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Aktia Bank PLC

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Aktia Bank PLC

SACP	bbb+

Anchor	a-	
Business Position	Moderate	-1
Capital and Earnings	Strong	+1
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Adequate	

+

Support	0

GRE Support	0
Group Support	0
Sovereign Support	+1

+

Additional Factors	0

Issuer Credit Rating
A-/Negative/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Well-established local retail franchise as the fourth largest retail bank in Finland. • Strong projected capitalization underpinned by sound earnings capacity. • Focus on low-risk collateralized lending to retail clients and small and midsize enterprises.	• Concentration risk due to focus on residential mortgage lending in Finland. • Limited geographical, business, and earnings diversification. • Reliance on wholesale funding market as covered bond issuer.

Outlook: Negative

The negative outlook on Aktia Bank reflects our view that the growing economic risks in Finland's export-oriented economy could adversely affect the Finnish banking sector's performance in the next two years. This could lead us to lower our baseline assessment (the anchor) on Finnish banks, including Aktia Bank, to 'bbb+' from 'a-'.

We could take a negative action if Aktia Bank's funding position deteriorates; it is currently 46% derived from comparably stable customer deposits. Furthermore, we could revise our assessment of Aktia Bank's capital and earnings position if its operations deteriorate substantially due to a downturn in the Finnish economy, in turn resulting in higher loan losses and lower earnings than in our current base-case scenario. This could reduce Aktia Bank's future build-up of capital and prevent it maintaining its strong ability to absorb losses as indicated by our risk-adjusted capital ratio (RAC) of 12.7% as of Dec. 31, 2013.

We believe that the European Authorities' intention to avoid future bail-outs (government support) by using bail-ins (burden sharing with investors, potentially including senior unsecured obligations) will gradually reduce the probability of extraordinary government support across Europe. We could lower our ratings on Aktia Bank if we see materially diminished prospects that the Finnish government would provide support to the bank's senior creditors in a crisis or if we reassess our opinion on Aktia Bank's systemic importance, with other factors unchanged.

We consider a positive rating action unlikely at this stage.

Rationale

Our ratings on Aktia Bank reflect its anchor of 'a-' for Finnish banks, its "moderate" business position as a regional bank with a concentrated business model focused on retail mortgage lending, and its "strong" capital and earnings mainly due to our expectation of an increase in the RAC ratio to about 14% in the next 12-18 months. The ratings equally reflect the bank's "moderate" risk position due to concentration risks on its loan book, partly mitigated by a high level of collateralization, its "average" funding and "adequate" liquidity, owing to a sound level of customer deposits and demonstrated access to capital markets as covered bond issuer. The stand-alone credit profile is 'bbb+'.

As the fourth-largest retail bank in Finland, where Pan-Nordic groups have sizable operations, and with a 4.1% market share of mortgage loans and 3.7% of customer deposits, we consider Aktia Bank to have "moderate" systemic importance in Finland's banking sector. We consequently factor one notch of extraordinary government support into our 'A-' long-term counterparty credit rating on Aktia Bank.

Anchor: 'a-' for banks operating only in Finland

Our bank criteria use our Banking Industry Country Risk Assessment's economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Finland is 'a-', based on an economic risk score of '2' and an industry risk score of '3'.

We view Finland as a competitive and resilient economy with high education levels. But it also depends on exports in cyclical industries, which subjects its economy to increasing pressure from Europe's worsening recession. Moreover, a lack of reforms to increase competiveness could hamper the economy. Low corporate and moderate household debt levels and a very strong payment culture contribute to leverage in the economy.

Diverse Nordic banking groups largely control Finland's concentrated banking industry, which in our view is underpinned by robust profitability metrics and stability. Deposits dominate funding, but the sector is a net external debtor, reflecting significant loan growth over the past decade and the country's lack of a deep domestic debt market.

