Landkreditt Bank AS Issuer Rating Report

SCOPE A- STABLE

Overview

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

When there is further clarity about the MREL requirements of Norwegian banks, Scope intends to adjust its ratings on senior unsecured debt. In line with our rating methodology, we expect to 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 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 a roughly equal balance between the two customer segments, with the mix currently more skewed to farmers.
- The bank maintains 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 group's solidity.
- As an online bank, Landkreditt is 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-
Senior unsecured debt rating	BBB+
Outlook	Stable
Covered bond rating (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. Both fiscal and monetary measures are being implemented to support households and businesses, including farmers, impacted by Covid-19. Norway is in a sound budgetary position, with significant resources available for sustaining the economy. While the eventual magnitude of the impact on the bank's asset quality is uncertain, we take comfort from the relatively low risk and secured nature of the loan portfolio.

Business expansion which increases the risk profile of the group. Aggressive growth and/or expansion into new markets or businesses which increases the risk profile of the group would be viewed negatively. Expansion of the group's business activities (i.e. insurance and real estate brokerage) has been aimed at strengthening 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

Leading provider of financial services to agricultural sector

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 2019, there were ca. 9,000 cooperative members from 16 regions. Representatives are elected to annual general meetings with voting done by electronic means to encourage wide participation. During the 2020 annual general meeting, 30 representatives were responsible for selecting five of seven board members.

Expanding product offering to cement customer relationships

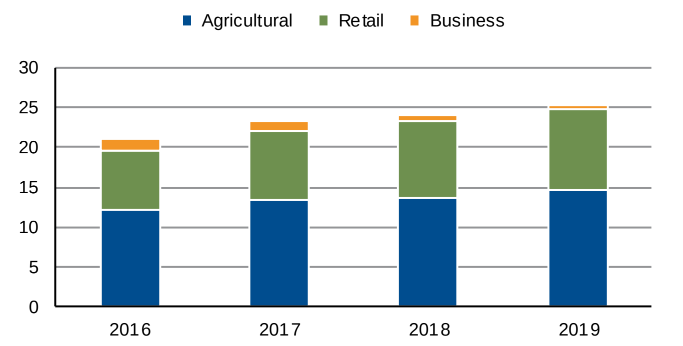
As detailed in its 2019-2022 strategic plan, the group aims to further strengthen its position in the agricultural sector and to reinforce customer relationships, particularly in light of developments like PSD2. Last year, the group acquired a small real estate broker focused on agricultural property. Management has also worked to more closely integrate the group's banking and insurance businesses to foster greater cooperation and sales. Activities such as risk management, compliance and IT are now handled at group level.

In 2018, the group had increased its ownership stake in the insurance business Landbruksforsikring to nearly 93%. The company was subsequently renamed 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.

Nearly all lending is secured

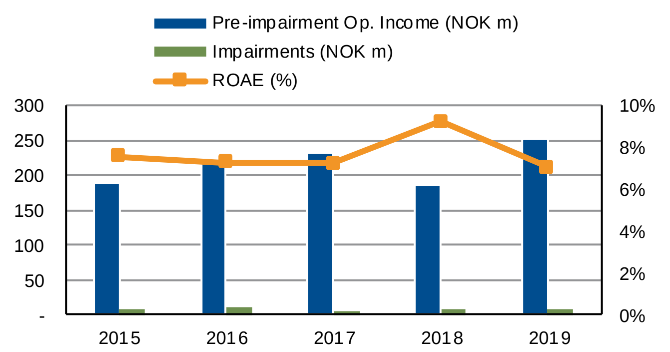
Over the last few years, the bank has determinedly grown retail volumes to achieve greater scale and a more diversified business. The retail business is essentially mortgage lending. While the goal is to achieve a roughly 50/50 balance, management recognizes the increasingly competitive conditions in the retail market and remains committed to the group's core client base of farmers. Non-agricultural customers currently account for about 40% of credit exposures.

