Moody's Investors Service

Global Credit Research
Credit Opinion
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Credit Opinion: Eksportfinans ASA

Eksportfinans ASA

Oslo, Norway

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Aa1
Senior Unsecured	Aa1
Subordinate	Aa2
Preferred Stock	Aa3
Commercial Paper	P-1
Other Short Term	P-1

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Key Indicators

Eksportfinans ASA

	[1]2009	[2]2008	2007	2006	2005	[3]Avg.
Total assets (NOK billion)	270.65	296.90	218.72	172.36	135.93	[4]23.50
Total assets (EUR billion)	30.19	30.50	27.55	20.99	17.02	--
Total capital (NOK billion)	11.22	9.56	4.60	5.25	4.02	[4]18.61
Return on average assets	2.87	1.35	-0.08	0.10	0.11	0.34
Recurring earnings power [5]	3.96	1.87	-0.11	0.14	0.15	0.47
Net interest margin	0.63	0.47	0.31	0.31	0.30	0.36
Cost/income ratio (%)	1.82	4.20	-806.10	44.92	50.84	-134.74
Problem loans % gross loans	1.10	0.05	0.02	0.02	0.04	0.06
Tier 1 ratio (%)	8.70	8.10	6.30	8.30	9.85	9.05

[1] As of March 31. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate. [5] Preprovision income % average assets.

Opinion

SUMMARY RATING RATIONALE

In accordance with Moody's rating methodology for government-related issuers (GRIs), the Aa1/Prime-1 ratings of Eksportfinans reflect the combination of the following inputs: (i) a Baseline Credit Assessment (BCA) of 4 (on a scale of 1 to 21, where 1 represents the lowest credit risk); (ii) the Aaa local currency deposit ceiling of the Norwegian government; (iii) high default dependence; and (iv) high probability of support.

Eksportfinans has a strong position in export lending - the institution has a legal monopoly over Norway's government-supported export schemes and is the only specialised export lender in the country. On 7 May 2009, Eksportfinans announced that it will sell its wholly owned subsidiary Kommunekreditt to Kommunal Landspensjonskasse (KLP), a Norwegian life insurance company and going forward will focus on export finance. Kommunekreditt is a key lender to Norwegian local governments, with a market share of about 20%.

Eksportfinans's lending activities have a low risk profile due to the credit enhancement of its export loan portfolio via sovereign and bank guarantees. To date, Eksportfinans has not 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 had access to market funding, but there have not been any benchmark deals since H1 2008 and the cost of long-term market funding has increased. Access to government funding has been helpful but we note the temporary nature of the facility. Eksportfinans's ability to attract funding on competitive terms is a key element of the institution's strategy given its wholesale-dependent funding profile and low-margin lending business. Operating costs have remained under control.

Moody's views the institution's 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's 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. In addition, the government agreed in November 2008 to provide Eksportfinans with funding for qualifying export projects under the government-supported financing scheme over the next two years. 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

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

- High loan quality reflecting sovereign and bank guarantees

- Diversified funding base

- Large liquidity reserve

Credit Challenges

- Continuing to offer efficient means of providing export finance

- Maintaining low risk profile

- Low core profitability

- Dependence on competitive international funding

- Ability to maintain high quality of liquidity portfolio

Rating Outlook

The outlook on Eksportfinans's long-term ratings is negative.

The negative outlook on Eksportfinans's long term-ratings reflects uncertainty related to its financial position given its focus on export lending going forward; the institution will be dependent on a single business line, which could make it more vulnerable to changes in market dynamics. Moody's acknowledges Eksportfinans's strong position as a provider of export loans and monopoly position in the government-supported schemes in Norway, but also considers export lending to be more cyclical than local government lending.

What Could Change the Rating - Up

Upward pressure on the ratings is unlikely at this time given the recent downgrade and negative outlook.

What Could Change the Rating - Down

As reflected by the negative outlook, Moody's will closely follow Eksportfinans's implementation of its strategy as a pure export lender and the impact on the entity's financials and overall franchise.