Table 1

Aktia Bank Key Figures					
	--Year ending Dec. 31--				
(Mil. €)	**2013**	**2012**	**2011**	**2010**	**2009**
Adjusted assets	10,448	10,865	10,752	10,728	10,335
Customer loans (gross)	6,867	7,267	7,122	6,645	6,089
Adjusted common equity	512	494	467	444	394
Operating revenues	225	218	225	251	233
Noninterest expenses	157	154	167	159	154
Core earnings	52	43	37	58	34

Business position: Solid local retail franchise as the fourth largest bank in Finland

We consider Aktia Bank's business position to be "moderate," reflecting the bank's concentrated business model focused primarily on residential mortgage lending.

Aktia Bank is a midsize commercial bank in Finland with total assets of €10.9 billion as of December 2013. The bank has a well-established local retail franchise in growth regions in coastal areas and the larger cities with some 350,000 customers, and a stable market share of 4.1% in residential mortgage lending and 3.7% customer deposits.

However, we view Aktia Bank's regional concentration and narrow product focus on residential mortgage lending as the main weaknesses to the business model. These factors may expose the bank to potential volatility in the real estate market in Finland. The diversity benefits from the bank's small corporate banking activities are limited and we expect no material increase in the medium term.

We view positively that the bank's asset management and life insurance activities complement the product offering and their contribution to revenues will in our view increase over time (combined 20% of Aktia Bank's operating revenues and around 30% of the operating profit in 2013). The asset management activities are steadily growing and hold a 7% market share in mutual funds in Finland. Furthermore, Aktia Life Insurance provides the banking clients with insurance and investment products.

However, due to the Aktia Life's limited size and market share of around 3% in the Finnish life insurance market, the insurance operations bring only moderate diversification benefits to the group in our opinion. We don't expect the bank to expand its network to further regions in Finland but believe that it could gain market share by increasing cross-selling, namely insurance and savings products, to the existing customer base.

Aktia Bank announced in January 2013 that the cooperation with independent local savings banks and local co-operative banks will be phased out by the beginning of 2015. We anticipate that the discontinuation of the cooperation will allow Aktia to focus its resources on its own growth going forward and as such won't have a negative impact on our assessment of the bank's business position. As of March 2014, two local savings banks have decided to merge with Aktia Bank and we anticipate that further partner banks might opt for closer cooperation or mergers with

Aktia Bank. Yet, due to the limited size of these single banks, we don't expect this to substantially increase Aktia Bank's size or market share.

We consider Aktia Bank's management to be prudent and well aware of the limits set by the group's size and product offering. We believe that Aktia Bank will maintain a low risk appetite and conservative lending standards, which we expect to provide stability to its financial position.

Table 2

Aktia Bank Business Position

	--Year ending Dec. 31--				
	2013	**2012**	**2011**	**2010**	**2009**
Loan market share in country of domicile	4.1	4.3	4.2	4.3	4.2
Deposit market share in country of domicile	3.7	3.4	3.5	3.6	2.8
Total revenues from business line (currency in millions)	225.4	228.2	224.8	251.0	233.6
Commercial & retail banking/total revenues from business line	79.0	70.5	73.9	75.1	79.8
Insurance activities/total revenues from business line*	20.3	12.2	20.4	17.2	15.8
Asset management/total revenues from business line	N/A	11.6	9.6	8.4	6.7
Other revenues/total revenues from business line	0.6	5.7	(3.9)	(0.7)	(2.2)
Return on equity	8.9	9.3	7.7	12.5	9.5

*Includes asset management and life insurance business since 2013. N/A--Not applicable.

Capital and earnings: Strong capitalization underpinned by sound earnings capacity and asset reduction.

We assess Aktia Bank's capital and earnings as "strong." This is mainly due to our expectation that our RAC ratio for Aktia Bank will increase to about 14% over the next 12-18 months, compared with 12.7% on Dec. 31, 2013.

The main driver for the increase in the RAC ratio is the ongoing run off of Aktia Bank's subsidiary, Aktia Real Estate Mortgage Bank (AREMB) and the resulting reduction in risk-weighted assets. The loan book of AREMB--amounting to €2.9 billion, including €1.65 billion of mortgage loans through partner local savings and cooperative banks--is currently fully consolidated on Aktia Bank's balance sheet and we expect run off of AREMB's activities to reduce the share of partner banks' loans. Combined with only moderate growth in Aktia Bank's own loan origination due to a slow-down in demand for mortgage loans in Finland, we expect this to lead to a decrease of €1 billion in Aktia Bank's overall loan book in the next two years. Consequently, we forecast a lower level of Standard & Poor's risk-weighted assets.

