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CREDIT OPINION
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Update

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Contacts

Alexios Philippides +357.2569.3031
VP-Senior Analyst
alexios.philippides@moodys.com

Malika Takhtayeva +44.20.7772.8662
Associate Analyst
malika.takhtayeva@moodys.com

Simon James Robin Ainsworth +44 207 772 5347
Associate Managing Director
simon.ainsworth@moodys.com

Sean Marion +44.20.7772.1056
MD-Financial Institutions
sean.marion@moodys.com

Eika Boligkreditt AS

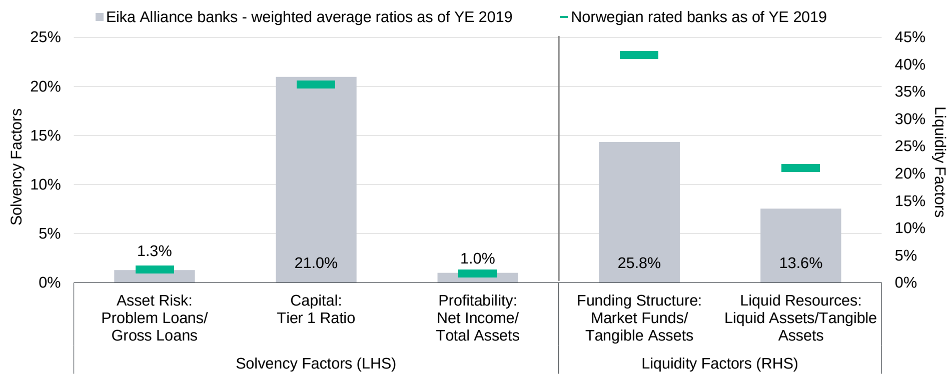
Update to credit analysis

Summary

Eika Boligkreditt AS's Baa1 long-term issuer rating, its A3 Counterparty Risk Rating (CRR) and its A3(cr) Counterparty Risk (CR) Assessment reflect the respective weighted-average credit profiles of the 64 local banks that form the Eika alliance and that are shareholders and users of Eika Boligkreditt,[1] as well as, our assessment of the likelihood that these banks will support Eika Boligkreditt, in case of need, taking into account the balance of their formal obligations and other incentives to do so under the Eika structure.

Our view of the Eika alliance banks' credit profiles reflects (1) their solid capitalisation and relatively strong historical asset quality and low-risk retail lending focus, which is also reflected in the high quality assets the banks transfer to Eika Boligkreditt, but also taking into account their high indirect exposure to Norway's real estate sector, which drive their predominantly investment-grade creditworthiness; (2) that there is no legally-binding commitment among alliance banks to support each other; and (3) our Advanced Loss Given Failure (LGF) analysis on the banks' liability structure that leads to rating uplift for their issuer ratings, CRRs and CR Assessments. LGF considers the risks faced by the different debt and deposit classes across the liability structure should any of the banks enter resolution. We expect that the economic fallout from the coronavirus-induced disruption will lead to modest loan quality deterioration in the coming quarters and the Eika banks' profitability to come under some pressure, also because of low interest rates.

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Investors Service

Credit strengths

» Eika alliance bank's standalone creditworthiness, which is supported by solid capital and historically strong asset quality

» Norway's operating environment, where Eika and its alliance banks operate, remains supportive despite the economic challenges expected in 2020

» The member banks' commitment to safeguard Eika Boligkreditt's access to sufficient liquidity and capital

Credit challenges

» High concentration of the individual banks and Eika Boligkreditt in the Norwegian real estate market

» Coronavirus outbreak will drive modest asset quality deterioration and profitability will be dampened

» Lack of an explicit guarantee by the owner banks towards Eika Boligkreditt's obligations

Rating outlook

The stable outlook assigned to Eika Boligkreditt’s issuer rating reflects our expectation that the alliance banks’ average financial profiles, and their capacity and willingness to support Eika Boligkreditt will remain broadly stable, amid a modest deterioration in the banks' asset quality and profitability over the next 12-18 months that will not however materially impact their capital levels.