Figure 1: Loans by customer type (NOK bn)



Source: Company data, Scope Ratings.

Figure 2: Reasonable returns and low credit losses



Note: Return in 2018 included a NOK 101m gain from the sale of stake in leasing company, Landkreditt Finans. Source: Company data, Scope Ratings.

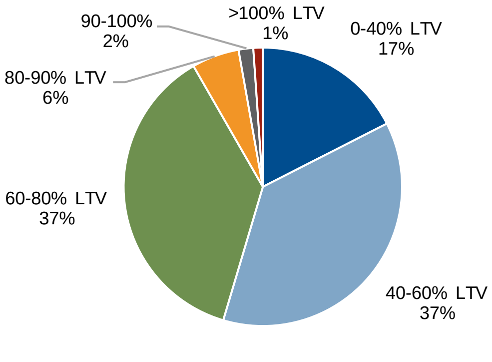
The bank has demonstrated its ability to manage growth while maintaining low credit losses (Figure 2). With agricultural customers, credit decisions benefit from the bank's in-depth knowledge and expertise in the sector. As of YE 2019, problems loans accounted for less than 1% of gross loans.

Over 95% of loans have LTVs below 80%

Over 99% of credit exposure is secured via residential property or agricultural buildings and land. Meanwhile, over 95% of loans have LTVs below 80%. About 60% of the credit exposure is in the greater Oslo region, with the remainder spread throughout the country.

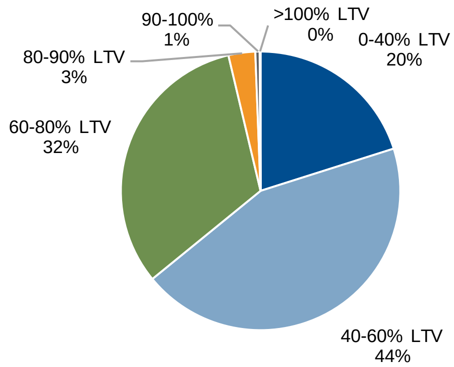
In addition to the NOK 24.8bn of credit exposure to agricultural and retail customers shown in Figures 3 and 4, the bank has another NOK 0.5bn in exposure to SME customers with a comparable risk profile. Management has decided to focus only on farmers and retail customers; and has been gradually discontinuing SME lending.

Figure 3: LTV profile of agricultural exposures



Source: Data as of YE 2019. Agricultural exposures of NOK 14.6bn.
Source: Company data, Scope Ratings.

Figure 4: LTV profile of retail exposures



Source: Data as of YE 2019. Retail exposures of NOK 10.2bn.
Source: Company data, Scope Ratings.

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

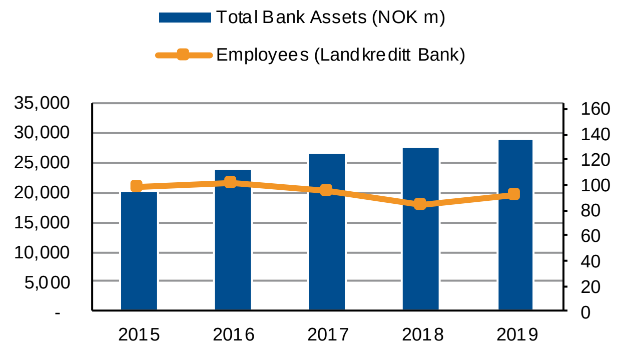
Since its establishment in 2002, Landkreditt Bank has been an online bank and therefore is not burdened by a legacy branch network. The bank invests in established IT infrastructure, and systems are essentially outsourced. Furthermore, the bank offers relatively simple products, reducing operational 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 TietoEVRY, a leading Nordic IT services and software provider. Under the agreement, TietoEVRY is expected to deliver next-generation core banking and payment solutions, including further improvements in respect of self-service and automation in the areas of loans and credit. As shown in Figure 5, the volume of bank assets continues to outpace the growth in employees.

