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Ratings

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# Bonum Bank PLC


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# Bonum Bank PLC

| SACP | bbb+ | | + | Support | 0 | + | Additional Factors | -1 |
|---|---|---|---|---|---|---|---|---|

| | | |
|---|---|---|
| Anchor | a- | |
| Business Position | Weak | -2 |
| Capital and Earnings | Very Strong | +2 |
| Risk Position | Moderate | -1 |
| Funding | Average | 0 |
| Liquidity | Adequate | |

| | |
|---|---|
| ALAC Support | 0 |
| GRE Support | 0 |
| Group Support | 0 |
| Sovereign Support | 0 |

| Issuer Credit Rating |
|---|
| BBB/Stable/A-2 |

## Major Rating Factors

**Strengths:**

- Very strong capitalization.
- A solid and mutual business model.
- Sound regional franchise in selected rural areas.

**Weaknesses:**

- Concentrated business operations focused on lending to individuals and small and midsize enterprises.
- Weak earnings and cost efficiency.
- A short operating history under the amalgamation structure.

**Outlook: Stable**

S&P Global Ratings' stable outlook on Bonum Bank PLC reflects our view that the wider POP Bank Group will continue its ongoing integration, but that it may not reach the efficiency and profitability of its peers over the next two years. Bonum Bank is the group's central credit institution. The group has a short operating history under the current amalgamation structure, and we expect it will realize synergies mainly by increasing the integration of shared support functions. The stable outlook also reflects our expectations that the bank group will maintain a risk-adjusted capital ratio (RAC) sustainably above 15%.

We could lower the ratings if the group's cohesiveness does not strengthen as we anticipate and if lagging efficiency leads to a weakening of its combined capital and risk position.

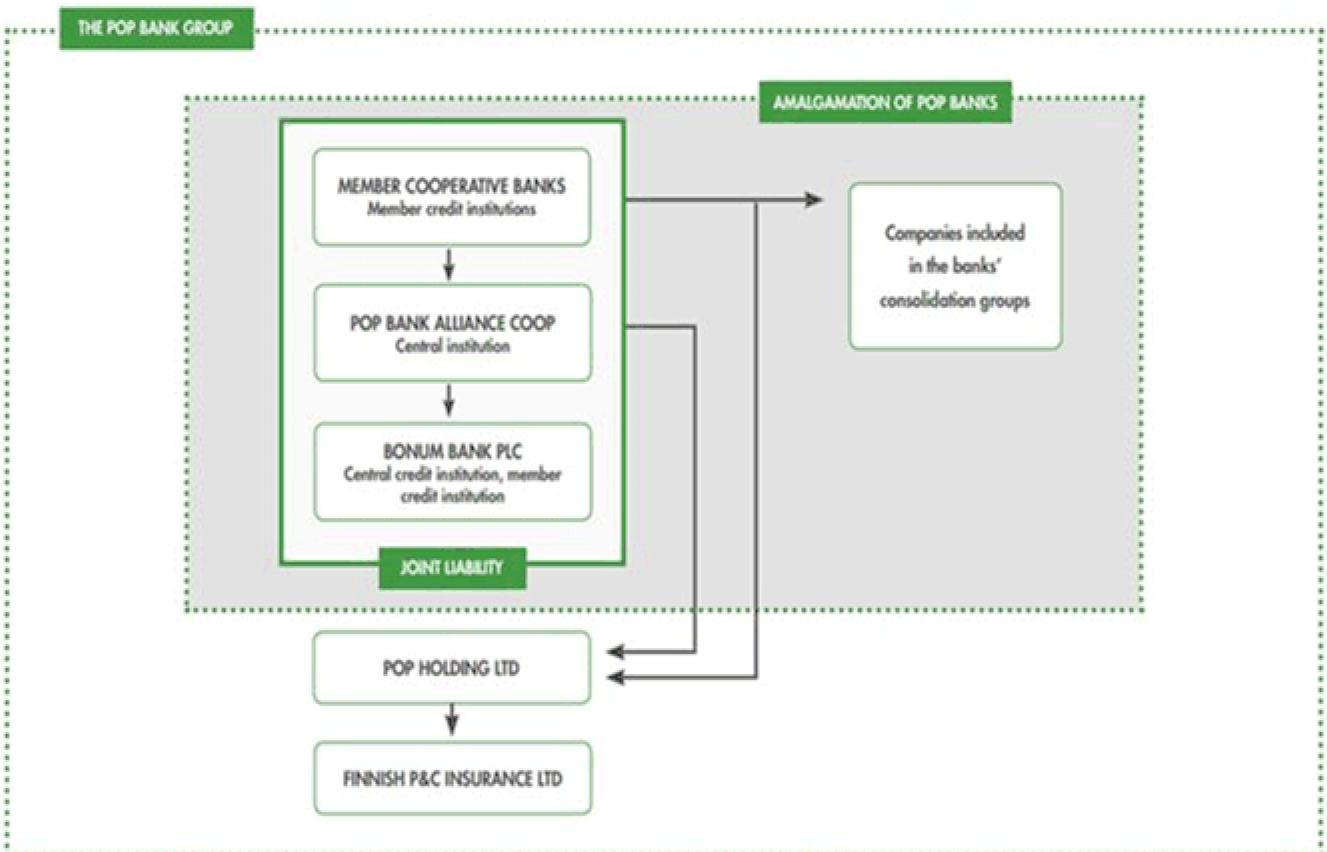
We could consider a positive rating action if we observed clear improvements in the group's revenue generation, cost structure, and profitability, leading to an earnings buffer more in line with peers.