Downward pressure could be also exerted on the long-term ratings if Eksportfinans were to increase its risk appetite, particularly in relation to its financial investments. Deterioration in core financial fundamentals (particularly profitability and capitalisation) and a weakening of the liquidity profile, or any sign of decreased commitment or support from the Norwegian government, would also exert downward pressure on the ratings.

Recent Results and Company Events

On 7 May 2009, Eksportfinans announced that it had sold its fully owned subsidiary, Kommunekreditt, to KLP. Kommunekreditt was acquired by Eksportfinans in 1999 and is the second-largest provider of loans to the Norwegian local government sector, with around a 20% market share. The entity was sold at the book value and includes a loan portfolio totalling NOK42 billion, which accounted for almost 40% of Eksportfinans's loans to customers at 31 March 2009. Eksportfinans will provide funding for the acquired loan portfolio for a two-year period, during which time the loans will be gradually transferred to KLP. The sale is subject to regulatory approval.

Eksportfinans reported a good financial result for Q1 2009 - net profit from continuing operations was NOK2.0 billion compared with a loss of NOK203 million in Q1 2008. The main positive contributor was unrealised gains on financial instruments, which were mainly related to the changes in the fair value of Eksportfinans's own debt and will be reversed over time. In comparison, in Q1 2008, unrealised losses on the securities portfolio (now covered by the portfolio hedge agreement) had a significant negative impact on the result. Regarding lending operations, net interest income improved to NOK353 million from NOK108 million in the same period in the previous year, reflecting higher volumes as well as margin increases in lending and investments in the liquidity portfolio.

The capital level is satisfactory - the Tier 1 ratio was 8.7% and the total capital ratio was 12.0% at end-March 2009.

On 27 November 2008, Eksportfinans announced that it had entered into an agreement with the Norwegian government whereby the government would provide funding to Eksportfinans for the financing of new export lending that qualifies under the government-supported financing scheme. The funding will be provided for the coming two years and with maturities of up to five years. The agreement was approved by parliament in December 2008 and by the general assembly of Eksportfinans and EFTA Surveillance Authority in January 2009. It reflects the weaker market conditions where the availability of market funding has not been sufficient to cover demand for export loans. In our view, the agreement also reflects Eksportfinans's function as an important tool for the government as a provider of funding to the Norwegian export sector.

In March 2008, Eksportfinans entered into a portfolio hedge agreement with the majority of its owner banks. The hedge agreement offsets losses of up to NOK5 billion in the liquidity portfolio, held as of 29 February 2008. The agreement also offsets any gains in the portfolio. Eksportfinans pays a monthly fee of NOK5 million to the banks participating in the portfolio hedge agreement. In June 2008, the Norwegian parliament approved the government's decision to participate in the portfolio hedge agreement, as a result of its government's 15% stake in Eksportfinans. As of end-March 2009, about 46% of the portfolio hedge agreement was used.

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

DETAILED RATING CONSIDERATIONS

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

Franchise Value

Trend: Neutral

Eksportfinans focuses on export-related financing, amounting to NOK79 billion at Q1 2009. The loan book, which is being transferred to KLP within a two-year period, totalled NOK42 billion at end-Q1 2009. Eksportfinans's position as an important provider of export financing is emphasised by the government's decision to provide funding to Eksportfinans and thus support the competitiveness of the export sector, which is highly important for the Norwegian economy.

Eksportfinans 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 co-operation position and consequent good franchise in export lending for its other shareholders - major Norwegian banks. In export loans, Eksportfinans is co-operating with Norwegian and some international banks to provide attractive financing packages to customers.

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.

The earnings stability of Eksportfinans is influenced by its export lending activities, which is seen by Moody's as a less stable earnings source than retail or public sector lending given that the export sector is more exposed to cyclicality. After the sale of Kommunekreditt, Eksportfinans will be dependent on a single business line, which could make it more vulnerable to changes in market dynamics. In addition, the large liquidity portfolio has caused volatility in earnings, although since March 2008 this has been offset by the portfolio hedge agreement. Also, fluctuation in the fair value of the institution's own debt has resulted in fluctuation in reported earnings.