While the margins on new loans are expected to remain relatively stable, the decreasing contribution from maturing hedging transactions will result in a lower overall net interest margin of around 1.0%-1.05% over the next two years (1.15% as of Dec. 31, 2013), which we incorporate in our forecast. Furthermore, we anticipate the improving net fee and commission income (+5% per year) and stable dividend payout ratio (50%-60%) to support the capital build-up. We expect Aktia Bank's organizational streamlining--achieved partly through reducing its staff and optimizing its branch network--to support its cost-efficiency measures targeting a 5% annual reduction in operating expenses.

We consider Aktia Bank's quality of capital, consisting mainly of paid-in capital, and its earnings, to be adequate. We believe that the bank's earnings capacity will improve over time owing to stable operating revenues, planned cost cuts, and our expectation of low loan losses. This is reflected in our three-year average earnings buffer of about 130 basis points (bps) for the group, which is in line with other Nordic regional banks.

Aktia Bank has applied for approval on the internal-rating based model for credit risk when calculating regulatory capital and expects to implement it in the course of 2014. Although this will not directly impact our capital ratios, we understand that the application would raise the tier 1 capital ratio from the current 12.3% as of Dec. 31, 2013, by about four percentage points to around 15%-16%. The positive effects of this will be counterbalanced by the changes in new capital regulations under EU Capital Requirements Directive (CRDIV) related to deductions for holdings in insurance companies and for minority holders' paid-in equity which will in turn negatively impact Aktia Bank's regulatory capital base starting from 2015. We understand, however, that Aktia Bank already fulfils the Basel III capital requirement.

Table 3

Aktia Bank Capital And Earnings

	--Year ending Dec. 31--				
(Mil. €)	**2013**	**2012**	**2011**	**2010**	**2009**
Tier 1 capital ratio	12.3	11.8	10.6	10.1	9.5
S&P RAC ratio before diversification	12.7	11.5	11.1	N.M.	N.M.
S&P RAC ratio after diversification	11.6	10.6	10.7	N.M.	N.M.
Adjusted common equity/total adjusted capital	100	100	100	100	100
Net interest income/operating revenues	50.0	53.7	57.3	59.5	65.2
Fee income/operating revenues	31.4	29.9	26.5	22.7	19.9
Market-sensitive income/operating revenues	3.7	1.3	(6.6)	(2.2)	0.4
Noninterest expenses/operating revenues	69.8	70.6	74.1	63.4	66.1
Preprovision operating income/average assets	0.6	0.6	0.5	0.9	0.8
Core earnings/average managed assets	0.5	0.4	0.3	0.5	0.3

N.M.--Not meaningful.

Table 4

Aktia Bank PLC RACF [Risk-Adjusted Capital Framework] Data

(Mil. €)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**Standard & Poor's RWA**	**Average Standard & Poor's RW (%)**
Credit risk					
Government and central banks	749	0	0	23	3
Institutions	2,247	270	12	329	15
Corporate	485	362	75	300	62
Retail	6,382	2,366	37	1,729	27
Of which mortgage	5,462	1,911	35	1,311	24
Securitization§	0	0	0	0	0
Other assets	83	65	79	81	98
Total credit risk	9,946	3,062	31	2,462	25
Market risk					
Equity in the banking book†	53	33	99	534	1,011
Trading book market risk	--	0	--	0	--
Total market risk	--	33	--	534	--

Table 4

Aktia Bank PLC RACF [Risk-Adjusted Capital Framework] Data (cont.)

Insurance risk					
Total insurance risk	--	--	--	577	--
Operational risk					
Total operational risk	--	368	--	449	--
(Mil. €)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		3,463		4,022	100
Total Diversification/Concentration Adjustments		--		400	10
RWA after diversification		3,463		4,422	110
(Mil. €)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		427	12.3	512	12.7
Capital ratio after adjustments‡		427	12.3	512	11.6

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2013, Standard & Poor's.