## Rationale

The ratings on Bonum Bank reflect the wider group's franchise and creditworthiness. The amalgamation, established in December 2015, brought together the group's 26 member cooperative banks, POP Bank Alliance, and Bonum Bank to operate as a single entity for regulatory purposes under a joint-liability scheme. The group also includes specialized institutions, such as the non-life insurance company Finnish P&C Insurance Ltd., which operate outside the amalgamation and joint-liability framework.

Chart 1

POP Bank Group Structure






The long-term rating on Bonum Bank reflects our 'a-' anchor for Finnish banks, and our view of POP Bank Group's weak business position, based on its concentrated business operations, which are focused primarily on retail mortgage lending in and around small cities in Finland. We also consider the group's lagging efficiency and short track record of operating under the amalgamation, but very strong capital and earnings, based on our expectation that the RAC ratio will reach 16.5%-17.0% by year-end 2018. The rating also reflects the group's moderate risk position, due to concentration risks in the loan book being partly offset by sound collateralization and prudent underwriting standards. We view the bank's funding as average and its liquidity as adequate, owing to sound funding metrics, the dominance of customer-deposit funding, and a comfortable liquidity position.

We do not factor in any extraordinary government support because we regard POP Bank Group as having low systemic importance in Finland and the Finnish government's supportiveness toward the banking sector as uncertain since the implementation of the EU Bank Recovery and Resolution Directive on Jan. 1, 2016.

We deduct one notch from our 'bbb+' assessment of the group credit profile (GCP) because we regard POP Bank Group as a weaker performer than its peers, due to its poor operating efficiency and the group's short track record under its current structure.

Because we view Bonum Bank as integral to the group's operations, we equalize our long-term rating on Bonum Bank with the 'bbb' GCP.

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

To determine a bank's anchor, we use our Banking Industry Country Risk Assessment's (BICRA's) economic risk score and the industry risk score. The anchor is the starting point in assigning an issuer credit rating under our criteria for banks. For a commercial bank like Bonum Bank PLC that operates only in Finland, we determine an anchor of 'a-'. The anchor is based on an economic risk score of '2' and an industry risk score of '3'.

We classify the banking sector of Finland in group '2' under our BICRA. Countries in group '2' are among others Sweden, Norway, Belgium, and Germany.

We view Finland as an innovative and wealthy economy with high education levels. After a mild economic downturn in 2012-2014, we expect economic growth to gradually recover over the next two years, supported by private consumption and starting from 2018 by recovery of exports. We believe that the risk of a house price correction is becoming more remote as economic prospects and consumer confidence improve. We expect banks' asset quality to remain strong in the next two years, based on the sound financial position of the household and corporate sectors, the banking sector's moderately conservative underwriting standards, and the persisting low interest rate environment.

