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]2008	2007	2006	2005	2004	Avg.
Total assets (NOK billion)	253.95	218.72	172.36	135.93	109.35	[2]19.15
Total assets (EUR billion)	30.58	27.55	20.99	17.02	13.28	--
Total capital (NOK billion)	5.65	4.60	5.25	4.02	4.03	[2]2.49
Return on average assets	-0.10	-0.08	0.10	0.11	0.21	0.12
Recurring earnings power [3]	-0.14	-0.11	0.14	0.15	0.29	0.17
Net interest margin	0.37	0.31	0.31	0.30	0.39	0.35
Cost/income ratio (%)	-138.10	-775.00	44.92	50.84	32.46	-123.48
Problem loans % gross loans	0.01	0.02	0.02	0.04	0.19	0.07
Tier 1 ratio (%)	--	6.30	8.30	9.85	12.70	10.11

[1] As of September 30. [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 Aa1/P-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. The long-term ratings were downgraded to Aa1 on 16 December 2008.

The BCA is underpinned by Eksportfinans's strong position in its niche segments. The institution has a legal monopoly over Norway's government-supported export schemes and is the only specialised provider of export finance in Norway. Its wholly owned subsidiary Kommunekreditt is a key lender to Norwegian local governments, with a market share of 34% of the funding provided by financial institutions at year-end 2007. Kommunekreditt's loan portfolio has, however, decreased during 2008 due to reprising of the loans and Eksportfinans has expressed its intention to sell the subsidiary.

Eksportfinans's 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 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 had access to market funding although the cost of long-term funding has increased notably and there have not been benchmark deals in the second half of 2008. We note that the ability to attract funding on competitive terms is a key element of Eksportfinans's strategy given its wholesale-dependent funding profile as well as its low-margin lending business. Eksportfinans has been increasing margins reflecting higher funding cost but profitability remains relatively thin. 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 has agreed to provide Eksportfinans with funding for qualifying export projects under the government-supported financing scheme. 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 strong 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 finances

- Low profitability

- Dependence on competitive international funding

- Ability to maintain high quality of liquidity portfolio

- Finding solution for Kommunekreditt

Rating Outlook

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

The negative outlook on Eksportfinans's long term-ratings reflects the uncertainty related to the potential changes in its business structure and financial position given that the institution has stated its intention to sell Kommunekreditt and focus on export lending going forward. Local government lending is a significant part of the business and accounted for about 46% of total lending at end-September 2008. 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. Therefore, a shift towards a concentration on export loans is likely to increase earnings volatility from the current level.

What Could Change the Rating - Up

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

What Could Change the Rating - Down

As reflected by the negative outlook, Moody's will follow closely potential changes in the business structure of Eksportfinans and effects on the institution's financial position.

Downward pressure could be also exerted on the long-term ratings if Eksportfinans were to increase its risk appetite, particularly in relation to financial investments. Deterioration in core financial fundamentals (particularly profitability) 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 27 November 2008, Eksportfinans announced that it had entered into an agreement with the Norwegian government whereby the government will 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. This agreement was approved by the parliament on 12 December 2008. The agreement reflects the weaker market conditions where the availability of market funding has not been sufficient to cover demand for export loans. In our view it also reflects Eksportfinans's function as an important tool for the government as a provider of funding to the Norwegian export sector. At the same time, Eksportfinans also commented that, going forward, it intends to focus on export financing and is considering selling its subsidiary, Kommunekreditt.

Eksportfinans continued to record adverse financial results in January-September 2008. The pre-tax result showed a loss of NOK250 million compared with a loss of NOK89 million in January-September 2007, mainly due to a reduction in the value of exposure to Icelandic banks. The core lending business has remained sound, reflecting still brisk growth in export-related lending. As a result of the repricing of the majority of the portfolio (due to higher funding costs), net interest income from local government lending also increased. The repricing, however, has affected the competitive position of Kommunekreditt and resulted in a 10% decrease in the local government loan book from year-end 2007. Overall, the loan portfolio increased by 6% in January-September 2008 driven by a 26% increase in export lending.

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 of 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 took the decision to participate in the portfolio hedge agreement, according to the government's 15% stake in Eksportfinans. As of end-September 2008, 37% (about NOK1.87 billion) 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. However, as of end-September 2008 the Tier 1 ratio had decreased to 7.4% reflecting negative profit and loan growth.

DETAILED RATING CONSIDERATIONS

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

Franchise Value

Trend: Neutral

Eksportfinans focuses on export-related and local government financing, representing 54% and 46% of its loan portfolio, respectively, at Q3 2008. Its 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 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 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 about 30% in local government lending provided by the financial institutions and is the second-largest lender after Kommunalbanken. However, Eksportfinans has announced that, going forward, it wishes to concentrate on export lending and is considering selling its local government lending business.

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 large proportion of 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. In 2008, local government lending has been reduced, and an increasing proportion of Eksportfinans's net interest income is derived from export-related credits - 61% in the first nine months of 2008 (53% in 2007, 78% in 2006). Therefore, a sale of Kommunekreditt would affect our assessment of earnings stability. In addition, the large liquidity portfolio has caused volatility in earnings although it has been mitigated by the portfolio hedge agreement.

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. 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. The other owners are 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 whom represent the owner banks (the three largest owner banks, DnB NOR, Nordea and Danske Bank, are represented). We do not have concerns about Eksportfinans's corporate governance. The institution faces no "key-man" risk, although we note that the CEO has been in position for a relatively short period of time.