Ongoing IT investments to support business growth

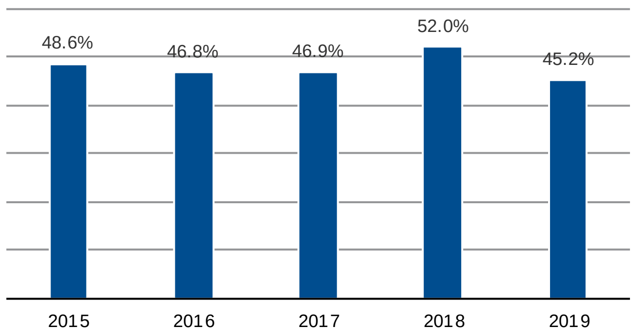
Nearly all the bank's employees operate out of a single building in Oslo. With the addition of the insurance and real estate businesses, a small number of insurance representatives and real estate brokers are joining the group to increase cross-selling opportunities. A new IT system for the insurance business is being put in place over the next couple of years to support these efforts.

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

After several years of strong expansion, the bank's lending and deposit growth is moderating. However, the pace of lending still generally outstrips deposit growth, with deposits being insufficient to support lending activities. The deposit-to-loan ratio was 71% in 2019, 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.

Covered bonds are an important source of relatively stable funding

To diversify funding sources, a fully owned covered bond issuer, Landkreditt Boligkreditt, was established in 2010. As of YE 2019, NOK 4.4bn 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.

Both Landkreditt Bank and Landkreditt Boligkreditt are regular issuers in the domestic bond market, issuing secured, senior and subordinated debt. In 2019, the two entities tapped the markets four times, raising NOK 1.8bn in total. Investors include Norwegian pension funds, asset managers and insurance companies. As of YE 2019, the average maturity of outstanding debt was about three years while the average interest rate was 2.1%.

Primarily to meet LCR requirements, the bank group held a liquidity buffer of NOK 1.9bn in government and covered bonds as of YE 2019. The bank group's LCR and NSFR were reassuring at 263% and 155%, respectively as of YE 2019. There is a limited amount of debt coming due in 2020 (Figure 7).

Reassuring solvency metrics driven by regulatory demands

Over the past few years, Landkreditt Bank has bolstered its solvency position through retained earnings and capital contributions from its parent (NOK 130m in 2014, NOK 300m in 2016). According to management, cooperative members 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.

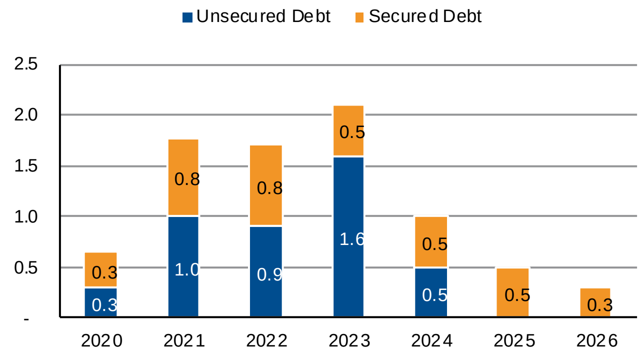
Capital position well above requirements

With a CET1 capital ratio of 20.3% as of YE 2019, the group has a strong capital buffer against uncertainties posed by Covid-19. For 2020, the group targets a CET1 capital ratio of at least 14.3%, which includes a 0.5% management buffer above the requirement of 13.8%. The requirement incorporates a 3% systemic risk buffer, a 1% countercyclical capital buffer and a 2.8% Pillar 2 requirement (Figure 8). As part of the measures implemented to mitigate the impact of the pandemic, the countercyclical capital buffer was lowered to 1% from 2.5% on 13 March 2020.

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.

