

Research Update:

# Bank of Aland Affirmed At 'BBB/A-2' On Correction Of Criteria Misapplication; Outlook Remains Positive

July 15, 2021

## Overview

- We are correcting a previous misapplication of our hybrid criteria published July 1, 2019, which occurred when we included a Swedish krona (SEK) 19.5 million Tier 2 capital instrument issued by Bank of Aland in 2018 in our total-adjusted capital (TAC) measure.
- For going-concern contingent capital instruments classified as tier 2 regulatory capital to qualify for intermediate equity content, and therefore for inclusion in TAC, among other key features, the instrument's documentation must stipulate that the instruments may only be replaced by an equivalent or stronger instrument before redemption.
- Bank of Aland has recently publicly clarified its replacement intent for this tier 2 instrument, and as a result we can continue to include it in our capital measure.
- The previous misapplication had no impact on our ratings on Bank of Aland, and we have affirmed them at 'BBB/A-2'.
- The positive outlook indicates the potential for an upgrade because of the bank's continued capital buildup.

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## Rating Action

On July 15, 2021, S&P Global Ratings affirmed its 'BBB' long-term issuer credit rating on Bank of Aland. The outlook remains positive.

At the same time, we affirmed our 'A-2' short-term issuer credit rating on the bank.

## Rationale

**Bank of Aland's 2018 tier 2 instrument had comparably weaker language relative to previous instruments.** Over 2015-2018, Bank of Aland issued several Tier 2 instruments, some of which were primarily issued to retail customers as an investment product. The hybrid issuance documentation for the instruments listed below contains language stipulating that the

instruments may only be replaced by issuing new common equity instruments, or equivalent or stronger instruments (with high or intermediate equity content), and that such a replacement would take place before the redemption of the instruments:

- €8.6 million nominal, issued in 2015, with a June 2020 call date.
- €6.2 million nominal amount, issued in 2016, with an August 2021 call date.
- €2.3 million nominal amount, issued in 2017, with an August 2022 call date.

However, in May 2018 an additional €19.5 million tier 2 instrument was issued (with a May 2023 call date), which included replacement language that was based on regulatory oversight of the bank; this language introduced an alternative that increases ambiguity on timely replacement and, as a result, should not have been given intermediate equity content.

**Our assessment of Bank of Aland's risk adjusted capitalization is unchanged.** Excluding the 2018, tier 2 instrument from Bank of Aland's TAC would have lowered the RAC ratio by approximately 100 basis points (bps) to 113 bps over 2018-2020. However, since the bank has maintained a pro forma RAC of 12.7%-13.1% over that period, we would have maintained our strong capital and earnings assessment and with it our issuer credit rating, meaning that the rating would not have been different as a result of the exclusion. We also review published statements that influence issuer behavior, in addition to legal terms and conditions for such issuance, as well as Bank of Aland's recently published clarification of its intent to replace the 2018 instrument. Consequently, we can conclude that the instrument now fully meets our requirements to be included in TAC.

**Once launched, the Borgo mortgage platform project should provide clarity on the bank's capital management and future capital levels.** On Sept. 20, 2019, Bank of Aland announced that together with four partners (ICA Bank, IKANO Bank, Söderberg & Partners, and newly formed Borgo) it intends to establish a new Swedish mortgage company; Sparbanken Syd has since stated it intends to be a fifth partner. This online mortgage distribution platform, which is in the process of being formed, is where mortgage loans and cover pools from the various partners are anticipated to be transferred over the medium term.

**Bank of Aland's RAC ratio may exceed our 15% threshold for a very strong capital and earnings assessment once the Swedish mortgage loan book is carved out.** Bank of Aland has delivered solid results over the past several years and, in addition to issuing capital instruments, has succeeded in building its capital base through earnings retention. As a result of ongoing transformation of the bank's loan book, we expect there could be some volatility in Bank of Aland's capitalization, with the RAC ratio not rising meaningfully above 15%. Once the Borgo platform is finalized and we have full data transparency, we will analyze whether the RAC ratio can sustainably exceed 15%.

## Outlook

The positive outlook reflects our view that Bank of Aland could build an ample capital base in the coming two years on the back of sustained robust earnings and limited credit losses, while diversifying its revenue base further through the mortgage lending joint venture.

## Upside scenario

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

## Downside scenario

We could revise the outlook to stable over the next 24 months if Bank of Aland's profitability and the pace or quality of its capital buildup remain weaker than our expectations. 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.

## 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 and	Average and (0)
Liquidity	Adequate
Support	0
ALAC support	0
GRE support	0
Group support	0
Sovereign support	0
Additional factors	0

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015

- 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: Principles Of Credit Ratings, Feb. 16, 2011

## Related Research

- Banking Industry Country Risk Assessment Update: June 2021, June 29, 2021
- FAQ Published About Banks' Tier 2 Contingent Capital Instruments, June 28, 2021
- Banking Industry Country Risk Assessment: Finland, Feb. 9, 2021
- Outlooks On Seven Finnish Banks Revised Due To Their Resilience In The COVID-19-Induced Downturn, Jan. 22, 2021
- Bank of Aland PLC, Dec. 15, 2020

## Ratings List

### Ratings Affirmed

#### Bank of Aland PLC

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