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's role in and services to Norway's economy. The government also has an indirect ownership in Eksportfinans through its 34% stake in DnB NOR. The other owners are smaller Norwegian commercial and savings banks and Danske Bank, which became an owner after it acquired Fokus Bank.

We understand that, due to its important role supporting the Norwegian export industries, the government's intention is to maintain its co-ownership, but Eksportfinans does not benefit from a guarantee from the government. We also note that the government is supporting Eksportfinans in terms of funding for qualifying export projects for a two-year period until the end of 2010. In addition, the government has changed the ownership classification to a higher category 3 from a category 1, which reflects that in addition to commercial objectives the entity also has other specifically defined objectives as a lender to the Norwegian export sector. The government owned local government lender Kommunalbanken is also placed in the category 3.

Eksportfinans follows the Norwegian code of practice for corporate governance. The board of directors consists of eight members, four of whom represent the owner banks (the three-largest owner banks, DnB NOR, Nordea and Danske Bank, are represented). The CEO is not a member of the board. In our view, the institution does not face "key-man" risk. We do not have concerns about Eksportfinans's corporate governance.

Eksportfinans has been re-evaluating its risk management framework. We are following the process closely and have seen actions taken in terms of increased focus on risk management and the strengthening of the risk management function.

As regards credit risk, Eksportfinans's 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. The largest counterparties are the Kingdom of Norway (through GIEK, the Norwegian Government Guarantee Agency) and DnB NOR Bank. The largest direct exposure to any counterparty was 38% of equity at year-end 2008. Credit risk exposure to financial institutions is mainly limited to the ratings of at least A3 and to entities in the EU or OECD. In addition, Eksportfinans has some exposure to banks that are not internationally rated - mainly Norwegian. Ship-related loans represent the largest concentration, accounting for over 20% of the loan portfolio. This exposure more than doubled in 2007 and increased by over 60% in 2008, reflecting the favourable terms of the government-supported lending scheme. However, in the first three months of 2008, the growth in ship-related loans slowed to 6% from end-2008.

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 the libor interest rate. In general, the swaps transform market risk to liquidity risk since about 60% of structured funding (i.e. 40% of total funding) is callable or has 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 in the past few years, although the interest rate risk has increased since year-end 2006. The limit for the net currency position is NOK120,000 in relation to a one-basis-point movement in any foreign currency and also for the total value of the currency position. At year-end 2008, the net currency position was NOK31 million (0.8% of Tier 1 capital). The limit for interest rate risk has been lowered to NOK300,000 from NOK700,000 in relation to a one-basis-point movement in interest rates.

For managing the liquidity, Eksportfinans holds a sizeable securities portfolio, representing 34% of total assets as of end-March 2009. The "old" liquidity portfolio has been classified as "held for trading" and therefore is subject to mark-to-market valuation despite the institution's intention to hold these assets until maturity. This portfolio is however covered by the portfolio hedge agreement up to NOK5 billion of losses. The portfolio consists of senior financials (62%) with an average rating of A1 and asset-backed securities (ABS, 38%) with an average rating of Aaa as at Q1 2009. 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 "old" liquidity portfolio, Eksportfinans entered into a portfolio hedge agreement with its owner banks effective from 1 March 2008. The portfolio hedge agreement offsets losses of up to NOK5 billion (as of 31 March 2009, about 46% had been used) as well as any gains in the portfolio held as of 29 February 2008 and valued at approximately NOK70 billion. Since then, Eksportfinans has mainly made new investments in short-term European financial papers.

The importance of good liquidity management is underlined by Eksportfinans's reliance on market funding and therefore we expect to see more prudent asset-liability management as regards the matching of funding and lending maturities. We note that liquidity management has been emphasised in the recently revised risk management policy. The institution has decided to put greater focus on the liquidity of the liquidity reserve portfolio, which should provide a buffer in the event of disrupted access to market funding. Overall, our concerns are related to structured investments since these instruments have proven less liquid during financial stress events. In the revised risk management policy, the board of directors has limited the proportion of ABS investments to maximum of 20%. We will follow the performance of the revised investment strategy closely.

