Credit Opinion: Eksportfinans ASA

Global Credit Research - 09 Jan 2012

Oslo, Norway

Ratings

Category	**Moody's Rating**
Outlook	Rating(s) Under Review
Issuer Rating	*Ba1
Senior Unsecured	*Ba1
Subordinate	*Ba2
Pref. Stock Non-cumulative	*B1 (hyb)
Commercial Paper	NP
Other Short Term	(P)NP

* Placed under review for possible downgrade on November 22, 2011

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Key Indicators

Eksportfinans ASA (Consolidated Financials) [1]

	[2]**9-11**	[2]**12-10**	[2]**12-09**	[2]**12-08**	[3]**12-07**	**Avg.**
Total Assets (NOK billion)	**226.4**	**215.5**	**225.3**	**296.9**	**218.7**	[4]**0.9**
Total Assets (EUR million)	**28,743.9**	**27,642.6**	**27,177.6**	**30,503.8**	**27,551.0**	[4]**1.1**
Total Assets (USD million)	**38,565.8**	**37,083.8**	**38,992.9**	**42,401.8**	**40,281.0**	[4]**-1.1**
Tangible Common Equity (NOK billion)	**3.5**	**2.0**	**1.8**	**-0.9**	**1.5**	[4]**23.2**
Tangible Common Equity (EUR million)	**448.3**	**257.5**	**212.0**	**-90.6**	**193.0**	[4]**23.5**
Tangible Common Equity (USD million)	**601.5**	**345.4**	**304.2**	**-125.9**	**282.2**	[4]**20.8**
Net Interest Margin (%)	**0.7**	**0.6**	**0.6**	**0.3**	**0.3**	[5]**0.5**
PPI / Avg RWA (%)	**2.3**	**2.9**	**2.4**	**-0.4**	**-1.9**	[6]**1.8**
Net Income / Avg RWA (%)	**1.7**	**2.1**	**1.7**	**-0.2**	**-1.4**	[6]**1.3**
(Market Funds - Liquid Assets) / Total Assets (%)	**37.3**	**36.0**	**27.3**	**38.3**	**45.1**	[5]**36.8**
Tier 1 Ratio (%)	**12.8**	**12.7**	**9.7**	**8.1**	**6.3**	[6]**10.8**
Tangible Common Equity / RWA (%)	**11.3**	**6.3**	**4.5**	**-1.9**	**3.8**	[6]**5.0**
Cost / Income Ratio (%)	**21.4**	**14.5**	**15.1**	**-840.8**	**-33.5**	[5]**-164.7**
Problem Loans / Gross Loans (%)	**1.1**	**0.6**	**0.1**	**0.0**	**0.0**	[5]**0.4**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 22 November 2011, Moody's downgraded Eksportfinans ASA's issuer and debt ratings to Ba1/Not Prime from Aa3/Prime-1. All long-term ratings remain on review for further downgrade.

The rating action follows the decision by the Norwegian government (on 18 November 2011) to take over responsibility for the system of government-subsidised export lending - i.e. the 108-agreement scheme - which had been administered by Eksportfinans. The removal of the government-supported export loan monopoly leaves Eksportfinans without a viable business model as a credit provider to the Norwegian export industry. As a consequence of this decision, Eksportfinans' management immediately initiated a run-off process of the company.

The rating review focuses on (i) the implications of the run-off process on Eksportfinans' remaining operations, especially regarding risks to its liquidity and capitalisation and (ii) the remaining value of its balance sheet.

Moody's is particularly concerned about Eksportfinans' liquidity position given; (i) the possibility of various kinds of debt repayment triggers being activated following the significant changes in the company's business model, (ii) the risk of derivative positions being affected, (iii) the potential for funding shortfall arising due to asset and liability mismatches, (iv) the possible impact of capital market fluctuations on valuations in the structured funding portfolio or other events prompting a need for additional funding.

On 22 November 2011 the company's major shareholders, the Norwegian government (rated Aaa), DNB Bank (rated Aa3/Prime-1/C), Nordea Bank Norge (rated Aa2/Prime-1/C) and Danske Bank (rated A2/Prime-1/C) published a press release indicating their intention to provide capital support to Eksportfinans, if needed, although this has, so far, not translated into legal commitments.

Moody's note that Eksportfinans has received an alleged declaration of default from a Japanese bond holder.

Credit Strengths

- The government and large Nordic banks currently own approximately 80% of Eksportfinans' equity capital

- Loan quality is stable, reflecting sovereign and bank guarantees

- Liquidity reserves are sizeable

Credit Challenges

- Securing liquidity throughout the run-off process

- Avoiding any material changes to the current funding base such as repayment triggers, market fluctuations of the structured funding portfolio, and asset and liability mismatches

- Complying with the requirements on large exposures as stipulated in CRD

Rating Outlook

Eksportfinans' long-term ratings are on review for further downgrade.

What Could Change the Rating - Up

The risks associated with Eksportfinans' run-off status imply that upward pressure on the ratings is very unlikely unless the downside risks are mitigated.

What Could Change the Rating - Down

Downward pressure would be exerted on the ratings should the run-off process have any negative implications for Eksportfinans' remaining operations especially regarding its liquidity and capitalisation.

DETAILED RATING CONSIDERATIONS

Eksportfinans' Ba1 issuer and senior debt ratings and Not Prime short-term ratings are based on Moody's methodologies for Government Related Issuers (GRI). In line with those methodologies, Eksportfinans' Ba1 issuer and senior debt ratings are derived from (i) a baseline credit assessment of 11 (on a scale of 1 to 21, whereby 1 represents the lowest credit risk), (ii) the supporting government's rating (Norway rated Aaa), (iii) an estimate of the default correlation between the two entities (dependence), (iv) an estimate of the likelihood of extraordinary government support (support).