We do not consider the banking sector's competitive landscape to be distorted despite concentration stemming from the presence of large pan-Nordic banks and the domestic cooperative banking group OP Financial Group. We also deem the sector's overall profitability and capitalization to be resilient and expect banks to maintain their restrained risk appetite. That said, the sector remains highly interconnected with other Nordic banking systems, which results in potential spill-over risks for the Finnish economy from external events. We expect deposits to continue to dominate the banks' funding profiles and foresee that banks will rely moderately on external funding, given the limited size of domestic capital markets.

**Table 1**

**POP Bank Group Key Figures**

| | --Fiscal year ended Dec. 31-- | | |
|---|---|---|---|
| **(Mil. €)** | **2016** | **2015** | **2014** |
| Adjusted assets | 4,173 | 4,021 | 3,812 |

**Table 1**

| POP Bank Group Key Figures (cont.) | | | |
|---|---|---|---|
| | --Fiscal year ended Dec. 31-- | | |
| **(Mil. €)** | **2016** | **2015** | **2014** |
| Customer loans (gross) | 3,210 | 3,031 | 2,943 |
| Adjusted common equity | 449 | 410 | 380 |
| Operating revenues | 111 | 104 | 101 |
| Noninterest expenses | 91 | 86 | 84 |
| Core earnings | 8 | 9 | 7 |

### Business position: A concentrated business model and high cost structure

We assess POP Bank Group's business position as weak due to the group's small domestic market share and its concentrated business model with a focus on retail banking and small-and-midsize enterprise (SME) lending, mainly in less urban regions in Finland. We believe that the short track record of operating as an amalgamation creates uncertainties and, additionally, we do not regard the structure and strategy as completely set at this time.

The POP Bank Group had total assets of €4.2 billion as of Dec. 31, 2016. In our view, the amalgamated structure allows the POP banks to act as a unified group for regulatory purposes and compete better in the market, owing to an enhanced common market presence and expected efficiency improvements through shared back-office operations and other services, leading to advantages of scale. However, this needs to be demonstrated and proven in the future. We believe the legal set-up as a mutual group will support the group's long-term financial targets and aligns well with its strategy and prudent approach in managing risks. However, we also see certain risks in governance and cooperation, given the group's short track record in its current form. We view the possibility of member banks leaving the group, curbing the benefits of the remaining group, as remote, not least due to the joint-liability obligation that runs for five years after a member exits.

The POP banks are focused on retail banking, mainly residential real estate lending, but they also engage in SME and agricultural lending and service about 250,000 customers through 85 branches, mainly in Finland's less urban regions. In our view, concentration in terms of customer segments and geographic reach presents the main weakness of the group's business model as it may expose POP banks to potential volatility in Finland's real estate market or a downturn in the domestic economy.

We expect the group to improve its revenue diversification through non-life insurance business run by Finnish P&C Insurance Ltd. over time. Furthermore, the group may also extend its knowledge of digital distribution from insurance business to the banking business.

Although the group lacks a significant position nationwide, most of the POP banks hold sound local franchises in their regions. The group appears to have a loyal customer base, which allows it to take higher lending margins than larger peers and provides business stability. POP Bank Group earns about 60% of its revenues from net interest income (NII) and almost 30% from fees and commissions, most of which stem from payment transfers, followed by lending. We expect fees and commission income to increase somewhat as the group's integration improves.

**Table 2**

| POP Bank Group Business Position | | | |
|---|---|---|---|
| | --Fiscal year ended Dec. 31-- | | |
| **(%)** | **2016** | **2015** | **2014** |
| Total revenues from business line (€ mil.) | 117.2 | 103.8 | 100.9 |
| Commercial & retail banking/total revenues from business line | 93.1 | 94.9 | 95.7 |
| Insurance activities/total revenues from business line | 6.9 | 5.0 | 1.3 |
| Other revenues/total revenues from business line | N/A | 0.2 | 3.0 |
| Return on equity | 2.3 | 2.3 | N/A |

N/A--Not applicable.