Factors that could lead to an upgrade

» Positive pressure could develop on Eika Boligkredit’s ratings following improvements in the risk profile of a significant proportion of the owner banks, as evidenced by improving asset quality metrics and reduced concentration to commercial real estate.

» An unconditional, irrevocable and enforceable guarantee of Eika Boligkredit’s obligations by the owner banks would also result in a rating upgrade.

Factors that could lead to a downgrade

» The ratings could be downgraded if the credit profile of a significant portion of the alliance banks weakens significantly, as evidenced by worsening financial fundamentals including a sustained deterioration in profitability, asset quality and capital.

» Eika Boligkreditt’s ratings would also be downgraded in case of reduced likelihood of the owner banks supporting it, for example by a loosening in the support agreements that are currently in place between Eika Boligkreditt and the banks.

Key indicators

Exhibit 2
Eika Boligkreditt AS (Consolidated Financials) [1]

	12-19[2]	12-18[2]	12-17[2]	CAGR/Avg.[3]
Total Assets (NOK Billion)	105.8	108.0	99.6	3.1[4]
Total Assets (USD Million)	12,044.0	12,468.8	12,177.4	(0.5)[4]
Tangible Common Equity (NOK Billion)	5.2	4.6	4.2	11.2[4]
Tangible Common Equity (USD Million)	590.4	527.7	513.4	7.2[4]
Tangible Common Equity / Risk Weighted Assets (%)	15.2	13.5	13.3	14.0[5]
Net Interest Margin (%)	0.6	0.6	--	0.6[5]
PPI / Average RWA (%)	0.2	0.5	--	0.3[5]
Net Income / Tangible Assets (%)	0.1	0.1	0.1	0.1[5]
Cost / Income Ratio (%)	56.7	29.4	25.2	37.1[5]
Market Funds / Tangible Banking Assets (%)	50.0	50.3	50.5	50.3[5]
Liquid Banking Assets / Tangible Banking Assets (%)	13.5	16.3	14.5	14.8[5]

[1]All figures and ratios are adjusted using Moody's standard adjustments. [2]Basel II; IFRS. [3]May include rounding differences because of the scale of reported amounts. [4]Compound annual growth rate (%) based on the periods for the latest accounting regime. [5]Simple average of Basel II periods. [6]Simple average of periods for the latest accounting regime.
Sources: Moody's Investors Service and company filings

Profile

The Eika alliance was made up of a group of 65 Norwegian local savings banks as of June 2020 together with Eika Boligkreditt, Eika Gruppen and Eika Banksamarbeidet. The alliance is the third-largest banking group in Norway with a 10.6% combined market share in retail lending and a 7.5% share in total banking system assets as of the end of 2019 (including assets transferred to Eika Boligkreditt), and had total assets equivalent to €40 billion and 211 local branch offices.

Eika Boligkreditt's primary business purpose is to provide access to the international debt markets to its owner savings banks.

Although individual members operate independently from each other, we note that the Eika alliance provides a number of additional support services, predominantly through Eika Gruppen, such as a shared information technology infrastructure, marketing and credit risk monitoring, which act as incentives for member banks to remain members of the Eika alliance. Eika Banksamarbeidet procures products and services on behalf of the alliance members (excluding ten banks that have given notice of termination to Eika Gruppen).

Recent developments

We expect advanced economies collectively to contract in 2020. We expect a gradual recovery beginning in the second half of the year, but that outcome will depend on whether governments can reopen their economies while also safeguarding public health. A rebound in demand will determine the ability of businesses and labour markets to recover from the shock. Even with a gradual recovery, we expect 2021 real GDP in most advanced economies to be below pre-coronavirus levels.

