STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Bank of North Dakota

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Bank of North Dakota

SACP	a+		
Anchor	bbb+		
Business Position	Strong	+1	
Capital and Earnings	Very Strong	+2	
Risk Position	Adequate	0	
Funding	Average	0	
Liquidity	Adequate		

\+

Support	+1
GRE Support	+1
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating
AA-/Stable/A-1+

Major Rating Factors

Strengths:	Weaknesses:
• Ownership by the state of North Dakota, whose robust oil industry supports its strong economy • Robust capital position supported by healthy earnings retention • Captive depositor base that supports funding stability	• Business concentration in North Dakota, with lending exposure to commodities • Rapid growth in the securities portfolio, with higher interest-rate risk if market conditions worsen unexpectedly • Loan growth opportunities in the footprint are constrained relative to deposit growth

Outlook: Stable

The stable rating outlook on Bank of North Dakota (BND), the only state-owned bank in the U.S., reflects Standard & Poor's Ratings Services' expectation that BND will continue to benefit from extraordinary state support, in addition to stand-alone factors underpinning the bank's performance such as North Dakota's strong commodities-driven economy; an excellent capital profile; and an attractive large, captive depositor base that offers a reliable and stable funding source. We could lower the stand-alone credit profile (SACP) if the state's economy weakens, if capital appropriations increase and markedly impair the bank's capital profile, if the bank's asset quality deteriorates significantly in response to growth in nonguaranteed loans, or if adverse market conditions significantly increase the market risk associated with the bank's growing securities portfolio. For example, all else remaining equal, we could lower the SACP if losses or appropriations cause capital to decline such that our risk-adjusted capital (RAC) ratio falls and remains consistently below 15%, and if management fails to judiciously manage asset quality and its securities portfolio. Given our rating on the state of North Dakota, however, the ratings on the bank would only be affected if we lowered the SACP more than two notches. However, we could lower the deposit ratings if we lower the state rating, given the extremely high link between the state and the bank's deposits.

Rationale

Standard & Poor's bases its ratings on BND on the state of North Dakota's ownership of the bank. In our opinion, there is a high likelihood that the state of North Dakota would provide timely and sufficient extraordinary support to BND, if necessary. We assess the likelihood of support from the state as high, based on a "very strong" link and "important" role for the bank. The 'AA-' rating on the bank includes one notch of uplift from the company's 'a+' SACP, based on our expectation the bank would receive support from the state and the application of our criteria for government-related entities (GREs). In our assessment of BND's SACP, we factor in the bank's "strong" (as our criteria describe it) business position, which North Dakota's strong economy underpins, and its robust capital position. Factors constraining the rating include the bank's geographic concentration in North Dakota with its exposure to the energy and agriculture industries, its vulnerability to higher interest-rate risk on account of its sizable and growing securities portfolio, and its limited capital flexibility based on the potential for changes in appropriations.

The 'AA+' rating on the bank's deposits include three notches of uplift from the SACP and reflects our assessment that the likelihood of support for the bank's deposits--which are explicitly backed by the state--to be "extremely high," considering 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. Specifically, because the law requires all monies of the state and state institutions must be deposited with BND, any changes to this arrangement would necessitate a change in the state legislative code. We therefore believe defaulting on the deposits would have a critical impact for the government for the following reasons:

- All deposits benefit from guarantees issued by the State of North Dakota as specified in the state legislative code governing the bank. By contrast, this preferential status does not explicitly extend to other obligations of the bank.
- Because the law requires all monies of the state and state institutions must be deposited with BND, in our view,

these guarantees served a central purpose of maintaining trust and financial market stability, and avoiding reputational risks. Also, a default on these state-guaranteed deposits has never happened in the bank's nearly 100-year old history.

- Given the state's ownership, material ties to, and oversight over BND, exploiting the wording of the respective laws and not honoring the deposit guarantees in a timely fashion would create significant reputational risk for the state and its own standing in the markets.

Anchor: Reflects economic and banking industry risk in the U.S.

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores to determine a bank's anchor SACP, the starting point in assigning an issuer credit rating. Our anchor SACP for a bank operating only in the U.S. is 'bbb+', based on an economic risk score of '3' and an industry risk score of '4'.

