insurance companies), including Pohjola Bank Plc and the member cooperative banks, are responsible for each other's liabilities as outlined in the Cooperative Bank Act. That is a strength for Pohjola Bank Plc as it for example enables the bank to issue debt at more advantageous interest rates.

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

Looking ahead, we expect Pohjola Bank Plc's profitability to remain strong, owing to the bank's corporate banking focus which is a higher return/risk business compared to household lending. Moody's calculated return on equity was 14.2% in 2014 compared to 9.2% in 2011. That said, we expect profits, in absolute terms, to drop materially as non-life and asset management businesses are transferred away from the bank.

Pohjola Bank Plc has a track-record of strengthening its efficiency over many years. Its Moody's calculated cost-to-income ratio was 49.7% in 2014 compared to 62.4% 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 programme, aiming to save EUR50 million (less than one third of personnel costs in 2014) 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.

Looking ahead, we do not expect loan impairment charges to hit profits although we forecast zero economic growth in Finland for 2015. This assessment is based on historical performance; for example, 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 WHOLESALF FUNDING MITIGATED BY LIQUIDITY BUFFER

Pohjola Bank Plc currently plays the role of central bank for OP Financial Group meaning that, among other things, the bank is responsible for issuing senior unsecured debt and managing the group's liquidity portfolio. Pohjola Bank Plc's funding position would remain unaffected, even if it no longer played the role of central bank, as long an entity under the group guarantee issues the debt on behalf of the bank.

Pohjola Bank Plc's funding structure consist mainly of short-term debt such as interbank and commercial paper (29.7% of total funding). Long-term bonds (25.6%) and deposits (22.3%) are also key funding sources. Although Pohjola Bank Plc is reliant on short-term wholesale funding, which exposes it to swings in investor sentiment, we positively note that the bank has taken steps to lengthen its debt maturity profile. That said, Moody's thinks that the loss of central bank status would likely mean that some of the long-term debt would be replaced by internal funding from the entity that would assume the role of group central bank. A decision to strip Pohjola Bank Plc 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. Most securities are eligible for Central Bank repo transactions which gives the bank some flexibility in a currently unlikely stress scenario.

- ASSET QUALITY IS GOOD IN SPITE OF MODERATE INDUSTRY CONCENTRATION

Pohjola Bank Plc has a track record of good asset quality. Its Moody's calculated problem loans ratio tends to be in the 2.5% to 3.5% range although it sometimes is higher or lower. This range is comparable with Nordic banks with corporate lending. Only Nordic banks that almost exclusively focus on household mortgage lending tend to benefit from less problem loans.

Above said, and as reflected in our scorecard, we view Pohjola Bank Plc's asset quality as constrained by its high corporate borrower concentration. Some of the larger industry exposures include real-estate (including trading, renting and operating real estate) at 23.1%, trade at 9.8% and energy at 9.9% of corporate exposure. 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 Plc'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

Pohjola Bank Plc reported a CET1 ratio of 12.4% and a Tier 1 ratio of 13.4% at year end-2014. 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 it is to meet a return on equity target of 13% a year earlier. To help reach the profitability target, Pohjola Bank Plc's dividend pay-out targets have been reduced to 30% of profits. This is relative to the previous minimum 50% dividend policy.

NOTCHING CONSIDERATIONS

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We apply our advance loss-given-failure analysis to Pohjola Bank Plc and the OP Financial Group as the bank is subject to the EU Bank Resolution and Recovery Directive (BRRD), which we consider to be an Operational Resolution Regime. For this analysis we assume that equity and losses stand at 3% and 8%, respectively, of tangible banking assets in a failure scenario. We also assume a 25% run-off of "junior" wholesale deposits and a 5% run-off in preferred deposits. Moreover, we assign a 25% probability to junior deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

We believe that Pohjola Bank Plc's deposits are likely to face low loss-given-failure, due to the loss absorption provided by senior unsecured debt, subordinated debt and preference shares. In addition, the bank has a large deposit base, meaning that any losses would be spread over a large base, thus translating into low losses for the individual depositor. Hence, we have affirmed the bank's senior unsecured debt and deposit ratings.

Pohjola Bank Plc's adjusted BCA was unaffected by the introduction of our new bank rating methodology in March 2015 and consequently Pohjola Bank Plc's subordinated and junior subordinated debt ratings were unchanged.

GOVERNMENT SUPPORT

The implementation of the BRRD has caused us to reconsider the potential for government support to benefit certain creditors. We now expect a moderate probability of government support for deposits and senior unsecured debt, resulting in a one-notch uplift compared to the previous three notches.

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						
<i>Problem Loans / Gross Loans</i>	2.8%	a2	← →	baa2	Single name concentration	Sector concentration
Capital						
<i>TCE / RWA</i>	10.5%	baa2	← →	baa2	Risk-weighted capitalisation	
Profitability						
<i>Net Income / Tangible Assets</i>	1.0%	baa1	← →	baa2	Earnings quality	
Combined Solvency Score		baa1		baa2		
Liquidity						
Funding Structure						
<i>Market Funds / Tangible Banking Assets</i>	58.9%	b3	← →	ba3	Market funding quality	
Liquid Resources						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	55.0%	aa2	← →	aa2	Stock of liquid assets	
Combined Liquidity Score		baa3		baa2		

Financial Profile

baa2

Qualitative Adjustments

Business Diversification
Opacity and Complexity
Corporate Behavior
Total Qualitative Adjustments

Adjustment

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

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