Since 13 March 2020, Norway's central bank, the Ministry of Finance and the Norwegian FSA have taken a number of actions to alleviate the impact on the economy from both the coronavirus-related lockdown and the plunge in oil prices. These measures include reducing the key policy rate by 150 bps points to 0%, reducing banks' countercyclical capital buffer requirement to 1%, providing special F-loans to banks to help manage any funding and liquidity stress, and the extension of unemployment benefits and various social policy schemes to support individuals. These measures will help alleviate the negative impact stemming from the coronavirus outbreak and will largely sustain borrowers' solvency.

Nonetheless, the inevitable negative impact on both the economy and the banks in the next 12-18 months triggered a change of our Banking System Outlook for Norway to negative from stable on 16 April 2020. The outlook change was also driven by our expectation that sectors such as tourism, hospitality and transportation are more vulnerable to the pandemic, and by the fact that very low oil prices have historically strained Norway's oil/offshore industry, which remains a significant pillar of the economy.

Detailed credit considerations

Source of facts and figures cited in this report

Unless noted otherwise, system ratios refer to the weighted average of Norwegian rated banks. The data presented in exhibit 1 and discussed in the text refer to the weighted average ratios for Eika alliance banks. Exhibit 2 presents the data for Eika Boligkreditt itself.

The predominantly investment-grade credit profiles of the banks that own Eika Boligkreditt form the starting point for the company's ratings

The credit profiles of the banks that collectively form the alliance and own Eika Boligkreditt are underpinned by three key components: (1) the individual member banks' standalone creditworthiness, as established by their respective geographic areas of operations, financial characteristics and any relevant qualitative factors; (2) their capacity and willingness to help each other in case of failure of one or more members; and (3) the application of our Advanced LGF analysis on the individual members' liability structures in order to assess the extent to which junior debt classes could cushion the impact of any regulatory "bail-in" of the banks' creditors.

Eika alliance banks' standalone creditworthiness is supported by solid capital and historically strong asset quality, although, exposure to Norway's real estate sector is high; coronavirus outbreak will drive modest asset quality deterioration and profitability will be dampened

To establish a view on the credit risk profile of the alliance we analyse the individual member banks. The majority of the alliance banks maintain relatively strong financial fundamentals, with limited variations in overall credit quality amongst individual members. The banks also continue to benefit from operating in Norway's Very Strong- environment. Although Norway's operating environment is deteriorating as a result of the global coronavirus outbreak and the recent plunge in oil prices, we believe that the banking system still benefits from the government's generally strong fiscal flexibility and countercyclical buffers available through its sovereign oil fund to respond to economic shocks.

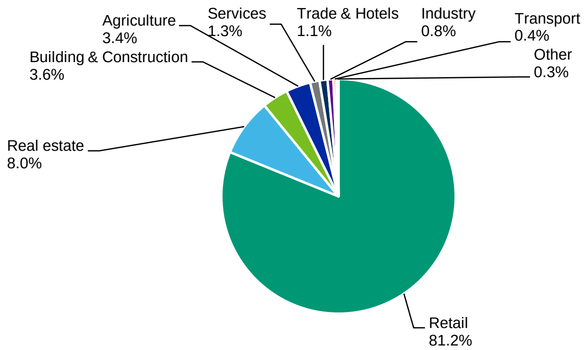
Historical asset quality for Eika alliance banks has been strong, driven by a high proportion of retail mortgage lending. However, the banks are exposed to Norway's property sector considering their mortgage lending activities and direct lending to real estate and construction. We expect the banks' asset quality to deteriorate modestly over the coming quarters as a result of the economic downturn and the higher level of unemployment. The full extend of the asset quality deterioration will, however, depend on the length and extend of the economic fallout.

The banks' weighted average ratio of problem loans (impaired loans and loans overdue by more than 90 days) to gross loans on the banks' own books was 1.3% as of the end of 2019, up from 1.0% at end-2018, in line with the average for other rated Norwegian banks. The member banks' strong recent asset performance reflects their retail banking focus. Loans to households, predominantly residential mortgages, made up on average 81% of the banks' total loan books as of year-end 2019 (including the loans transferred to Eika Boligkreditt, see Exhibit 3). In addition, the banks' have little to no exposure to shipping and the oil sector, and moderate levels of large exposures to single borrowers, which have been declining.

