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Research Update:

Finland-Based Bank of Aland PLC Rated 'BBB/A-3'; Outlook Stable

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Research Update:

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Overview

- We are assigning our 'BBB/A-3' long- and short-term counterparty credit ratings to Bank of Åland PLC, a small, concentrated bank with a retail franchise in Finland's Åland Islands, niche segments such as private banking on the Finnish mainland, and recently acquired operations in Sweden.
- The ratings reflect the bank's weak business position, strong capital and earnings, moderate risk position, above-average funding, and adequate liquidity.
- We consider the bank to have low systemic importance in Finland and consequently do not factor any extraordinary support into the ratings.
- The outlook is stable, reflecting our view that the bank's capital base is stable and that its risk-adjusted capital ratio will remain at about 11% over the next 18-24 months.

Rating Action

On Aug. 10, 2012, Standard & Poor's Ratings Services assigned its 'BBB/A-3' long- and short-term counterparty credit ratings to Finland-based Bank of Åland PLC (Ålandsbanken). The outlook is stable.

Rationale

The ratings reflect the bank's "weak" business position, "strong" capital and earnings, "moderate" risk position, "above average" funding, and "adequate" liquidity, as our criteria define these terms. We see Ålandsbanken as having "low" systemic importance and factor no potential extraordinary government support into the ratings.

Ålandsbanken's stand-alone credit profile (SACP) is 'bbb', largely reflecting the 'a-' anchor we assign to banks operating in both Finland and Sweden. Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) methodology and economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating.

Our economic risk assessment reflects our view of Finland as a competitive and resilient economy, though dependent on exports by cyclical industries such as forestry, metals, and manufacturing. Moderate private debt levels and credit growth coupled with contained asset prices contribute to healthy leverage.

In terms of industry risk, the very concentrated Finnish banking industry, largely controlled by diverse Nordic banking groups, is underpinned by robust profitability metrics and strong regulatory oversight. Our "intermediate" risk assessment of Finland's funding market reflects a high share of deposits but also a net external banking debtor position, which is explained by the country's eurozone membership and lack of a deep domestic debt market.

We consider Ålandsbanken's business position to be "weak," reflecting its significantly concentrated franchise, which overrides some other positive aspects of its business profile. Ålandsbanken, with total assets of €3.6 billion as of June 30, 2012, is a conservative retail and private bank with market shares of 55%-60% in its wealthy home region, Finland's Åland Islands. In addition, it has niche operations elsewhere in Finland and newly acquired operations in Sweden. Although we recognize its efforts to diversify its franchise with the recent acquisition in Sweden, we need more evidence that the acquisition is successful before fully incorporating the broader revenue base into our assessment of the bank's franchise which we currently consider to be narrow. Positively, we believe Ålandsbanken benefits from a loyal customer base and relatively stable earnings dominated by interest and fee income although the latter is to a meaningful extent related to asset management and capital market activity. In our view, a prudent and long-term strategy underpinned by a strong local shareholder collective supports the bank's strengths.

We assess Ålandsbanken's capital and earnings as "strong" on the basis of its risk-adjusted capital (RAC) ratio, which we project will remain at about 11% over the next 18-24 months, underpinned by a strong capital base composed entirely of common equity. In view of the bank's objective of achieving a core Tier 1 level in line with its larger Nordic peers at about 11%-12% (9.6% on June 30, 2012), it conducted a rights issue on Oct. 30, 2011 that was oversubscribed and raised €30 million.

Currently low activity in the stock market and preference for fixed income investments as well as low interest rates are putting pressure on the bank's fee and interest income and we expect the trend to continue in the second half of 2012 and 2013. Although we expect significantly lower costs in 2012 compared with 2011, when the bank launched the restructuring of its Swedish operations and incurred redundancy expenses by laying off 50 full-time employees, we expect recurrent earnings to be close to break even. We expect our earnings buffer metric, which measures the capacity of a bank to cover our estimation of its normalized losses (expected losses), to be slightly negative given the bank's relatively low earnings.

We view Ålandsbanken's risk position as "moderate." The bank faces concentration risk as a result of its limited geographic exposure, limited number of client segments, and some large single exposures, which we believe are not fully reflected in our capital assessment. These factors are offset to some extent by the bank's focus on wealthy individuals and their related corporations, prudent underwriting, and strategy of engaging mainly in collateralized lending. We believe the bank's planned expansion in the Swedish

market and some reductions in special segments of its corporate portfolio will be positive from a diversification perspective and do not expect any meaningful exposure to build up in high-risk segments. We note that the bank's strong loan-loss track record outperforms the Finnish market average thanks to its focus on high net-worth retail clients with average loan losses of about 10 basis points annually. We expect this level to increase slightly in the next two years.

Ålandsbanken's funding is "above average" in our opinion, reflecting a strong deposit base without any significant concentration that covers 80% of the bank's funding needs. Wholesale funding is almost exclusively domestic and a meaningful share of the investor base is made up of bank clients. This compares favorably with other domestic banks, which are more reliant on wholesale funding and external investors. The bank has addressed significant maturities in 2012 through bond issuance and by participating in the European Central Bank's extraordinary long-term refinancing operations while waiting to launch a covered bond program in the second half of 2012 that is intended to replace most of its wholesale funding needs.

We assess the bank's liquidity as "adequate." On June 30, 2012, Ålandsbanken had a liquidity portfolio of about €435 million consisting of cash and securities which all are eligible for repurchase agreement transactions at the Finnish central bank. The bank runs various stress test scenarios and in a severe liquidity crisis involving closure of all access to short- and long-term capital market funding and a significant deposit outflow, it could survive for six months.

We consider Ålandsbanken to have "low" systemic importance and consequently do not factor any extraordinary government support into the ratings.

Outlook

The stable outlook reflects our expectations that Ålandsbanken will report stronger earnings in 2012 and 2013 and maintain its current RAC ratio of about 11%. We also expect the bank to continue its prudent underwriting, which underpins credit quality, and its conservative approach to funding its business mainly through customer deposits.

We could take a negative rating action if the bank's operations were to deteriorate substantially resulting in loan losses that drove the RAC ratio below 10% or led us to reassess the bank's risk position and the concentration risks in its lending book.

We could consider a positive rating action if we conclude that the integration of the Swedish operations is proving successful and meaningfully broadens the bank's franchise and diversity by reducing concentrations in its business position. Although currently unlikely, we could raise the ratings if the bank's capital position strengthens significantly, such that the RAC ratio rises above 15% on a sustainable basis.

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