Risk position: Sound risk management but concentration risk due to focus on retail mortgage lending

We view Aktia Bank's risk position as "moderate," due mainly to the concentration risk on the bank's loan book, which exposes it to potential volatility in the domestic real estate market.

We view positively Aktia Bank's focuson low-risk lending, mortgage loans, and loans to small and midsize enterprises (SME). However, we still consider that the regionally focused retail loan book (87% of the total loan book at year-end 2013) exposes the bank to concentration risk and makes it vulnerable to real estate price developments in limited regions in Finland.

The concentration is partly mitigated by the retail loan book's high granularity and sound collateralization. Mortgage loans are principally granted in Finland's larger cities, which we consider to be economically stronger and where we assume prices to be more stable. Less than 5% of the total loan stock has loan-to-value ratios above 70%. We note that the credit quality in AREMB's loan portfolio is excellent. The portfolio has no non-performing loans and there have been no credit losses reported throughout the bank's history. Furthermore, the declining corporate lending book of €541 million (8% of the total loan book) does not show any significant single-name or sector concentration.

We consider Aktia Bank's risk culture to be sound. Aktia Bank has applied stricter underwriting standards since 2010, which is reflected in the improving asset quality. The ratio of nonperforming loans to total loans was 0.66% at December 2013, comparing positively with peers with similar product mixes and economic risks. The small SME portfolio shows somewhat weaker credit quality, but to our understanding it is well collateralized. We acknowledge that the bank has actively managed down the risks in its run-off portfolio (consisting of loans that are no longer in line with the credit policy) where loan volumes decreased to €180 million as of year-end 2013 (€250 million as of December 2012).

Despite our view of growing economic imbalances in the Finnish household sector, we anticipate Aktia Bank to maintain the low level of credit losses at around 10-15bps over the near term (4bps in 2013). We believe that the potential increase could result from Aktia Bank's corporate exposures. However, these exposures are mitigated by the declining size of the SME portfolio. Aktia Bank's market risk is minor since it has no trading book.

Table 5

Aktia Bank Risk Position					
	--Year ending Dec. 31--				
(Mil. €)	**2013**	**2012**	**2011**	**2010**	**2009**
Growth in customer loans	(5.5)	2.0	7.2	9.1	12.2
Total diversification adjustment / S&P RWA before diversification	9.9	8.7	3.0	N.M.	N.M.
Total managed assets/adjusted common equity (x)	21.3	22.8	23.7	24.8	26.8
New loan loss provisions/average customer loans	0.0	0.1	0.2	0.2	0.6
Net charge-offs/average customer loans	0.0	0.1	0.1	0.1	0.1
Gross nonperforming assets/customer loans + other real estate owned	0.7	0.7	0.8	0.5	0.6
Loan loss reserves/gross nonperforming assets	144.4	130.1	105.9	160.0	142.8

N.M.--Not meaningful.

Funding and liquidity: Sound funding profile benefiting from regional deposit franchise and covered bonds issuance

We consider Aktia Bank's funding to be "average." Our view is based on Aktia Bank's sound regional franchise and proximity to customers that should continue to provide the bank with a relatively stable and granular inflow of deposits (46% of funding as of December 2013). Aktia Bank has increased the customer deposits gradually over the past five years demonstrating, in our view, a relatively low sensitivity to customer confidence. A major part of the customer deposits is from households, followed by SME clients, and three quarters of all deposits are covered by the Finnish deposits insurance scheme. Therefore, we expect Aktia Bank's stable funding ratio to remain at an adequate level of around 100% over 2014-2015 (106.5% as of Dec. 31, 2013).

The funding profile also benefits from the bank's continuous access to capital markets through issuance of covered bonds, which we expect to represent 20%-25% of funding going forward. Aktia Bank was granted a covered bond licence by the Finnish Supervisory Authority in March 2013 and it successfully issued the first covered bond in June 2013. We believe that there is a healthy demand from the investor side for further issuances. AREMB in turn, is to focus on the management and refinancing of the current stock. We understand that AREMB will refinance the redeeming covered bonds by selling the underlying assets back to the distributing banks. As the owners of AREMB will grant new loans from their own balance sheets the run-off will gradually reduce Aktia Bank's balance sheet and refinancing needs.

