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Research Update:

Finland-Based Bank Of Åland Outlook Revised To Positive On Potentially Stronger Capitalization And Profitability

Primary Credit Analyst:

Salla von Steinaecker, Frankfurt (49) 69-33-999-164; salla.vonsteinaecker@spglobal.com

Secondary Contact:

Cihan Duran, Frankfurt (49) 69-33-999-242; cihan.duran@spglobal.com

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Overview

- Bank of Åland is gradually strengthening its capitalization on the back of earnings retention, which might be complemented by further hybrid capital issuances.
- We anticipate that the bank's profitability will improve, supported by cost management and some growth in its loan book in its home regions, Finland and Sweden.
- We are revising the outlook on Bank of Åland to positive from stable and affirming our 'BBB/A-2' long- and short-term issuer credit ratings.
- The positive outlook reflects that the bank's risk-adjusted capital ratio could sustainably exceed 15% over the next 24 months.

Rating Action

On July 25, 2018, S&P Global Ratings revised its outlook on Finland-based Bank of Åland PLC to positive from stable. At the same time, we affirmed our 'BBB/A-2' long- and short-term issuer credit ratings.

Rationale

The outlook revision to positive reflects our view that Bank of Åland's capital and earnings profile could improve in the next 24 months if the bank's risk-adjusted capital (RAC) ratio increases to over 15%. An upgrade will hinge on Bank of Åland's efforts to keep a solid profit base through cost containment while upholding sound risk management.

Bank of Åland's capital basis remains strong, with a RAC ratio of 13.6% as of Dec. 31, 2017. We forecast a RAC ratio of 14.8%-15.2% by year-end 2019 on the back of internal capital buildup and recent hybrid capital issuances that, in our view, will offset an increase in risk-weighted assets from its lending operations in Finland and Sweden. However, a large share of revenues comes from a relatively narrow business line--private banking--and our forecast assumes that costs will remain stable despite further business growth. These elements limit the predictability of earnings retention. 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 12.8% as of June, 30, 2018, up from

10.9% at year-end 2014.

We view the bank's capital quality as weaker than peers because its total adjusted 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 have no hybrid instruments in their capital base. Our RAC projection includes a recently issued 200 million Swedish krona (SEK) (€20 million) tier 2 instrument to Swedish institutional investors, but does not include further issuances, which might lift RAC higher. We would view any further hybrid capital issuances at the expense of organic capital growth through earnings retention negatively.

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 78% in 2017, as the consolidation of IT company CrossKey has weighed on the bank's cost-efficiency metrics. Bank of Åland's cost of risk continued to be one of the lowest in Finland at 0.06% in 2017. 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.

Bank of Åland has managed to grow its asset base significantly in the past few years due to supportive economic environments in Finland and Sweden, and a targeted growth strategy in selected business segments. It has continued to expand its retail private and premium banking franchise in Finland's Åland Islands and certain areas in mainland Finland and Sweden. Our current rating level considers the bank's concentrated retail private banking franchise, which makes it vulnerable to cyclical swings in the countries of operation. In addition, similar to other banks in the Nordic countries, Bank of Åland is investing in its digital infrastructure to improve the customer experience and to strengthen the cost efficiency of its activities. We view Bank of Åland's efforts to broaden its customer base by initiating partnerships with fintech companies positively.

Outlook

The positive outlook on Bank of Åland reflects our view that the bank will continue to build up its capital base, improve 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. Preconditions for an upgrade would hinge 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 lending standards to grow 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.

Ratings Score Snapshot

Issuer Credit Rating

	To	From
	BBB/Positive/A-2	BBB/Stable/A-2
SACP	bbb	bbb
Anchor	a-	a-
Business Position	Weak (-2)	Weak (-2)
Capital and Earnings	Strong (+1)	Strong (+1)
Risk Position	Moderate (-1)	Moderate (-1)
Funding and Liquidity	Average and Adequate(0)	Average and Adequate (0)
Support	(0)	(0)
ALAC Support	(0)	(0)
GRE Support	(0)	(0)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)
Additional Factors	(0)	(0)

Related Criteria

- Criteria - Financial Institutions - General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And

Assumptions, Nov. 9, 2011

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment: Finland, Feb. 2, 2018
- Nordic Banks' Capitalization Should Remain Stable Despite Revised Basel III Standards, Jan. 24, 2018
- Banking Industry Country Risk Assessment: Sweden, Nov. 24, 2017

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Bank of Åland PLC		
Issuer Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2

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