### Capital and earnings: Very strong capitalization neutralizes weak earnings

We assess POP Bank Group's capital and earnings as very strong. This is mainly based on our projection of POP Bank Group's RAC ratio in the range of 16.5%-17.0% in the next 24 months, compared with a RAC ratio of 16.2% as of Dec. 31, 2016.

In our view, the group's revenues are relatively predictable, based on POP banks' sound regional positions in household lending and payments. This is further underscored by the proven price insensitivity of the group's customer base, since the POP banks' average margins are well above its peers'. We also expect the POP banks' net interest margins to remain fairly stable and outperform peers because margins on new loans are priced higher than the portfolio average. This offsets the negative impact of the transfer of lower-margin loans from Aktia Bank (originated by POP Banks and refinanced through covered bond issuance of run-down entity Aktia Real Estate Mortgage Bank, now integrated in Aktia Bank). POP Bank group's capitalization is supported by profit retention because member banks, as mutually owned cooperatives, do not pay dividends.

While we see resilient revenue streams as a strength for the group's earnings, they do not translate into strong profits because the group has high operating costs. This results in a thin but improving three-year average earnings buffer of 0.55% (an earnings buffer of about 1.0% indicates adequate earnings capacity), and we see a risk of capital erosion if interest rates were to fall further or the cost of risk increased.

The group's cost-to-income ratio at 74.6% at year-end 2016 remains high in comparison with Nordic peers', and we do not regard the cost base as particularly flexible. The high cost base is partly explained by the group's still decentralized structure and we anticipate that the newly formed amalgamation will convey efficiency gains over the coming years. Subsequently, the group's target cost-to-income ratio of 50% is realistic in the medium term, but not within our two-year outlook horizon, in our view.

We consider POP Bank Group's quality of capital, which consists solely of common equity, to be high. That said the group's financial flexibility is somewhat limited, but the individual member banks could issue additional cooperative capital in the form of POP shares, if needed.

**Table 3**

## POP Bank Group Capital And Earnings

| | --Fiscal year ended Dec. 31-- | | |
|---|---|---|---|
| **(%)** | **2016** | **2015** | **2014** |
| Tier 1 capital ratio | 21.2 | 20.7 | 19.5 |
| S&P RAC ratio before diversification | 16.2 | 15.5 | N.M. |
| S&P RAC ratio after diversification | 13.9 | 13.2 | N.M. |
| Adjusted common equity/total adjusted capital | 100.0 | 100.0 | 100.0 |
| Net interest income/operating revenues | 56.3 | 59.0 | 60.4 |
| Fee income/operating revenues | 25.6 | 29.1 | 26.7 |
| Market-sensitive income/operating revenues | 7.2 | 3.6 | 9.1 |
| Noninterest expenses/operating revenues | 82.2 | 82.8 | 83.1 |
| Preprovision operating income/average assets | 0.5 | 0.4 | N/A |
| Core earnings/average managed assets | 0.2 | 0.2 | N/A |

N/A--Not applicable. N.M.--Not meaningful.

**Table 4**

## POP Bank Group Risk-Adjusted Capital Framework Data

| | Exposure* | Basel III RWA | Average Basel III RW (%) | S&P Global Ratings' RWA | Average S&P Global Ratings' RW (%) |
|---|---|---|---|---|---|
| **Credit risk** | | | | | |
| Government and central banks | 452,631,925 | 336,780 | 0 | 18,706,050 | 4 |
| Institutions | 134,003,415 | 26,996,887 | 20 | 22,121,426 | 17 |
| Corporate | 631,173,934 | 590,594,291 | 94 | 416,890,529 | 66 |
| Retail | 2,604,969,656 | 1,060,610,079 | 41 | 808,719,927 | 31 |
| Of which mortgage | 2,208,068,716 | 771,082,359 | 35 | 530,355,977 | 24 |
| Securitization§ | 0 | 0 | 0 | 0 | 0 |
| Other assets | 118,068,197 | 106,895,258 | 91 | 116,803,181 | 99 |
| Total credit risk | 3,940,847,127 | 1,785,433,294 | 45 | 1,383,241,113 | 35 |
| **Market risk** | | | | | |
| Equity in the banking book† | 305,706,250 | 298,638,223 | 98 | 722,082,839 | 236 |
| Trading book market risk | -- | 25,596,704 | -- | 38,395,056 | -- |
| Total market risk | -- | 324,234,927 | -- | 760,477,895 | -- |
| **Insurance risk** | | | | | |
| Total insurance risk | -- | -- | -- | 406,165,238 | -- |
| **Operational risk** | | | | | |
| Total operational risk | -- | 197,536,221 | -- | 220,546,998 | -- |
| | | **Basel III RWA** | | **S&P Global Ratings' RWA** | **% of S&P Global Ratings' RWA** |
| **Diversification adjustments** | | | | | |
| RWA before diversification | | 2,308,525,784 | | 2,770,431,243 | 100 |
| Total diversification/concentration adjustments | | -- | | 473,682,069 | 17 |