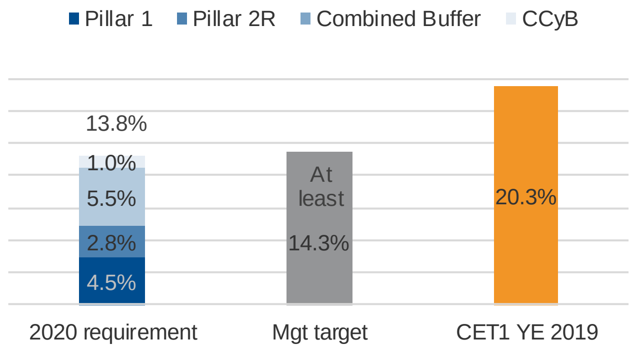
As of 2019YE, the bank group's leverage ratio was 9.2% which compares well to both domestic and international peers. All Norwegian banks must hold a buffer of at least 2% above the minimum requirement of 3%. In addition, management intends to maintain a further buffer of 1%.

Figure 7: Funding maturity profile (NOK bn)



Note: Figures as of YE 2019.
Source: Company data, Scope Ratings.

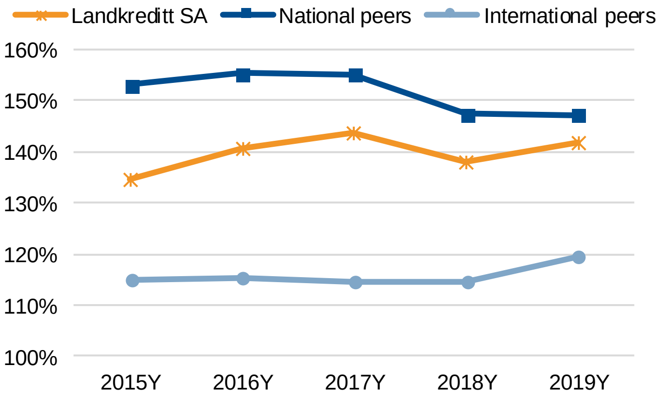
Figure 8: Landkreditt group - actual CET1 vs management target and requirements



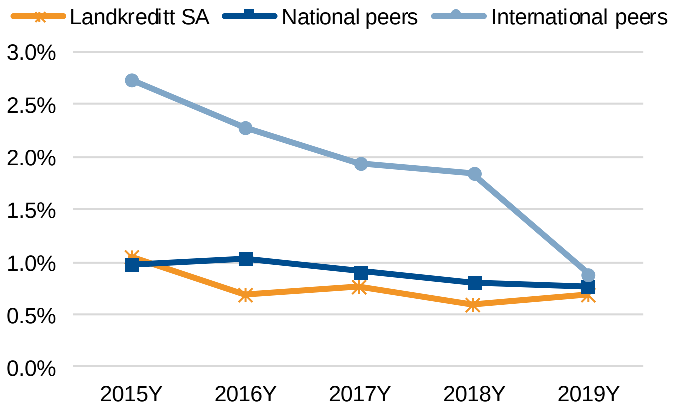
Notes: Combined buffer comprises 2.5% capital conservation buffer and a 3% systemic risk buffer. CCyB = countercyclical capital buffer.
Source: Company data, Scope Ratings.

