Credit Opinion: Eksportfinans ASA

Eksportfinans ASA

Oslo, Norway

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Aaa
Senior Unsecured	Aaa
Subordinate	Aa1
Preferred Stock	Aa2
Commercial Paper	P-1
Other Short Term	P-1

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Key Indicators

Eksportfinans ASA

	[1]**2007**	**2006**	**2005**	**2004**	**2003**	**Avg.**
Total assets (NOK billion)	**218.72**	**172.36**	**135.93**	**109.35**	**103.34**	[2]**19.15**
Total assets (EUR billion)	**27.55**	**20.99**	**17.02**	**13.28**	**12.31**	**--**
Total capital (NOK billion)	**4.60**	**5.25**	**4.02**	**4.03**	**4.07**	[2]**2.49**
Return on average assets	**-0.08**	**0.10**	**0.11**	**0.21**	**0.26**	**0.12**
Recurring earnings power [3]	**-0.11**	**0.14**	**0.15**	**0.29**	**0.36**	**0.17**
Net interest margin	**0.31**	**0.31**	**0.30**	**0.39**	**0.46**	**0.35**
Cost/income ratio (%)	**-775.00**	**44.92**	**50.84**	**32.46**	**29.35**	**-123.48**
Problem loans % gross loans	**0.02**	**0.02**	**0.04**	**0.19**	**0.09**	**0.07**
Tier 1 ratio (%)	**6.30**	**8.30**	**9.85**	**12.70**	**13.40**	**10.11**

[1] As of December 31. [2] Compound annual growth rate. [3] Preprovision income % average assets.

Opinion

SUMMARY RATING RATIONALE

In accordance with Moody's rating methodology for government-related issuers (GRIs), the Aaa/P-1 ratings of Eksportfinans reflect the combination of the following inputs: (i) Baseline Credit Assessment (BCA) of 2 (on a scale of 1 to 21, where 1 represents lowest credit risk); (ii) the Aaa local currency deposit ceiling of the Norwegian government; (iii) High default dependence; and (iv) High probability of support.

The BCA is underpinned by Eksportfinans' strong position in its niche segments. The institution has a legal monopoly for Norway's government-supported export schemes and is the only specialised provider of export finance in Norway. In addition, its wholly owned subsidiary Kommunekreditt is a key lender to the Norwegian local governments with a market share of 34% of the funding provided by the financial institutions at year-end 2007.

Eksportfinans' lending activities have a low risk profile due to the credit enhancement of its export loan portfolio via sovereign and bank guarantees and the high credit quality of the Norwegian local governments. To date, Eksportfinans has never experienced loan losses. Interest and currency risks are contained but we note concentration risks in the liquidity portfolio and liquidity risks related to structured funding. In the prevailing turbulent market conditions Eksportfinans has maintained access to market funding although cost of long-term funding has increased notably. We note that ability to attract funding in competitive terms is a key element of Eksportfinans' strategy given the wholesale dependent funding profile as well as the low margin lending business. Pressured margins have resulted in lower profitability but operating costs have remained under control.

Moody's views default dependence as high due to the financial strength and business mix of Eksportfinans in relation to the credit strengths of the Kingdom of Norway, which directly owns 15% of the institution. In addition, the government has an indirect ownership via its 34% stake in DnB NOR which owns 40% of Eksportfinans. The high probability of support in a distress scenario reflects Eksportfinans' importance to the government and its bank owners. The owners' support was demonstrated in the form of a capital injection in March 2008 and a portfolio hedge agreement to offset further losses in the liquidity portfolio. We note, however, that Eksportfinans does not benefit from a guarantee from the government.

Credit Strengths

- Legal monopoly for Norway's government-supported export schemes

- Only specialised export finance provider in Norway

- Key lender to Norwegian local governments

- Government's commitment and solid co-operation with other shareholders

- High loan quality

- Diversified funding base

- Large liquidity reserve

Credit Challenges

- Maintaining low risk profile

- Continuing to offer efficient means of providing export and local government finances

- Low and pressured profitability

- Dependence on competitive international funding

- Ability to maintain high quality of liquidity portfolio

- Strengthening of risk management

Rating Outlook

The outlook of the Eksportfinans' long-term rating is negative.

On 1 November 2007 Moody's changed the outlook to negative from stable. This action followed Eksportfinans' announced third quarter loss, resulting mainly from unrealised losses in securities acquired for liquidity purposes.

The review on the Aaa debt ratings was triggered by Moody's concerns related to growth in the structured part of the liquidity portfolio as well as increasing structured funding. Due to the institution's thin core earnings base, the shift towards more structured products exposes the bank to higher earnings volatility.