**Table 4**

| POP Bank Group Risk-Adjusted Capital Framework Data (cont.) | | | | |
|---|---|---|---|---|
| RWA after diversification | 2,308,525,784 | | 3,244,113,312 | 117 |
| | **Tier 1 capital** | **Tier 1 ratio (%)** | **Total adjusted capital** | **S&P Global Ratings' RAC ratio (%)** |
| **Capital ratio** | | | | |
| Capital ratio before adjustments | 488,306,724 | 21.2 | 449,455,000 | 16.2 |
| Capital ratio after adjustments‡ | 488,306,724 | 21.2 | 449,455,000 | 13.9 |

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' 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, 2016, S&P Global Ratings.

### Risk position: Concentration risk, due to focus on retail lending in sparsely populated areas

We view POP Bank Group's risk position as moderate. In our view, the concentration of households and SMEs in selected regions exposes the group to potential economic shocks in Finland. However, we regard the operating environment as having stabilized, and the risk of a house price correction has become remote.

POP Bank Group focuses mainly on low-risk lending to private customers (66% of the loan portfolio in 2016), lending to small agricultural and forestry clients (18%) and SMEs (16%). This concentration is partly mitigated by the loan book's high granularity and adequate collateralization, and residential real estate lending in less urbanized low-growth areas results in moderate loan sizes in the retail portfolio. In addition, the group's SME lending--targeted principally to small businesses across different sectors--shows a conservative approach to loan sizes and collateralization. In our view, there are no meaningful single-name concentrations.

We consider that POP Bank Group's loan portfolio is adequately collateralized, mainly by real estate and the share of non-collateralized is marginal. The majority of mortgage loans have loan-to-value (LTV) ratios below 60%, but we view the share of LTV above 70% as somewhat higher than at domestic peers. We note that member banks do not have trading books and take no currency risk.

We expect POP Bank Group to maintain its prudent risk culture and underwriting standards, while increasing the use of unified standards within the amalgamation and implementing risk policies, limits, and guidelines at the group level. The core of POP Bank Group's risk management is three lines of defense, which consist of member institutions, independent risk control, and compliance of the central institution and central institution's internal audit. This means that each bank controls itself and will be controlled by the other bank as well as by the central institution.

Consequently, we believe that the group's asset quality will remain sound over the coming years. The ratio of nonperforming loans to customer loans remains stable and was 0.75% at year-end 2016, which is in line with the peer average. However, we see the group's cost of risk, which we estimate at about 16 bps in 2017-2018 as somewhat weaker than the peer average.

**Table 5**

| POP Bank Group Risk Position | | | |
|---|---|---|---|
| | --Fiscal year ended Dec. 31-- | | |
| **(%)** | **2016** | **2015** | **2014** |
| Growth in customer loans | 5.9 | 3.0 | N.M. |
| Total diversification adjustment / S&P RWA before diversification | 17.1 | 17.9 | N.M. |
| Total managed assets/adjusted common equity (x) | 9.4 | 9.9 | 10.2 |
| New loan loss provisions/average customer loans | 0.2 | 0.2 | N/A |
| Gross nonperforming assets/customer loans + other real estate owned | 0.8 | 0.8 | 1.0 |
| Loan loss reserves/gross nonperforming assets | 90.0 | 73.4 | 57.8 |

N.M.--Not meaningful. N/A--Not applicable.