I. Appendix: Peer comparison

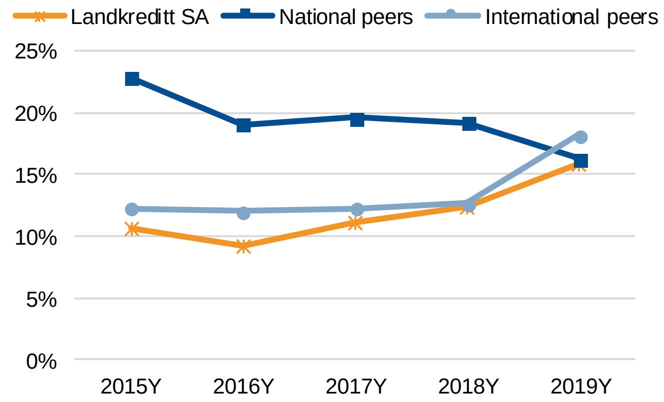
Amortised loans % Deposits



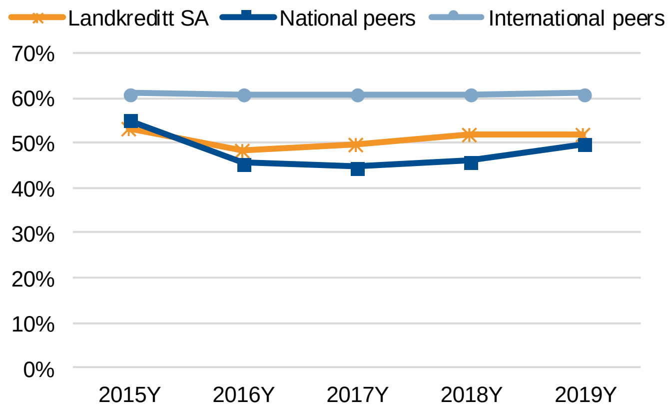
Problem loans % Gross customer loans



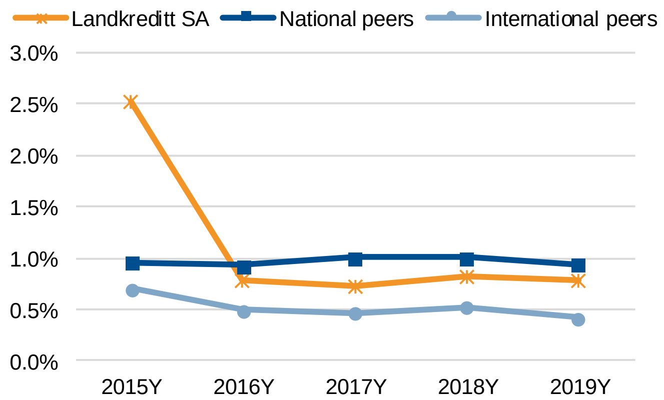
Net fee and commission income % Operating income



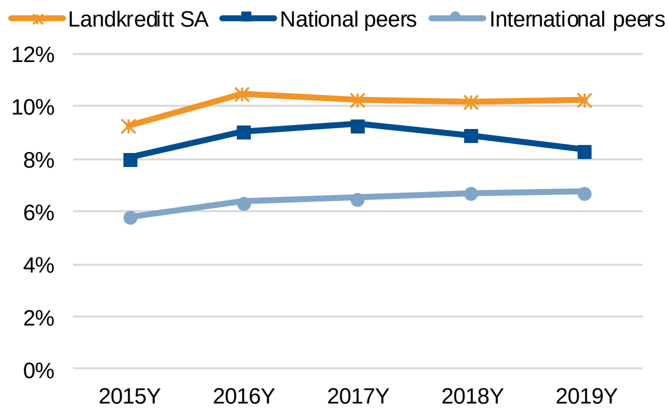
Costs % Income



Return on average assets (%) *



Leverage ratio (%)



* Note Landkreditt had a gain of NOK 359m in 2015 from the sale of property.
Domestic peers: Landkreditt SA, SpareBank 1 SMN, SpareBank 1 SR-Bank, DNB, Jaeren Sparebank, Totens Sparebank. Sandnes Sparebank, Sparebank 1 Nordvest, BN Bank.
International peers: Landkreditt SA, Nationwide Building Society, Coventry Building Society, Santander UK, Kutxabank, Rabobank, Bausparkasse Wustenrot AG.