Exhibit 3

Retail lending forms the bulk of the Eika banks' operations; however, there is also concentration towards the real estate and construction sectors

Loan book breakdown by sector (including the loans transferred to Eika Boligkreditt) as of the end of 2019



Source: Eika Boligkreditt

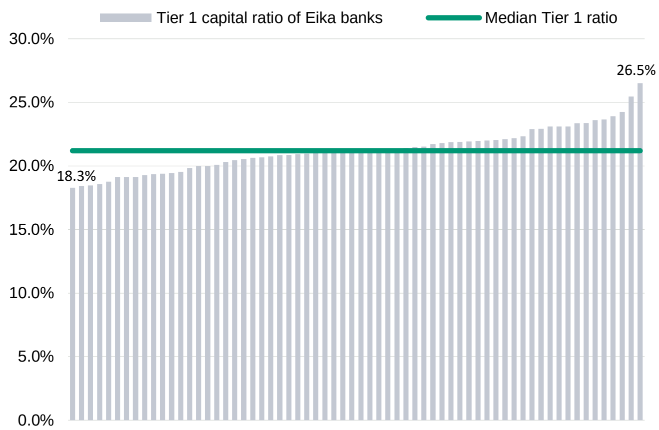
The average loan-to-value (LTV) of the bank's mortgage portfolio was a conservative 53% as of the end of 2019. In November 2019, Eika Boligkreditt made it possible for banks to originate mortgages with a maximum LTV of 75%, up from 60%, and in line with domestic peers. However, we do not expect this change to materially shift the structure of banks' mortgage books because they use Eika Boligkreditt for roughly 30% of their mortgages, whereas the bulk is funded on their own accounts. Following the coronavirus outbreak and the lockdown restrictions in Norway, the unemployment rate in the country increased. The Norwegian government has launched generous support packages to mitigate the effects of the outbreak on households. Therefore, we expect the repayment capacity of households to be somewhat sustained.

Our assessment of the Eika banks' asset risk also considers the concentration to Norway's general real estate sector both through the banks' mortgage lending activities but also through direct lending to the real estate, building and construction sectors that made up a further 11.6% of their loan books as of year-end 2019 (including transferred loans).

Capital levels for the Eika alliance banks are robust, and were on average higher compared to their rated Norwegian peers. Capitalisation will be supported by lower credit growth this year along with profit retention in light of the economic downturn and despite the impact on risk-weighted assets (RWAs) from potentially higher problem loans. The median Tier 1 capital ratio of the Eika alliance banks stood at 21.2% at the end of 2019 (see Exhibit 4), compared to 20.4% for other Norwegian rated banks. The lowest reported Tier 1 capital ratio by an alliance bank was 18.3%, and the highest 26.5% at the end of 2019, against a minimum regulatory requirement of 12.5% that applied as of March 2020, which included the pillar I requirement, the 2.5% capital conservation buffer, a 3.0% systemic risk buffer and a 1.0% countercyclical buffer following its partial release from 2.5% on 13 March 2020 due to the coronavirus pandemic. The systemic risk buffer may increase to 4.5% by end-2022. A number of Eika banks have also received individual pillar 2 capital requirements by the Norwegian FSA.