In our view, Aktia Bank's funding mix will continue to represent a relatively balanced asset-liability structure with a long-term funding ratio of about 80%, which is in line with the ratios of its domestic competitors. Furthermore, if we adjust Aktia Bank's loan book for mortgage loans sold by the partner banks, its loan-to-deposits ratio stands at about

128%, slightly above that of domestic peers. We believe that the ongoing run off of AREMB will gradually improve Aktia Bank's funding and liquidity metrics.

As a result of the termination of Aktia Bank's services as a central credit institution, the role of excess liquidity placed by independent local savings and cooperative banks with Aktia Bank will decrease over time. When adjusting for transaction accounts, the share of local banks' deposits in Aktia's funding base is of minor importance.

Our assessment of Aktia Bank's liquidity as "adequate" mirrors our estimate of the bank's one-year liquidity ratio (broad liquid assets to short-term funding) of 165% as of year-end 2013. Aktia Bank had a liquidity position of about €2.8 billion, consisting of cash and securities, mainly covered bonds, which to a high extent are eligible for repurchase (repo) agreement transactions at the Finnish Central Bank. The bank reduced its investments in covered bonds in eurozone periphery countries to around €47 million as of Dec. 31, 2013 (€173 million as of Dec. 31, 2012), and the bank has no sovereign exposure to these countries. Consequently, we believe that in a severe liquidity crisis involving closure of access to capital market funding and a significant deposit outflow, Aktia Bank could survive for more than 12 months with access to the central bank through the repo activity in its liquidity book.

We understand that Aktia Bank already fulfils the future funding and liquidity requirements under the Basel III framework.

Table 6

Aktia Bank Funding And Liquidity

	--Year ending Dec. 31--				
(Mil. €)	**2013**	**2012**	**2011**	**2010**	**2009**
Core deposits/funding base	45.7	43.4	39.5	37.0	34.4
Customer loans (net)/customer deposits	165.4	178.9	193.6	193.9	199.4
Long term funding ratio	82.2	76.6	74.0	77.7	69.0
Stable funding ratio	106.5	97.4	92.0	98.8	88.6
Short-term wholesale funding/funding base	19.1	25.0	22.8	18.6	29.2
Broad liquid assets/short-term wholesale funding (x)	1.7	1.2	1.3	1.7	1.1
Net broad liquid assets/short-term customer deposits	31.6	13.8	16.4	37.7	13.0
Short-term wholesale funding/total wholesale funding	35.1	44.2	37.7	29.5	44.5
Narrow liquid assets/3-month wholesale funding (x)	2.8	6.1	3.9	4.5	3.7

External support:One notch of government support

The long-term rating on Aktia Bank is one notch higher than the SACP, reflecting our view that the bank has "moderate" systemic importance in Finland and that the Finnish government is supportive toward the domestic banking sector. We base our assessment on Aktia's position as the fourth-largest retail bank in Finland, where pan-Nordic groups have sizable operations, and with a 4.1% market share of mortgage loans and 3.7% of customer deposits.

We believe that the implementation of resolution regimes in the EU in 2016 will gradually reduce the probability of government support. We continue to monitor developments, and by end-April 2014 we plan to review our ratings on European banks that benefit from systemic support uplift, such as Aktia Bank. See "Standard & Poor's To Review

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Government Support In European Bank Ratings," published on March 4, 2014, for further details.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria And Research

- Standard & Poor's To Review Government Support In European Bank Ratings, March 4, 2014
- Banking Industry Country Risk Assessment: Finland, Jan. 3, 2014
- Ratings On Finland Affirmed At 'AAA/A-1+'; Outlook Stable, Oct. 18, 2013
- Finnish Aktia Bank 'A-/A-2' Ratings Affirmed On Intragroup Merger Forming New Parent; Outlook Negative, July 2, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Anchor Matrix

Industry Risk	Economic Risk									
	1	**2**	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	**a-**	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of March 26, 2014)	
Aktia Bank PLC	
Counterparty Credit Rating	A-/Negative/A-2
Senior Unsecured	A-
Counterparty Credit Ratings History	
12-Dec-2012	A-/Negative/A-2
Sovereign Rating	
Finland (Republic of)	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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