### Funding and liquidity: Stable funding combined with a granular deposit base

We consider POP Bank Group's funding to be average, reflecting the group's stable and granular deposit base rooted in a sound retail franchise and proximity to customers.

We expect POP Bank Group to maintain its sound deposit base (which represents 96% of funding), owing to its steady market share of about 3% of domestic customer deposits. About 75% of customer deposits stem from retail customers, 12% from SME, and 10% from agricultural clients.

At the same time, we anticipate an increase in the share of wholesale funding as a result of the group's improved access under the amalgamation structure (owing to joint liability within the amalgamation) and its loan growth targets. We consider this to be positive for POP Bank Group, in terms of diversification and funding costs. Consequently, we expect the group will maintain its stable funding ratio at a comfortable 100%-110% over 2017-2018 (110% as of Dec. 31, 2016).

We assess POP Bank Group's liquidity as adequate. At year-end 2016, the group had a liquidity position of about €460 million, consisting mainly of cash at the Finnish Central Bank and securities, a large part of which we understand is eligible for repurchase (repo) agreement transactions. We believe that under stressful conditions involving the closure of access to capital market funding and a significant deposit outflow, POP Bank Group could survive for more than six months, but dependence on the central bank through the repo activity could become significant thereafter. Also, the amalgamation structure implies improved transferability of liquidity across the member banks. We estimate the bank's one-year liquidity ratio (broad liquid assets to short-term funding) at an elevated 38.0x as of Dec. 31, 2016, but anticipate it will decrease over the next two years, but remain comfortably above 1.0x, despite the group's increased use of wholesale market funding. More importantly, the net broad liquid assets cover about 17% of the customer deposits.

**Table 6**

| POP Bank Group Funding And Liquidity | | | |
|---|---|---|---|
| | --Fiscal year ended Dec. 31-- | | |
| **(%)** | **2016** | **2015** | **2014** |
| Core deposits/funding base | 95.92 | 94.48 | 96.57 |
| Customer loans (net)/customer deposits | 90.97 | 90.16 | 90.11 |

**Table 6**

| POP Bank Group Funding And Liquidity (cont.) | | | |
|---|---|---|---|
| | --Fiscal year ended Dec. 31-- | | |
| (%) | 2016 | 2015 | 2014 |
| Long term funding ratio | 99.71 | 97.12 | 99.83 |
| Stable funding ratio | 109.93 | 107.25 | 106.13 |
| Short-term wholesale funding/funding base | 0.33 | 3.21 | 0.18 |
| Broad liquid assets/short-term wholesale funding (x) | 38.01 | 3.97 | 47.08 |
| Net broad liquid assets/short-term customer deposits | 17.48 | 13.91 | 12.18 |
| Short-term wholesale funding/total wholesale funding | 8.10 | 58.20 | 5.38 |

