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Research Update:

Bank of North Dakota 'AA-/A-1+' Ratings Affirmed Despite Lower Stand-Alone Credit Profile; Outlook Remains Stable

Primary Credit Analyst:

Raphael A Hunter, Centennial (1) 347-346-3445; raphael.hunter@standardandpoors.com

Secondary Contact:

Devi Aurora, New York (1) 212-438-3055; devi.aurora@standardandpoors.com

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Overview

- We view Bank of North Dakota (BND)'s direct and indirect energy exposures (including commitments) as fairly significant at 9% and 18% of total loans, respectively, as of June 30, 2015. We believe a sustained period of low oil and natural gas prices could create revenue instability and asset quality deterioration.
- As a result, we are lowering our stand-alone credit profile (SACP) on BND, the only state-owned bank in the U.S., to 'a' from 'a+'.
- We are affirming our long- and short-term issuer credit ratings on the bank at 'AA-/A-1+' and our deposit rating of 'AA+', reflecting our expectation of extraordinary state support, in line with the application of our criteria for government-related entities (GREs).
- The stable rating outlook reflects our view that BND's link to the state of North Dakota supports our issuer credit and deposit ratings on the company, and, therefore, even an additional one-notch reduction of the bank's SACP would not affect these ratings.

Rating Action

On Sept. 22, 2015, Standard & Poor's Ratings Services affirmed its 'AA-/A-1+' issuer credit ratings on the Bank of North Dakota and its 'AA+' deposit rating. The rating outlook remains stable.

At the same time, we lowered the company's SACP to 'a' from 'a+'.

Rationale

Standard & Poor's Ratings Services' ratings on BND reflect the state of North Dakota's ownership of the bank. As a state-run financial institution, the bank's charter enables it to participate in activities that broadly promote commerce, agriculture, and industry in North Dakota. We assess the likelihood of extraordinary support from the state to the bank as "high," based on our assessment of a "very strong" link and "important" role for the bank, as defined in our GRE criteria. The 'AA-' rating on the bank includes two notches of uplift from the company's 'a' SACP, based on our expectation the bank would receive extraordinary support from the state, should it come under stress.

We revised the bank's SACP to 'a' from 'a+' because we believe the weaknesses in the energy sector could hurt the bank's operating conditions (concentrated in North Dakota) and BND's revenue stability over the next few years, particularly if oil prices were to remain low for a prolonged period of time. As of June 30, 2015, BND's direct and indirect exposures to energy were fairly sizeable at 9% and 18% of total loans, respectively, including commitments. Although asset quality metrics remain satisfactory for the bank, we expect profitability and growth expectations will weaken among many companies in the commodities sector to which the bank has exposure. Furthermore, even beyond the current decline in oil prices, we believe the lower SACP more accurately captures BND's exposure to the inherent volatility of commodities prices because of the company's attachment to the North Dakota economy. As a result, we have lowered the business position score to "adequate" from "strong" (as our criteria define the terms). As of June 30, 2015, the bank's \$4.1 billion loan book included commercial loans (41% of total loans), student loans (31%), residential loans (16%), and farm loans (12%).

We assess BND's capital and earnings as "very strong" based on the bank's moderate-risk assets and good earnings performance. Standard & Poor's risk-adjusted capital (RAC) ratio was at a high 18.1% as of March 31, 2015. About 44% of the loan portfolio (mainly student loans and residential loans) benefitted from full or partial state and federal guarantees as of June 30, 2015. Our assessment factors in our view that the 2015-2017 biennium for North Dakota has the potential to reduce BND's capital up to \$158 million as the bank may be required by the state to fund a number of infrastructure- and community-related projects. Despite the expected capital reduction, we expect the bank's capital position (as measured by our proprietary RAC ratio) to remain very strong (above the 15% threshold) over the next two years.

We assess BND's risk position as "adequate." Credit quality metrics have remained satisfactory to date, with nonperforming assets, including those 90 days past due, of 1.75% as of June 30, 2015, and the company posted net recoveries of 0.25% of average loans. Following rapid growth in prior years, the bank has reduced the size of its securities book, which lowers potential market risk, in our view. The investment portfolio represented about 34% of total assets in the first half of 2015, down from 42% the prior year. We note that management concentrates this portfolio on very high quality securities, with an average life of approximately 3.1 years and an average maturity of five years.

We now assess the bank's funding profile as above average and its liquidity as adequate. State law requires that all state funds and funds of state institutions deposit with BND. We recognize the stickiness of the state-sourced captive deposits, and consider them as "core" to the bank. As of June 30, 2015, the bank's funding composition consisted of captive certificates of deposit (CDs; 66%), money market deposit accounts and negotiable order of withdrawal accounts (17%), noninterest-bearing deposits (7%), federal funds purchased (1%), Federal Home Loan Bank advances (8%), and noncaptive CDs (1%). The loan-to-deposit ratio was at a low 62%. Key

indicators of liquidity--such as broad liquid assets to wholesale funding--are at very comfortable levels.

The 'AA+' rating on the bank's deposits include four notches of uplift from the SACP and reflects our assessment that the likelihood of support for the bank's deposits--which the state explicitly backs--to be "extremely high," as characterized by a "very strong" link between the state and the bank's deposits and the "critical" role the deposits play, as defined in our GRE criteria. We believe the deposits' role is critical because, in our view, the bank provides services that a private entity could not readily undertake. Because the law requires all monies of the state and state institutions to be deposited with BND, any changes to this arrangement would necessitate a change in the state legislative code.

Outlook

The stable outlook reflects Standard & Poor's Ratings Services' view that the link between the bank and the current ratings of the state of North Dakota support the issuer credit and deposit ratings on BND, and our expectation that, given these linkages, a one-notch reduction in the SACP would not affect these ratings. We could lower the SACP if the state's economy weakens more than we expect, if capital appropriations by the state increased significantly--enough to impair BND's capital profile such that the RAC ratio remains below the 15% threshold on a consistent basis--or if the bank's asset quality deteriorates significantly.

We could lower the ratings on the bank and the bank's deposits if we lowered the rating on the state. We could also lower the ratings on the bank if we lowered the SACP by more than one notch.

Ratings Score Snapshot

Issuer Credit Rating	AA-/Stable/A-1+
SACP	a
Anchor	bbb+
Business Position	Adequate (0)
Capital and Earnings	Very strong (+2)
Risk Position	Adequate (0)
Funding and Liquidity	Above average and adequate (0)
Support	+2
GRE Support	+2
Group Support	0
Sovereign Support	0

Additional Factors 0

Related Criteria And Research

Related Criteria

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Group Rating Methodology, Nov. 19, 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

Ratings List

Ratings Affirmed

Bank of North Dakota	
Issuer Credit Rating	AA-/Stable/A-1+
Certificate Of Deposit	AA+

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