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 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. Credit risk exposure to financial institutions is limited to the A3 rating and to entities in the EU or OECD. In addition, Eksportfinans has some exposure to banks that are not internationally rated - mainly Norwegian. As regards local government lending, the Norwegian municipalities display solid financials. Ship-related loans represent the largest concentration, accounting for over 20% of the loan portfolio. This exposure more than doubled in 2007 and has continued to grow in 2008, reflecting the 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 the libor interest rate. In general, the swaps transform market risk to liquidity risk since about 60% of structured 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 past 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. 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 33% of total assets as of end-September 2008. 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. The portfolio consists of senior financials (60%) with an average rating of A1 and asset-backed securities (40%) 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 "old" 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 of up to NOK5 billion (as of 30 September 2008, 37% was 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 made new investments mainly 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 emphasis on the liquidity of the liquidity reserve portfolio which should provide buffer in an 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 also had access to the market despite global market turmoil, although we note the significantly higher price of funding in absolute terms, lower transaction volumes and no benchmark deals in the second half of 2008.

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. Regarding the time horizon, we believe that the past-five-years standard deviation is the best indicator due to the material changes in economic policies after the crisis of the early 1990s. We note that, at present, the operating environment has become more challenging due to the economic slowdown.

Profitability

Trend: Weakening

In common with specialised lenders, Eksportfinans has thin profitability due to low margin lending. Its net interest margin on average earning assets decreased to 0.31% in 2007 from 0.46% in 2003, but improved in the first nine months of 2008 to 0.37%, reflecting mainly income from higher equity. Volume growth has partly compensated for the narrow margins - the loan portfolio increased by 26% in 2007, which was mainly related to strong demand from municipalities, shipping and the oil & gas industries.

However, in the first nine months of 2008, loan growth slowed to 6%. In the local government sector, Eksportfinans has been raising margins due to higher funding costs, which has led to a 10% decrease in Kommunekreditt's loan book so far in 2008. At the same time, export lending has increased by 26%. 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, and therefore Eksportfinans is looking for a solution to sell Kommunekreditt. 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.

Even though the lending activities of Eksportfinans have developed favourably and net interest income has been increasing, its income statement showed a loss for January-September 2008. This was mainly a result of a decline in the fair value of exposure to Icelandic banks in Q3. The net result was also negative for 2007 due to the weak performance of the liquidity portfolio, resulting in large unrealised losses. We note that 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 of up to NOK5 billion.

In Moody's opinion, Eksportfinans's profitability could remain under pressure due to the higher funding costs. We note the agreement with the government that is to provide funding for export projects for a two-year period in market terms.

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 90% of senior debt at end-November 2008. Long-term bonds can be issued under euro-, US- or Australian medium-term note 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 include plain vanilla and structured issues, which are popular especially among Japanese investors. Structured issues have increased faster than plain vanilla issues during 2008. We note that about 60% of structured funding has features (call options or triggers) that might shorten the maturity of these issues and could affect liquidity. For short-term funding, Eksportfinans has in place USCP and ECP programmes, both amounting to US$6 billion.

In 2008, Eksportfinans has issued three benchmark bonds in euros and Swiss francs. We also note that, the USCP/ECP portfolio is smaller than earlier in the year.

Eksportfinans has a large securities portfolio, representing 33% of total assets and including highly rated securities. Regarding the liquidity portfolio under the portfolio hedge agreement, 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 more 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, 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 US$5 billion.

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 being less than two months.

Capital Adequacy

Trend: Neutral

Due to significant mark-to-market losses in the securities portfolio in H2 2007, the capital adequacy of Eksportfinans came under pressure and as a result the Tier 1 ratio dropped to 6.3% at year-end 2007 compared with 8.3% at year-end 2006 and 9.9% at year-end 2005. In order to strengthen the capital base, the shareholders agreed on a capital injection of NOK1.2 billion, which was paid in March 2008.

The portfolio hedge agreement should limit deterioration in capital adequacy, but we note that the negative result and the increase in lending put some pressure on the capital in Q3 2008. The Tier 1 ratio was 7.4% at end-September 2008. Eksportfinans's target is to keep the Tier 1 ratio at around 8%. 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's cost efficiency has been relatively good over the years although relatively low compared with that of some other specialised lenders in the region. Operating costs in relation to assets were 0.08% in January-September 2008 compared with 0.10% in 2007 and 0.11% in 2006. 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 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 never experienced loan losses. At end-September 2008, problem loans (interest and principal and not matured principal on loans over 90 days past due) 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.

However, in Q3 2008 Eksportfinans reported provisions regarding an Icelandic bank which had acted as an agent and guarantor for several loans due to a breach of its obligations. Some further provisions on this exposure could be expected in Q4 2008.

As regards the credit exposure, 50% of the loan portfolio was to local governments, 8% was to the central government, 30% was to Norwegian bank guarantors and 12% was to international bank guarantors at end-2007.

The loan book grew by 6% in January-September 2008 and amounted to over NOK130 billion at the end of the period. The growth has been driven by the booming maritime industry and the oil & gas sector. Lending to the local government sector has, however, decreased, reflecting the repricing of about 70% of the portfolio. Disbursements under the government-supported scheme for export lending have increased significantly due to favourable terms (fixed CIRR interest rate).

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