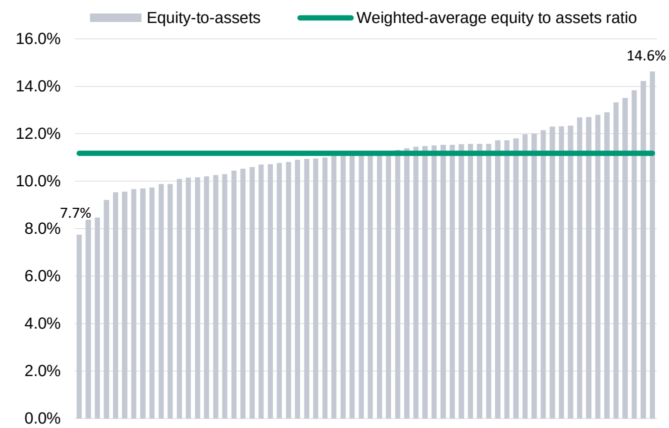
Furthermore, equity-to-total assets is particularly strong at a weighted-average of 11.2% as of the end of 2019 (see Exhibit 5), and compares well to regional peers, because all Eika banks apply the standardised approach in calculating RWAs. Therefore, the banks' capital metrics are less sensitive to rises in credit risk compared to banks using more risk-sensitive models and to potential amendments in regulatory methods to calculating RWAs, including floor requirements. Nevertheless, we also consider that some banks have relatively limited access to capital because the majority of the member banks are not publically listed, although many have issued equity certificates, and rely on earnings retention to shore up their buffers and finance growth.

Exhibit 4
Eika banks are well capitalised...
Tier 1 capital ratio as of the end of 2019



Source: Eika Boligkreditt AS, Moody's Investors Service

Exhibit 5
... supported by strong leverage
Equity-to-assets ratio as of the end of 2019



Source: Eika Boligkreditt AS, Moody's Investors Service

Profitability of the Eika alliance banks was generally in line with domestic peers, as reflected in their weighted-average net profit to total assets ratio of 1.0% in 2019, similar to an average of 0.9% for the rated Norwegian banks. For 2020, we expect the banks' profitability to be dampened by higher loan provisioning expenses and lower business activity as a result of the coronavirus crisis along with margin pressure as interest rates in Norway are likely to remain low coupled with already strong competition among Norwegian banks. Norway's central bank cut its policy rate to a historic low 0% in May 2020.

Member banks benefit from operational efficiencies, such as common IT systems and platforms that Eika Gruppen develops, as well as, risk policies and procedures, which the banks can then customise. We also expect the alliance banks to continue to focus on cost control. Nevertheless, the smallest Eika banks have an inflexible cost base and lack the benefits afforded by higher economies of scale. In general, the weighted average cost-to-income ratio of Eika banks was 48.9% in 2019, which is higher than the 43.2% for the Norwegian banking sector[2] as of Q3 2019.

The alliance banks maintain stable liquidity buffers and their reliance on potentially volatile wholesale funding is lower than peers. The alliance banks' weighted average market funds ratio was 19.6% of total assets (25.8% when we include covered bonds issued through Eika Boligkreditt) as of the end of 2019, below the 41.7% market funds to tangible banking assets of Norwegian rated banks for the same period.

Our assessment of the banks' credit strength does not incorporate any mutual support uplift among member banks

There are strong incentives for the banks to support each other in case of stress and there are past examples of such mutual assistance. However, our assessment of the banks' credit profiles does not result in any rating uplift for the purpose of establishing the collective strength of the banks behind the Eika alliance.

The banks do not have a legally binding commitment to support each other in case of need. Further, there is limited benefit that could be incorporated in the banks' ratings given the small variations in standalone credit quality among banks. Instead, the banks are more likely to allocate their resources in support of Eika Boligkreditt itself, and this support is already incorporated in the final ratings.

The application of our Advanced LGF analysis lifts the banks' credit profiles

In line with our methodology, our assessment of the member banks' credit risk profile incorporates an analysis of individual banks' liability waterfall in line with our Advanced LGF analysis. As part of this analysis and given the banks' small size and more retail and small-and-medium business focus, we assume that 10% of the banks' deposit base is made up of so-called "junior" deposits (i.e., more loss absorbing) rather than our standard assumption of 26%.

Our LGF analysis results, on average, in a two notch uplift to the banks' respective issuer rating levels and a three notch uplift to their respective CR Assessments and CRRs.