What Could Change the Rating - Down

Downward pressure could be exerted on Eksportfinans' ratings if the institution continues the expansion of its securities portfolio in structured products or if the company otherwise increases its risk appetite. We also expect to see strengthening of the risk management. Further deterioration in core financial fundamentals and particularly in profitability as well as weakening of the liquidity profile would also exert downward pressure on Eksportfinans' ratings. Any signs of decreased commitment or support from the Norwegian government would negatively affect the rating.

Recent Results and Developments

In Q1 2008, Eksportfinans' financial result continued to be negatively affected by unrealised losses in the liquidity portfolio. The pre-tax result showed a loss of NOK266 million compared to a gain of NOK93 million in Q1 2007. Core lending business has remained solid, reflecting brisk growth in export-related lending. Net interest income from local government lending, however, remained stable. Overall, in the first three months of 2008 loan growth slowed down to only 1.4%.

In March 2008, Eksportfinans entered into a portfolio hedge agreement with the majority of its owner banks. The hedge agreement, effective from 1 March 2008, will offset losses up to NOK5 billion in the liquidity portfolio held as of 29 February 2008. The agreement will also offset any gains in the portfolio. Eksportfinans will pay a monthly fee of NOK5 million to the banks participating in the portfolio hedge agreement. In June 2008, the Norwegian parliament made a decision to participate in the portfolio hedge agreement according to the government's 15% stake in Eksportfinans.

The owners injected new capital to Eksportfinans in March 2008 amounting to NOK1.2 billion. As a result, the Tier 1 ratio was 8.1% as of end-March 2008 compared to 6.3% at year-end 2007.

DETAILED RATING CONSIDERATIONS

Detailed consideration for Eksportfinans' currently assigned ratings are as follows:

Franchise Value

Trend: Neutral

Eksportfinans focuses on export-related and local government financing representing 45% and 55% of its loan portfolio, respectively, at Q1 2008. It has an unchallenged monopoly in providing government-supported export finance (the 108 Agreement) for capital goods and services as well as for ships in Norway, and a preferred position and consequent good franchise in export and local government lending for its other shareholders - major Norwegian banks. In export loans Eksportfinans is co-operating with Norwegian and some international banks in order to provide attractive financing packages to customers. Through Kommunekreditt, which was acquired in 1999 from Kreditkassen (Nordea), Eksportfinans has a market share of over 30% in local government lending provided by the financial institutions and is the second-largest lender after Kommunalbanken. Local governments account for more than 90% of customers, either as borrowers or as guarantors.

Importantly, Eksportfinans has no intention of moving towards commercial banking activities. To do so would affect its position as a specialised institution - the basis for the regulatory authorities allowing commercial banks to have a stake in Eksportfinans - and put it in direct competition with its shareholders.

Earnings stability of Eksportfinans is influenced by large proportion of export lending activities which is seen by Moody's as a less stable earnings source than retail or public lending. In 2007, over 50% of net interest income was derived from export-related credits. In addition, the large liquidity portfolio has caused volatility in earnings. However, local government lending is expected to balance earnings fluctuations if growth in export industries slows down significantly.

Risk Positioning

Trend: Neutral

The two largest banking groups in Norway are the main owners of Eksportfinans: DnB NOR holds 40% of shares and Nordea Bank Norge 23%. The government has a 15% ownership stake, which it acquired in 2001 to underline the importance of Eksportfinans' role and services to Norway's economy. The government also has an indirect ownership in Eksportfinans through its 34% stake in DnB NOR. We understand that due to its important role supporting the Norwegian export industries and local governments, the government's intention is to maintain its co-ownership, but Eksportfinans does not benefit from a guarantee from the government. The rest of the owners consist of smaller Norwegian commercial and savings banks and Danske Bank, which became an owner after it acquired Fokus Bank.

Eksportfinans follows the Norwegian Code of Practices for Corporate Governance. The Board of Directors consists of eight members, four of which represent the owner banks (three largest owner banks, DnB NOR, Nordea and Danske Bank, are represented). We do not have concerns about Eksportfinans' corporate governance. The institution faces no "key-man" risk, although we note that the CEO has been in the position for a relatively short time.

Eksportfinans is currently re-evaluating its risk management framework. We are following the process closely and expect to see increased focus on risk management, particularly in relation to concentration and liquidity risks, as well as overall strengthening of the risk management function.