Source: SNL

II. Appendix: Selected Financial Information – Landkreditt SA group

	2015Y	2016Y	2017Y	2018Y	2019Y
Balance sheet summary (NOK m)					
Assets					
Cash and interbank assets	970	977	759	993	931
Total securities	1,456	1,786	2,453	3,391	3,188
of which, derivatives	0	0	0	0	0
Net loans to customers	17,762	21,076	23,293	24,054	25,421
Other assets	125	183	227	500	614
Total assets	**20,313**	**24,022**	**26,732**	**28,938**	**30,155**
Liabilities					
Interbank liabilities	0	0	15	16	0
Senior debt	4,266	6,021	7,272	7,069	7,492
Derivatives	0	0	0	0	0
Deposits from customers	13,208	14,963	16,208	17,443	17,931
Subordinated debt	175	175	175	331	331
Other liabilities	172	177	170	1,066	1,168
Total liabilities	**17,821**	**21,337**	**23,840**	**25,925**	**26,922**
Ordinary equity	2,255	2,437	2,599	2,795	3,012
Equity hybrids	149	149	199	199	199
Minority interests	88	98	94	19	22
Total liabilities and equity	**20,313**	**24,022**	**26,732**	**28,938**	**30,155**
Core tier 1/ common equity tier 1 capital	2,294	2,487	2,651	2,795	2,934
Income statement summary (NOK m)					
Net interest income	347	355	379	380	411
Net fee & commission income	42	43	53	72	98
Net trading income	-15	32	28	92	48
Other income	25	30	16	40	59
Operating income	**400**	**459**	**476**	**585**	**615**
Operating expenses	212	221	237	303	319
Pre-provision income	**188**	**237**	**239**	**281**	**297**
Credit and other financial impairments	7	12	6	8	7
Other impairments	0	0	0	0	0
Non-recurring items	359	NA	NA	NA	NA
Pre-tax profit	**536**	**225**	**234**	**274**	**290**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	46	48	46	40	59
Net profit attributable to minority interests	11	12	10	5	3
Net profit attributable to parent	**478**	**165**	**178**	**229**	**228**

Source: SNL

III. Appendix: Selected Financial Information – Landkreditt SA group

	2015Y	2016Y	2017Y	2018Y	2019Y
Funding and liquidity					
Net loans/ deposits (%)	134.5%	140.9%	143.7%	137.9%	141.8%
Liquidity coverage ratio (%)	351.0%	294.0%	248.0%	238.0%	NA
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%	84.3%
Problem loans/ gross customer loans (%)	1.0%	0.7%	0.8%	0.6%	0.7%
Loan loss reserves/ problem loans (%)	24.2%	32.4%	27.8%	52.6%	42.9%
Net loan growth (%)	11.4%	18.7%	10.5%	3.3%	5.7%
Problem loans/ tangible equity & reserves (%)	7.4%	5.4%	6.1%	4.7%	5.5%
Asset growth (%)	11.1%	18.0%	11.3%	8.3%	4.2%
Earnings and profitability					
Net interest margin (%)	1.8%	1.6%	1.5%	1.4%	1.4%
Net interest income/ average RWAs (%)	3.1%	2.9%	2.8%	2.7%	2.8%
Net interest income/ operating income (%)	86.8%	77.3%	79.6%	65.0%	66.7%
Net fees & commissions/ operating income (%)	10.6%	9.3%	11.2%	12.4%	15.9%
Cost/ income ratio (%)	53.1%	48.3%	49.7%	51.9%	51.8%
Operating expenses/ average RWAs (%)	1.9%	1.8%	1.8%	2.1%	2.2%
Pre-impairment operating profit/ average RWAs (%)	1.7%	2.0%	1.8%	2.0%	2.1%
Impairment on financial assets / pre-impairment income (%)	3.9%	5.2%	2.3%	2.8%	2.4%
Loan loss provision/ average 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%	20.3%
Tier 1 capital ratio (%, transitional)	21.7%	20.7%	20.1%	21.2%	21.7%
Total capital ratio (%, transitional)	23.2%	22.1%	21.4%	23.0%	23.5%
Leverage ratio (%)	9.3%	10.5%	10.2%	10.2%	10.3%
Asset risk intensity (RWAs/ total assets, %)	55.5%	53.0%	53.0%	48.8%	47.8%

Source: SNL

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