The main owners of Eksportfinans are three of the largest banking groups in the Nordic area: DNB Bank (40%) and Nordea Bank Norge (23%) and Danske Bank (8%). The Norwegian government holds a 15% direct stake in Eksportfinans and an indirect holding through its 34% stake in DNB.

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

Franchise Value

We believe the Norwegian government's decision to transfer the monopoly of government-supported loans from Eksportfinans has left the company without a viable business model and franchise for future operations. We note that the company will not grant new loans and its business will be gradually managed to exit the market.

Liqudity

Eksportfinans relies totally on market funding and is not permitted to collect deposits; it is therefore highly sensitive to market movements. Around half of long-term funds are structured issuances, most of which have triggers that might shorten the maturity of these issuances and could therefore affect liquidity. For short-term funding, Eksportfinans has US and Euro Commercial Paper programmes.

Eksportfinans has increased the current liquidity portfolio to NOK36.9 billion as of Q3 2011, up from NOK31.9 billion at year-end 2010 - this portfolio mainly comprises bonds from financial institutions. It should be noted that, that the liquidity portfolios can be used in repo transactions with banks - Eksportfinans has committed repo facilities from its three-largest owner banks amounting to USD2 billion with a maturity of 12 months, which can be extended.

Factors that significantly add to the negative outlook on Eksportfinans' liquidity position are related to the run-off status and the substantial change to the company's business model which may result in debt repayment triggers being activated and derivative portfolios being affected. On 19-December-2011 Eksportfinans received a purported declaration of default from a Japanese bond holder. Furthermore, according to Eksportfinans' management, under normal circumstances, the company could occasionally require access to external funding in order to mitigate mismatches between assets and liabilities.

We regard a credible and timely approach to managing run-off liquidity, including the provision of any external support, as essential to ensure an orderly run-off process for Eksportfinans.

Capital Adequacy

Eksportfinans reported a Tier 1 ratio of 12.8% and total capital ratio of 16.5% as of Q3 2011 (according to the Basel II Standardised Approach). This represents an improvement from 10.3% and 14.4%, respectively, at year-end 2010, and we expect that the reduction in the loan book will reduce risk-weighted assets. However, these levels are not sufficient to cover Eksportfinans' current largest exposures, in accordance with the European Union's Capital Requirement Directive (CRD). Given the size of those exposures, the institution will need to raise capital and/or reduce the size of those loans by January 2013.

Risk Positioning

Eksportfinans' risk positioning reflects (i) its high dependence on market conditions and fluctuations; (ii) large loan concentrations; (iii) earnings volatility due to fluctuations in the fair value of its own debt; (iv) the absence of a viable business model; and (v) liquidity and capital risks during the run-off process.

A significant part of Eksportfinans' market risk relates to structured funding, as currencies, interest rates, equity prices, credit spreads and commodity prices can affect the maturity of the issued bonds. We note that market risk in these instruments is hedged in relation to fluctuations of indices but not in relation to maturities.

Further market risk arises from Eksportfinans' large securities portfolios: (i) an unwinding portfolio of NOK26.1 billion as of Q3 2011, comprising a significant portion of asset-backed securities; and (ii) a "new" liquidity portfolio (NOK36.9 billion) consisting of more-liquid assets and subject to a stop-loss limit of 25 basis points of the portfolio value and covenants on counterparties' ratings. The unwinding portfolio is hedged by a Portfolio Hedge Agreement (PHA) with the main shareholder banks, which protects NOK5 billion of the portfolio value.

The inherent uncertainty regarding how to manage the liquidity and capital positions during the run-off process of Eksportfinans reflects negatively on the company's risk positioning.

Asset Quality

The asset quality of Eksportfinans' loan book has historically been strong, although problem loans increased slightly in Q1-Q3 2011; at present, they represent just over 1% of gross loans. Problem loans are defined as interest and principal (and excludes matured principal) on loans 90+ days overdue. The company's loan quality reflects the fact that most of the export lending is guaranteed by the shareholder banks and/or the Norwegian government through the Norwegian Government Guarantee Agency (Garanti-Instituttet for Eksportkreditt or GIEK). However, as a result of its niche business, Eksportfinans loan portfolio exhibits considerable industry and single-name concentration.

Shipping-related loans represented the largest industry concentration, accounting for almost 40% of the loan portfolio at year-end 2010. This exposure has increased rapidly since 2007; it grew by more than 24% in 2010 and by almost 10% year-to-date (YTD) 2011. Eksportfinans borrower concentration - measured as the 20 largest exposures - remains high in relation to its European peers.

Profitability

Profit before tax increased in Q3 2011 to NOK367 million, from NOK81 million in Q2 2011. The difference was almost exclusively due to fluctuations of instruments reported at fair value, as Eksportfinans reported a gain of NOK35 million in Q3 2011 compared with a loss of NOK214 million in Q2 2011. Over the same period, net interest income improved somewhat to NOK373 million from NOK346 million in the previous quarter, and costs remained fairly stable. Although the earnings trend in Q3 2011 is positive, Eksportfinans' profitability remains susceptible to market movements, due to the effects of unrealised gains and losses on financial instruments.

More than 50% of Eksportfinans' underlying income (excluding unrealised gains or losses on financial instruments) stemmed from interest income on export lending. We understand that no further loans will be granted going forward.

Eksportfinans experienced significant volatility in its earnings due to the mark-to-market valuation of its own debt. Earnings volatility related to the securities holdings is now mitigated by the PHA (see "Risk Positioning").

Eksportfinans' earnings will no longer be supported by operational expansion, which weighs on its profitability score. The possible reduction of loans to comply with the CRD's large exposure provision may also hinder profitability.