As regards to credit risk, Eksportfinans loan portfolio exhibits considerable single-name and industry concentration, reflecting its niche operating areas. These risks are, however, mitigated by the fact that the largest exposures to the corporate sector are guaranteed by sovereign or highly rated financial institutions. Credit risk exposure to financial institutions is limited to A3 rating and to entities in the EU or OECD. In addition, Eksportfinans has some exposure to banks that are not internationally rated but are mainly Norwegian. As regards local government lending, the Norwegian municipalities display solid financials. Loans to the shipping industry represent the largest industry concentration, accounting for over 15% of the loan portfolio. This exposure more than doubled in 2007, reflecting favourable terms of the government-supported lending scheme.

An important risk relates to structured funding, since fluctuations in currencies, interest rates, equity prices, credit spreads and commodity prices can affect the maturity of the issued bonds. However, market risk in these instruments is swapped back to back and market risk left to Eksportfinans is only related to Libor interest rate. In general, the aforementioned swaps transform market risk to liquidity risk since about 60% of structured funding are callable or have triggers. Eksportfinans will call the bond issue if the swap is terminated. To manage this risk Eksportfinans has developed a proprietary tool to model the expected maturity of structured funding. The total currency exposure and interest rate risk have been limited by the Board and the positions have remained well below the limits over the past years although the interest rate risk has increased since year-end 2006. The limit for the net currency position is NOK180 million. The limit for interest rate risk is NOK700,000 in relation to a 1 basis point movement in interest rates.

For managing the liquidity, Eksportfinans holds a sizable liquidity portfolio representing almost 40% of its assets as of year-end 2007. The liquidity portfolio has been classified as "held for trading" and therefore it is subject to mark-to-market valuation despite the institution's intention to hold these assets until maturity. The portfolio consists of senior financials (61%) with an average rating of A1 and asset-backed securities (39%) with an average rating of Aaa. The majority of ABS investments are in Europe and in RMBS - less than 10% is in US securities and there is no direct sub-prime exposure.

To eliminate the earnings volatility resulting from the liquidity portfolio, Eksportfinans entered into a portfolio hedge agreement with its owner banks effective from 1 March 2008. The portfolio hedge agreement will offset losses up to NOK5 billion as well as any gains in the portfolio held as of 29 February 2008 and valued at approximately NOK70 billion. Since then, Eksportfinans has made only few new investments and excess cash has been rolled in short-term deposits. Going forward the institution is planning to put greater emphasis on liquidity of the portfolio. We view favourably the measures taken to eliminate earnings volatility resulting from the price fluctuations in the liquidity portfolio. However, we will continue to follow potential changes in the investment strategy closely. Our concerns are related to the proportion of structured investments since these instruments have proven less liquid in financial stress events.

The importance of good liquidity management is underlined by Eksportfinans' reliance on market funding and therefore we would like to see more prudent asset-liability management as regards matching of funding and lending maturities. We positively note a well-diversified funding base in terms of maturities and investors. Eksportfinans has also maintained access to the market despite global market turmoil, although we note the significantly higher price of funding in absolute terms. In relative terms, Eksportfinans has retained its favourable position in comparison to the owner banks.

Regulatory Environment

Eksportfinans is subject to supervision of Kredittilsynet, the Norwegian FSA. For a discussion of the regulatory environment please see Moody's Banking System Outlook on Norway, published in November 2007.

Operating Environment

Trend: Improving

When looking at the operating environment, we consider economic stability, level of integrity and corruption as well as legal system of the country. In the case of Norway, mainland GDP is used as a proxy for economic stability reflecting the segregation of oil income from the public finances that has been in place for the last decade. Regarding the time horizon, we also believe that the last five-year standard deviation would be a better indicator due to the material changes in economic policies after the crisis of the early 1990s.

Profitability

Trend: Weakening

Common to specialised lenders, Eksportfinans has weak profitability due to low margin lending. Its net interest margin has decreased from 0.5% in 2003 to 0.3% in 2007, but strong volume growth has partly compensated for narrowing margins - the loan portfolio increased by 26% in 2007 which was mainly related to strong demand from municipalities, shipping and oil & gas industries. However, in the first three months of 2008, loan growth has been slowing down and the loan portfolio only increased by 1.4%. In the local government sector margin pressure has been stronger, but due to increased funding cost Eksportfinans has been raising margins which has led to significantly lower loan growth in Kommunekreditt's loan book. However, we believe that it is not sustainable for Kommunekreditt to reduce lending to the local governments because of the government's focus on competition and fair conditions for municipal financing. We also note that margins under the government supported scheme, the 108 Agreement, were reduced for the larger loans in 2007. However, the volume growth in the 108 loans has been strong due to favourable terms to borrowers. In addition, some of these loans are 0% risk-weighted.

