

Research Update:

Finland-Based Bank of Åland Affirmed At 'BBB/A-2' On Swedish Mortgage Loan Cooperation; Outlook Still Positive

September 23, 2019

Overview

- We expect Bank of Åland to remain committed to robust risk-adjusted capitalization even though the transaction to create a joint mortgage company will delay capital buildup.
- We expect that Bank of Åland's balance sheet will temporarily be inflated by the transfer of mortgage loans from partners, but its capital position will likely be supported by hybrid capital issuance and subsequently the carve out of the Swedish mortgage book into a new mortgage company.
- We are consequently affirming our 'BBB/A-2' ratings on Bank of Åland.
- The positive outlook reflects that the bank's risk-adjusted capital ratio could sustainably exceed 15% by 2021.

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Rating Action

On Sept. 23, 2019, S&P Global Ratings affirmed its 'BBB/A-2' long- and short-term ratings on Bank of Åland. The outlook remains positive.

Rationale

Bank of Åland announced on Sept. 20, 2019, that it had signed an agreement to establish a new Swedish mortgage company together with four partners: ICA Bank (belonging to retailer ICA Group), IKANO Bank (IKANO Group belonging to the Kamrad family), Söderberg & Partners (advisor in wealth management, insurance, and pensions), and Borgo (digital mortgage company). The purpose is to create a platform to allow distribution of mortgage loans to Swedish customers of each partner and to refinance them in an efficient way through issuance of covered bonds. The cooperation results from the partners' need to find a replacement for SBAB Bank, a Swedish mortgage lender, which terminated the third-party funding agreements in 2018. This has

constrained new mortgage lending by the partners in Sweden.

The five parties aim to establish a mortgage company licensed by the Swedish Financial Supervisory Authority by the end of 2020. The mortgage company will benefit from Bank of Åland's knowhow in covered bond issuance, as well as in IT, treasury, and risk management systems. Bank of Åland and its 100% IT subsidiary CrossKey will provide services to the mortgage bank, thereby diversifying the Bank of Åland's revenue base. While overall we consider the creation of this joint venture as rating positive it also brings execution and potential operational risks for Bank of Åland.

Furthermore, in line with the distribution agreement signed with ICA Bank on Aug. 30, 2019, we expect Bank of Åland to assume a portfolio of Swedish mortgage loans on a temporary basis to bridge the funding until the mortgage company is in operation. This will inflate the bank's loan book and risk-weighted assets in 2020. Therefore, we expect that Bank of Åland is likely to issue hybrid capital in 2020 in order to support its regulatory capital ratios.

In our view, Bank of Åland's capital position remains strong, with a risk-adjusted capital (RAC) ratio of 14.2% as of Dec. 31, 2018, up 80 basis points from 2017. Under our base case, we forecast that the RAC ratio will hover close to 15% by year-end 2020 on the back of internal capital buildup that, in our view, will offset an increase in risk-weighted assets from lending operations in Finland and Sweden. We consider that the planned transaction will delay the projected capital buildup but the capital trajectory underlying our positive outlook remains unchanged.

Assuming the temporary transfer of the loan portfolio from ICA Bank and the creation of a mortgage company in the course of 2020, we believe that the RAC ratio will likely weaken temporarily. But the carve-out of the Swedish mortgage book into the new entity should reduce Bank of Åland's risk-weighted assets and capital needs. Therefore we expect that the dip in the capital position will be reversed by 2021.

As a large share of revenue comes from a relatively narrow business line--private banking--we believe that the cooperation in Swedish mortgage lending could add non-net interest income and provide a stable return, thereby diversifying Bank of Åland's earnings base. We forecast a dividend payout ratio of roughly 50% in the next 24 months.

The bank's common equity tier 1 ratio (CET1) ratio reached 13.3% as of June 30, 2019, representing a robust buffer against the regulatory capital requirement of 10.7%. However, we view the bank's capital quality as weaker than peers' because its total adjusted capital, our measure of loss-absorbing capital, includes a relatively high share of tier 2 instruments, with a partial write-down feature if its CET1 falls below 7%. These instruments represent about 14% of adjusted common equity, whereas many of its peers--Nordic midsize banks--have no hybrid instruments in their capital base. We would view negatively any further hybrid capital issuance at the expense of organic capital growth through earnings retention.

The bank's operating profits remain sound, in our view, with a return-on-equity target of over 10% but a relatively high cost-to-income ratio of 77% in first-half 2019, as the consolidation of CrossKey weighed on the bank's cost-efficiency metrics, as did the resolution fund fee payable in the first quarter. Bank of Åland's cost of risk continued to be one of the lowest in Finland at 0.03% in first-half 2019. Our rating also reflects the bank's growth momentum in Sweden--where we anticipate it will maintain prudent underwriting standards--and its strategy of keeping collateralized lending high.

Outlook

The positive outlook on Bank of Åland reflects our view that the bank will continue to build up its capital base, improve and diversify its earnings, and uphold a sound approach to risk over the next two years.

We could raise the rating if Bank of Åland's capitalization improves, as indicated by a sustained increase of its RAC ratio beyond 15% over the next 24 months including further earnings retention. An upgrade would depend on the bank's efforts to uphold sound profitability and an unchanged stance toward prudent underwriting standards and collateralization.

We could revise the outlook to stable over the next 24 months if Bank of Åland's profitability and the pace or quality of its capital buildup remain weaker than our expectation. More aggressive volume growth and lending standards to increase earnings, higher-than-expected credit losses, or sustained high costs with a subsequent drag on the bank's internal capital generation, would also weigh on the rating.

The creation of the cooperation in Swedish mortgage lending is at an early stage. We could take a negative rating action if we considered that the project encompasses heightened execution and operational risks to Bank of Åland, in particular from a governance and risk underwriting perspective.

Ratings Score Snapshot

Issuer Credit Rating BBB/Positive/A-2

SACP bbb

Anchor a-

- Business Position Weak (-2)
- Capital and Earnings Strong (+1)
- Risk Position Moderate (-1)
- Funding Average (0)
- Liquidity Adequate

Support (0)

- ALAC Support (0)
- GRE Support (0)
- Group Support (0)
- Sovereign Support (0)

Additional Factors (0)

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment: Sweden, April 11, 2019
- Nordic Banks' Strong Capital Will Cushion Them From The Challenges Ahead, March 28, 2019
- Bank of Åland, Aug. 17, 2018
- Finland-Based Bank Of Åland Outlook Revised To Positive On Potentially Stronger Capitalization And Profitability, July 25, 2018
- Banking Industry Country Risk Assessment: Finland:, Feb. 2, 2018

Ratings List

Ratings Affirmed

Bank of Åland PLC

Issuer Credit Rating	BBB/Positive/A-2
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Senior Unsecured	BBB
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