We positively note a well-diversified funding base in terms of maturities and investors. Eksportfinans has had access to the market but market funding is more expensive, there have been lower transaction volumes and no benchmark deals since H1 2008. However, funding from the government has been helpful although we note that it is temporary and in place until 2010.

Regulatory Environment

Eksportfinans is subject to supervision by Kredittilsynet, the Norwegian financial supervisory authority. For a discussion of the regulatory environment please refer to Moody's Banking System Outlook on Norway, published in November 2008.

Operating Environment

When looking at the operating environment of a country, we consider economic stability, the level of integrity and corruption, and the legal system. 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 past decade. We note that the operating environment has become more challenging due to the economic slowdown.

Profitability

Trend: Neutral

Like specialised lenders, Eksportfinans has thin core profitability due to low margin lending. Its net interest margin on average earning assets, however, increased to 0.47% in 2008 from 0.31% in 2007 and 2006, reflecting income from higher equity as well as higher net interest margins on local government lending. Volume growth has partly compensated for the narrow margins - the loan portfolio increased by 14% in 2008 and 25% in 2007. In Q1 2009, loans to ships, capital goods and export-related and other international activities increased by 40% on the annual level, but decreased slightly from end-2008.

The loan growth in 2008 was mainly related to strong demand from shipping and capital goods sectors. In the local government sector, Eksportfinans has been raising margins due to higher funding costs, which led to a 14% decrease in Kommunekreditt's loan book in 2008. Net interest margin on the local government lending was 0.35% in 2008 compared with 0.20% in 2007. Kommunekreditt's loan book, amounting to NOK42 billion, will be transferred to KLP within a two-year period and Eksportfinans will keep about NOK10 billion of Kommunekreditt's loans in its own books. We also note that margins under the government-supported scheme, the 108 Agreement, were reduced for 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.

In 2008 and Q1 2009, Eksportfinans reported a significant increase in net earnings due to positive mark-to-market valuation of its own debt, which reflects widening credit spreads. These unrealised gains will, however, be reversed as unrealised losses in the future. In comparison, the net result for 2007 was negative due to the weak performance of the liquidity portfolio, resulting in large unrealised losses. The earnings volatility related to the securities holdings is now 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 of up to NOK5 billion.

In Moody's opinion, Eksportfinans's core profitability could remain under pressure due to the higher funding costs; market volatility is also likely to affect the result given the mark-to-market valuation of the entity's own debt. Additionally, loan growth could be affected if the global economic slowdown continues. We note the agreement with the government that provides funding for export projects for a two-year period on market terms.

Liquidity

Trend: Neutral

Eksportfinans relies totally on market funding and is not allowed to collect deposits. The most important funding source is bond debt, which represented about 86% of issued debt securities at end-March 2009. Long-term bonds can be issued under euro-, US dollar- or Australian dollar-denominated medium-term note programmes and the Japanese debt shelf programme. For the issuance of structured bonds, Eksportfinans is also using a proprietary web-based tool, eFunding.

Long-term issues include plain vanilla and structured issues, which are popular especially among Japanese investors. Structured issues increased faster than plain vanilla issues during 2008. We note that about 60% of structured funding (i.e. 40% of total funding) has features (call options or triggers) that might shorten the maturity of these issues and could affect liquidity. Since H1 2008, Eksportfinans has not issued benchmark bonds, but has been active in private placements, especially in the Japanese and US markets. For short-term funding, Eksportfinans has in place USCP and ECP programmes, both amounting to US$6 billion. As regards to the USCP programme, we note that the entity has a repo facility in place.

