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Research Update:

Finland-Based Pohjola Bank 'AA-/A-1+' Ratings Affirmed And Off Watch; Outlook Negative

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

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Overview

- The tender offer for Finland-based Pohjola Bank PLC has concluded and the OP-Pohjola Group now holds more than 98% of the shares.
- Although the debt-financed purchase will deplete the OP-Pohjola Group's capital base, we believe that the recapitalization plan to reach a common equity Tier 1 ratio of 18% in 2016 underpins our strong assessment of the bank's capital and earnings position.
- We are therefore affirming our 'AA-/A-1+' ratings and removing them from CreditWatch negative.
- The negative outlook reflects our view of potentially less predictable extraordinary government support, risks related to the recapitalization process, and the negative trend we see for the Finnish banking sector.

Rating Action

On May 30, 2014, Standard & Poor's Ratings Services affirmed its 'AA-/A-1+' long- and short-term counterparty credit ratings on Finland-based Pohjola Bank PLC. The outlook is negative.

At the same time, we removed all issue ratings on Pohjola Bank's debt, and the long-term counterparty credit and financial strength ratings on its core subsidiary Pohjola Non-Life Insurance Co. Ltd., from CreditWatch negative, where we had placed them on Feb. 6, 2014.

Rationale

Our ratings on Pohjola Bank, OP-Pohjola Group's main operating entity, reflect the franchise and creditworthiness of the wider group. On April 25, 2014, the OP-Pohjola Group central cooperative (the group) announced that the extended tender offer period to buy the outstanding shares in Pohjola Bank had concluded, with the group now owning 98.41% of the bank. The remaining 1.59%, currently held by various minority investors, is being transferred to the group through compulsory redemption proceedings under the Finnish Limited Liability Companies Act.

The debt-financed transaction, valued at €3.4 billion, will deplete the group's capital base and lower the common equity Tier 1 ratio to approximately 11%, according to the group's projections. Likewise, we calculate that our risk-adjusted (RAC) ratio would also decrease to about 6%.

However, the group, which we think has a conservative capital policy, has announced a recapitalization plan to reach its newly set common equity Tier 1 target of 18% in 2016. The plan involves improving earnings and issuing profit shares (classified as equity under the regulatory regime) to retail member clients.

The new capital target requires the group to record earnings before tax above €1 billion within the next few years. This would be achieved on the back of higher lending margins and stronger insurance and fee income. Although we regard this strategy as challenging, we think the group is capable of meeting this target. However, more importantly, the group has started to sell new member profit shares to its retail network--shares we classify as equity for full inclusion into our preferred measure of capital, total adjusted capital--which will boost its capital position. Taking into account that recent results from these selling activities are well ahead of schedule, we expect the group to reach its targets of €1.3 billion for 2014 and 2015. In addition, the intention is to convert approximately €600 million of the existing supplementary cooperative capital into profit shares.

Overall, we expect that our RAC ratio will reach about 10.5% in 2015, supporting our "strong" assessment of the capital and earnings in the group and in line with our previous base case.

At year-end 2013, our liquidity ratio (broad liquid assets to short-term wholesale funding) for the group stood at 76%, and the stable funding ratio was 88%. We consider both ratios to be at the low end for our current assessment of the group's funding and liquidity. We expect these ratios to improve materially in the coming two years and to be in line with our "adequate" liquidity and "average" funding assessments.

The ratings on Pohjola Non-Life Insurance reflect our view of its core status as the non-life insurance subsidiary of the Finland-based OP-Pohjola financial services group, reflecting its successful bancassurance business model in Finland and the insurer's contributions to the group's earnings through insurance commission revenues.

Outlook

The negative outlook reflects our view of potentially less predictable extraordinary government support under the new EU legislative framework. We could lower the ratings by one notch by year-end 2015 if we believe there is a greater likelihood that senior unsecured creditors may incur losses if the bank fails. Furthermore, the negative outlook incorporates the uncertainty around the recapitalization process and the group's ability to reach and maintain a RAC ratio of more than 10% in the next 18-24 months, as well as its capacity to strengthen its funding and liquidity position by our measures. In addition, in our view, Finland's weak economic recovery could hamper the banking sector's performance over the next two years, which could lead us to lower our anchor for Finnish banks, including Pohjola Bank.

We could revise the outlook to stable if we consider that potential extraordinary government support for Pohjola's issuer credit ratings is unchanged in practice, despite the introduction of bail-in powers and international efforts to increase banks' resolvability; or if we believe that other rating factors, such as a large buffer of subordinated instruments, would provide substantial additional flexibility to absorb losses while the bank remains a going concern.

Ratings Score Snapshot

Issuer Credit Rating	AA-/Negative/A-1+
SACP	a+
Anchor	a-
Business Position	Strong (+1)
Capital and Earnings	Strong (+1)
Risk Position	Adequate (0)
Funding and Liquidity	Average and Adequate (0)
Support	+1
GRE Support	0
Group Support	0
Sovereign Support	+1
Additional Factors	0

Related Criteria And Research

Related Criteria

- Group Rating Methodology, Nov. 19, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment: Finland, Jan. 3, 2014

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CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Pohjola Bank PLC		
Counterparty Credit Rating	AA-/Negative/A-1+	AA-/Watch Neg/A-1+
Senior Unsecured	AA-	AA-/Watch Neg
Subordinated	A	A/Watch Neg
Commercial Paper	A-1+	A-1+/Watch Neg

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