Even though the lending activities of Eksportfinans have developed favourably, its income statement showed a loss for 2007 as well as for Q1 2008 due to weak performance of the liquidity portfolio resulting in large unrealised losses. We note that, going forward, the earnings volatility related to the securities holdings is mitigated by the portfolio hedge agreement. Eksportfinans pays a monthly fee of NOK5 million for the portfolio hedge provided by owner banks which will cover losses up to NOK5 billion.

In Moody's opinion, Eksportfinans' profitability will remain under pressure due to higher funding cost and competition in local government lending which is limiting the scope for margin increases.

Liquidity

Trend: Neutral

Eksportfinans relies totally on market funding and is not allowed to collect deposits. The most important funding source is long-term debt which represented about 80% of liabilities at year-end 2007. Long-term bonds can be issued under Euro-, US- or Australian MTN programmes and the Japanese debt shelf programme. For the issuance of structured bonds, Eksportfinans is using a proprietary web-based tool eFunding. Long-term issues are quite evenly divided between plain vanilla and structured issues, which are popular especially among Japanese investors. We note, however, that about 60% of structured funding has features (call options or triggers) that might shorten the maturity of these issues. For short-term funding, Eksportfinans has in place USCP and ECP programmes both amounting to USD6 billion.

Due to the more challenging market conditions since Q3 2007, Eksportfinans increased the usage of CP funding. In spring 2008, Eksportfinans has, however, issued benchmark bonds in euros and Swiss francs. We note that due to increased short-term funding, Eksportfinans has a liquidity gap in a 12-month period - assuming that the government-supported lending runs as anticipated and assuming there is no growth in other lending.

Eksportfinans has a large liquidity portfolio representing almost 40% of its assets and including highly rated securities. As described above, we have some concerns relating to the high proportion of structured securities (almost 40% of liquidity portfolio), which have proved less liquid in financial stress events. It should be noted that despite the portfolio hedge agreement the liquidity portfolio can be used in repo transactions with banks but Eksportfinans does not have direct access to the Central Bank of Norway. Eksportfinans has committed repo facilities from a number of banks amounting to USD5 billion.

Capital Adequacy

Trend: Neutral

Due to significant mark-to-market losses in the securities portfolio in the second half of 2007, capital adequacy of Eksportfinans came under pressure and as a result the Tier 1 ratio dropped to 6.3% at year-end 2007 compared to 8.3% at year-end 2006 and 9.9% at year-end 2005. In order to strengthen the capital base, shareholders agreed on a capital injection of NOK1.2 billion which was paid in March 2008 and increased the Tier 1 ratio to 8.1% at end-March 2008. Eksportfinans' target is to keep the Tier 1 ratio around 8%. The portfolio hedge agreement should limit any deterioration in capital adequacy going forward. Eksportfinans core capital includes hybrid capital amounting to NOK381 million at year-end 2007.

For Basel II purposes Eksportfinans is using the standardised approach to assess credit risk. It should be noted that in Norway loans to local government and municipalities carry a risk-weight of 20% whereas in Europe in general the risk-weight is zero.

Efficiency

Trend: Neutral

Eksportfinans' cost efficiency has been relatively good over the years although somewhat lower compared to other specialised lenders in the region. Operating costs in relation to assets were 0.10% in 2007 compared to 0.11% in 2006 and 0.15% in 2005 whereas for Kommunalbanken the comparable figures are below 0.10%. As such, maintaining a low cost base and access to competitive funding are vital for Eksportfinans due to low lending margins.

Among Eksportfinans' key challenges is its capacity to demonstrate, both to its key shareholders and to the Norwegian authorities, that it provides the most efficient means for export and competitive terms for local government financing in Norway.

Asset Quality

Trend: Neutral

The asset quality of Eksportfinans' loan book has historically been very strong. So far, the entity has never experienced any loan losses. At year-end 2007, problem loans accounted for less than 0.1% of gross loans. Good loan quality reflects the fact that most of the export lending is guaranteed by the banks and/or the government (through GIEK, the Norwegian Government Guarantee Agency). In general, the bank guarantors are highly rated - the five-largest guarantors are rated Aaa or Aa1. In addition, Norwegian municipalities have a high credit quality. As regards the credit exposure, 50% of the loan portfolio is to the local governments and 8% to the central governments, 30% to Norwegian bank guarantors and 12% to international bank guarantors. The loan book grew by 25% in 2007 and amounts to over NOK125 billion. The growth has been driven by the booming maritime industry and oil & gas sector as well as by good demand from the local government sector. Disbursements under government supported scheme for export lending have increased significantly due to favourable terms (fixed CIRR interest rate). So far in 2008, loan growth has been much slower and we anticipate slower growth also for the rest of the year.

We expect the quality of the loan book to remain good and take comfort of the high credit quality of guarantors and the solid local government sector in Norway.