Government support

We do not incorporate any government support uplift in the banks credit profiles because of the implementation of a resolution legislation in Norway and the banks' small individual national market shares.

ESG considerations

In line with our general view for the banking sector, Eika Boligkreditt and Eika alliance banks have a low exposure to Environmental risks. See our Environmental risks heat map for further information.

We believe banks face moderate Social risks. The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy which is partly mitigated by sizeable technology investments. Fines and reputational damage due to product misselling or other types of misconduct is a further social risk. Societal trends are also relevant in a number of areas, such as shifting customer preferences towards digital banking services, increasing information technology cost, aging population concerns in several countries, impacting demand for financial services or socially driven policy agendas that may translate into regulation that affects banks' revenue base. These trends are particularly important for Eika banks because they predominantly engage in retail banking activities and play an important role in their local communities. In addition, we regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. See our Social risks heat map for further information.

Governance is highly relevant both for Eika Boligkreditt itself and for its owner banks, similarly to all players in the banking industry. Corporate governance weaknesses can lead to a deterioration in a company's credit quality, while governance strengths can benefit its credit profile. Although Eika banks are typically small and have limited resources and expertise individually to deal with developments in this area, they benefit from systems and training provided by the alliance, such as in the area of anti-money laundering. As such, we currently do not have specific concerns around the banks' own governance. Nonetheless, corporate governance remains a key credit consideration and requires ongoing monitoring.

Support and structural considerations

Affiliate support

The Baa1 issuer rating, A3(cr) CR Assessment and A3 CRR assigned to Eika Boligkreditt incorporate our view of the likelihood that the owner banks will support Eika Boligkreditt.

While there is no explicit commitment from the banks to directly support Eika Boligkreditt's obligations vis-à-vis its bondholders, there are publicly-available and legally enforceable agreements in place between the banks and Eika Boligkreditt to safeguard Eika Boligkreditt's own access to adequate liquidity and capital.

Specifically, on a proportionate basis, banks would need to subscribe to any new covered bond issues in case there is a disruption in the covered bond market, and to new capital issuances to maintain Eika Boligkreditt's metrics above its regulatory requirements. Moreover, in case one or more of Eika Boligkreditt's owners are not able to provide their share of liquidity or capital, the remaining banks may be required by Eika Boligkredit to increase their contribution up to a maximum of twice their initial allocation.

Additionally, our view also reflects additional factors, such as the absence of any provision to avoid payment under the agreement, Eika Boligkreditt's strategic fit and strong operational integration with the alliance banks, as well as the reputational and operational risks associated to the sharing of a common brand and a common technology platform.

Counterparty Risk (CR) Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if an entity fails and are distinct from debt ratings in that they (1) consider only the risk of default rather than the likelihood of default and the expected financial loss suffered in the event of default; and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to an entity's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

Eika Boligkreditt's A3(cr) CR Assessment is an input in the rating of the entity's covered bond instruments.

Counterparty Risk Ratings

Counterparty Risk Ratings (CRR) are opinions of the ability of entities to honour the uncollateralized portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralized portion of payables arising from derivatives transactions and the uncollateralized portion of liabilities under sale and repurchase agreements.

Eika Boligkreditt's A3 CRR reflects our view that in a resolution, CRR liabilities might benefit from preferential treatment compared with senior unsecured debt.

Ratings

Exhibit 6

Category	Moody's Rating
EIKA BOLIGKREDITT AS	
Outlook	Stable
Counterparty Risk Rating	A3/P-2
Counterparty Risk Assessment	A3(cr)/P-2(cr)
Issuer Rating -Dom Curr	Baa1

Source: Moody's Investors Service

Endnotes

1 This excludes OBOS-banken AS, whereby the distribution agreement expired in February 2017, in line with the notice of termination given by Eika Boligkreditt a year earlier. OBOS-banken's financing from the company is decreasing in accordance with an agreed plan.

2 Source: The Financial Supervisory Authority of Norway.

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