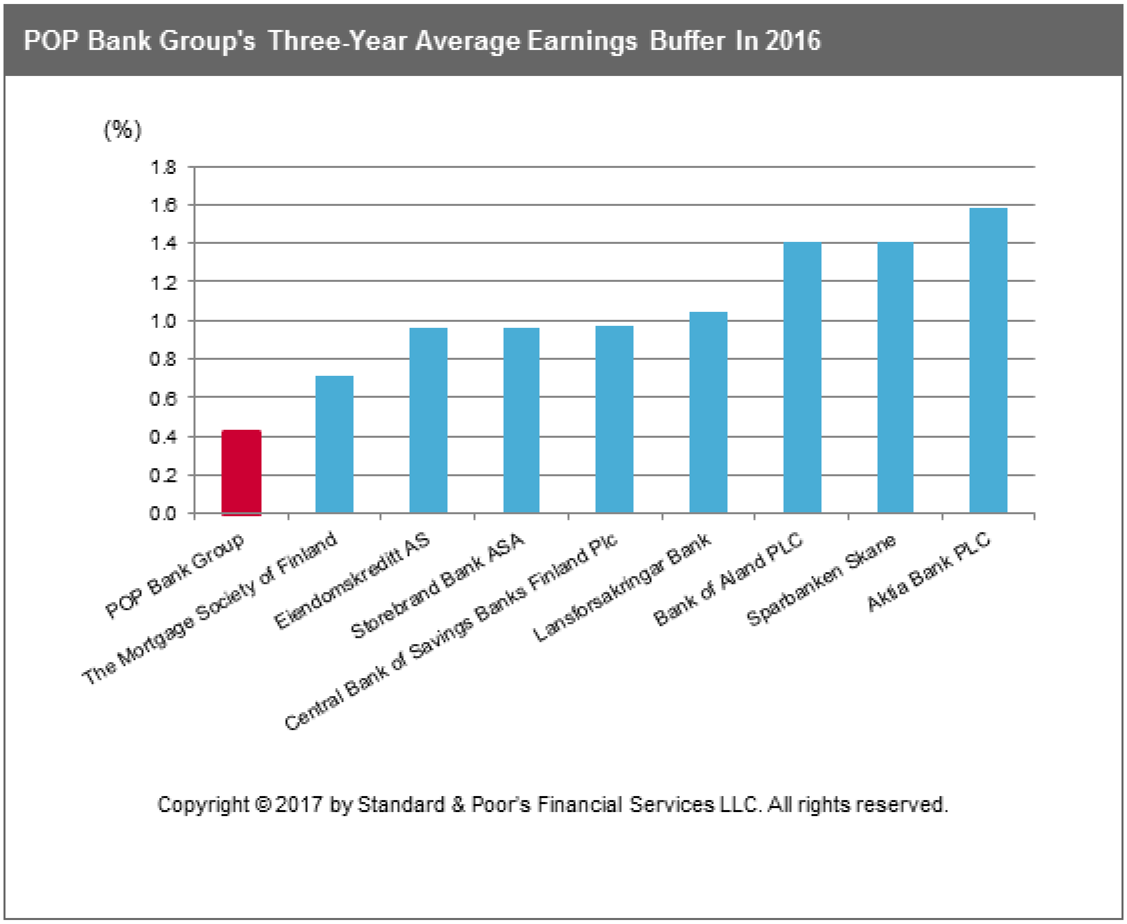
### External support: No uplift for external support

We do not factor any external support into our assessment of the group's credit profile. We believe the prospect of extraordinary government support for Finnish banks is uncertain, following the full implementation of the EU Bank Recovery and Resolution Directive, including bail-in powers. In addition, we assess the POP Bank Group to have low systemic importance in Finland, and the Finnish authorities have not identified POP Bank Group as subject to a well-defined bail-in process. Consequently, we do not include support from additional loss-absorbing capacity into the long-term rating on Bonum Bank.

### Additional rating factors: A poor performer in its peer group and an untested group structure

We deduct one notch based on the group's weaker earnings than its peers. Because of POP Bank Group's high cost base, its earnings buffer is marginal at only 0.4% at year-end 2016. A negative buffer would mean that the group's earnings are insufficient to cover normalized losses, which could start eating into its capital. Although we expect the earnings buffer to improve toward 0.75% over our two-year outlook horizon, it will remain relatively weak in a peer comparison (an earnings buffer of about 1.0% indicates adequate earnings capacity). Furthermore, there remain uncertainties regarding the functionality of the new group structure. The group has existed under amalgamation only since Dec. 31, 2015, and its structure and governance will likely evolve over the coming years. In our view, these uncertainties translate into overall risks that are more comparable with banks rated at 'BBB'.

**Chart 2**




## Related Criteria And Research

### Related Criteria

- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Group Rating Methodology, Nov. 19, 2013
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Rating Methodology and Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

### Related Research

- Various Positive Rating Actions On Finnish Banks on improved Economic Conditions, Nov. 17, 2016
- Finland-Based Credit Institution Bonum Bank PLC Rated 'BBB/A-2'; Outlook Stable, May 23, 2016

## 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 June 23, 2017)

| | |
|---|---|
| **Bonum Bank PLC** | |
| Counterparty Credit Rating | BBB/Stable/A-2 |
| Senior Unsecured | BBB |
| **Counterparty Credit Ratings History** | |
| 23-May-2016 | BBB/Stable/A-2 |
| **Sovereign Rating** | |
| Finland (Republic of) | AA+/Stable/A-1+ |

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.