Eksportfinans has a large securities portfolio, representing 34% of total assets at end-March 2009, and including highly rated securities. Regarding the liquidity portfolio under the portfolio hedge agreement (NOK67 billion or 72% of total securities on the balance sheet), we have some concerns relating to the high proportion of structured securities (almost 40% of the liquidity portfolio), which have proved less liquid in financial stress events. In the current challenging market conditions, there are uncertainties related to the value of the portfolio. It should be noted that, despite the portfolio hedge agreement, the liquidity portfolio can be used in repo transactions with banks - Eksportfinans has committed repo facilities from a number of banks amounting to US$5 billion. Regarding the access to the Central Bank of Norway, Eksportfinans has an indirect access via a Norwegian bank.

In addition to the liquidity portfolio under the portfolio hedge agreement, Eksportfinans has set up a new liquidity reserve portfolio, which consists of short-term papers of financial institutions; the spread duration currently being less than two months.

Capital Adequacy

Trend: Neutral

Thanks to a capital injection of NOK1.2 billion by the shareholders, which was paid in March 2008, the capitalisation of Eksportfinans improved in 2008. Prior to the capital increase, the Tier 1 ratio had dropped to 6.3% at year-end 2007 due to negative mark-to-market valuation of the securities portfolio. Eksportfinans did not pay out a dividend in 2007 or 2008.

At end-March 2009, Tier 1 ratio was 8.7% and total capital ratio 12.0%.

The portfolio hedge agreement has limited the deterioration in capital adequacy. We also note that changes in the fair value of the entity's debt do not have an impact on equity. Eksportfinans's target is to keep the Tier 1 ratio at around 8%. Core capital includes hybrid capital amounting to NOK506 million (£50 million) at year-end 2008.

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. At end-March 2009, the average risk-weight calculated on total assets was 17%.

Efficiency

Trend: Neutral

Eksportfinans's cost efficiency has been relatively good over the years. Operating costs in relation to assets were 0.08% in 2008 compared with 0.10% in 2007 and 0.11% in 2006. For Kommunalbanken, the comparable figures were below 0.10%. As such, maintaining a low cost base and access to competitive funding are vital for Eksportfinans due to the low lending margins.

Among Eksportfinans's 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 financing in Norway.

Asset Quality

Trend: Neutral

The asset quality of Eksportfinans's loan book has historically been very strong. Thus far, the entity has not experienced loan losses. Good loan quality reflects the fact that most of the export lending is guaranteed by the banks and/or the Norwegian government (through GIEK). Guarantees from GIEK cover political risks at 100% and the maximum cover for commercial risks is 90%. At end-Q1 2009, GIEK guarantees covered 20% of the export loan portfolio. In general, the bank guarantors are highly rated - the five-largest guarantors are rated in the range of Aa3 - Aaa. However, we note that in general, export lending has a weaker risk profile than local government lending in Norway.

In Q1 2009, problem loans (interest and principal and not matured principal on loans over 90 days past due) increased significantly and accounted for 1.1% of gross loans - this is mainly related to the exposure towards Icelandic banks, which according to Eksportfinans are not considered fully guaranteed in a satisfactory manner. In H2 2008, Eksportfinans reported provisions regarding an Icelandic bank that had acted as an agent and guarantor for several loans due to a breach of its obligations. In addition, the entity is engaged in a syndicated exposure to Icelandic banks amounting to NOK99 million at end-2008.

As regards the credit exposure, 34% of the loan portfolio was to local governments, 15% was to the central governments, 39% was to Norwegian bank guarantors and 12% was to international bank guarantors at end-March 2009. As a result of the sale of Kommunekreditt, the loan book decreased to NOK64 billion at end-Q1 2009 from NOK113 billion at year-end 2008. In addition, loans to credit institutions amounted to NOK37 billion at end-Q1 2009. Last year, the lending growth was driven by the booming maritime industry, although the outlook now is weaker. Disbursements under the government-supported scheme for export lending have increased significantly due to favourable terms (fixed CIRR interest rate).

With respect to the asset quality of the loan book, we take comfort from the good credit quality of the guarantors and the solid local government sector in Norway, but caution that there could be losses in relation to the Icelandic exposure although it is also noted that the bank has provisioned a significant amount of potential losses.