We view the U.S. as a diversified high-income economy, with an adaptable and resilient economic structure. We believe that the risk for economic imbalances has ebbed as the deleveraging in the U.S. is now complete. We expect house prices to increase and lending to the private sector to increase after four years of losing ground, indicating a gradual shift to the expansion phase of the credit cycle. On the other hand, we think that in the future, credit risks in the economy could increase because as interest rates remain low for a prolonged period and the burden of legacy losses eases, we anticipate banks may play a more active role in funding corporate loans. Corporations' strong appetite for leverage and a growing propensity for shareholder-friendly actions could become an incremental source of credit risk for banks over the next three to five years. We view the economic risk trend for the U.S. banking sector as stable.

With regard to industry risk, we view the regulatory reform agenda for U.S. banks as broad and substantive, beginning with the Dodd-Frank Wall Street Reform and Consumer Protection Act's passage in 2010. In addition, we believe U.S. regulators, led by the Federal Reserve, are at the forefront globally in championing several key initiatives, such as comprehensive annual stress tests and resolution planning for systemically important financial institutions. We believe the competitive environment for banks continues to evolve in response to these regulatory changes. We view funding risk favorably because U.S. banks typically benefit from a high and stable share of core deposits and exceptionally deep capital markets. We view the trend for industry risk as positive. We expect that with U.S. regulators' more stringent focus on qualitative factors (such as risk management and governance) in stress tests, banks could lower their risk appetite over time.

Table 1

Bank of North Dakota Key Figures						
		--Year ended Dec. 31--				
(Mil. $)	**2014***	**2013**	**2012**	**2011**	**2010**	**2009**
Adjusted assets	7,446.4	6,869.6	6,155.2	5,375.1	4,029.9	3,959.7
Customer loans (gross)	3,618.1	3,476.9	3,278.5	2,995.2	2,814.5	2,713.6
Adjusted common equity	599.5	551.7	446.8	394.2	326.7	270.0
Operating revenues	72.7	130.4	106.2	102.8	94.3	87.5
Noninterest expenses	15.2	36.2	22.6	21.5	20.4	19.1
Core earnings	57.5	94.2	81.6	70.3	61.9	58.1

*Data as of June 30.

Business position: Strong and unique, bolstered by conservative management strategy

We view BND's business position as unique and strong, and underpinned by its primary role in financing economic development in North Dakota. The bank, which is headquartered in Bismarck, was created in 1919 because of a dearth of lenders in the state willing to support local businessmen and farmers. BND had total assets of $7.45 billion as of June 30, 2014, a 12% increase over last year, mainly reflecting a tide of economic prosperity in the state, which has generated record growth in deposit balances. The bank's deposits are not federally insured by the Federal Deposit Insurance Corp. (FDIC), and although it enjoys access to the Federal Reserve's deposit window, it has no oversight from U.S. government authorities or banking regulatory bodies.

The bank has only one office and acts as the agent of several state-legislated programs, a lender, a depository for state agency funds, and a correspondent bank to private financial institutions in the state. We believe these roles and functions support our view of BND's very strong link to the state's government. In light of a strong economy, some lenders in North Dakota have been easing terms and increasing loan amortization periods. Other banks have been buying back loans with excess liquidity, creating less room for participations with BND. Competition has also increased with insurance companies looking to buy long-dated assets. However, we view BND's management strategy as conservative and supportive of the bank's business goals as well as the larger North Dakota community.

The bank continues to demonstrate its importance to the state. The state has had an influx of residents because of abundant employment opportunities, which has also strained the infrastructure of western and north central North Dakota. BND has helped the state fulfill its resolution to assist with financing to improve the state's infrastructure and has also established various lending programs in extraordinary times. Additionally, BND has started working with subdivisions that are seeing oil growth to fund infrastructure and housing in the state. Since 2008, oil has boosted the state's growth and is largely responsible for the state's extraordinarily low unemployment rate of 2.8% as of July 2014, which is the lowest across all states and significantly outperforms the national average of 6.2%. North Dakota's oil industry is growing rapidly, and the state is now the nation's second-biggest oil producer, after Texas.

Table 2

Bank of North Dakota Business Position Ratios

		--Year ended Dec. 31--				
(%)	**2014***	**2013**	**2012**	**2011**	**2010**	**2009**
Deposit market share in country of domicile	N/A	N/A	N/A	0.0	N/A	N/A
Total revenues from business line (mil. $)	72.7	130.4	106.2	102.8	94.3	87.5
Commercial and retail banking/total revenues from business line	97.8	98.8	100.9	100.2	98.3	98.0
Trading and sales income/total revenues from business line	0.0	0.0	0.0	0.0	0.0	0.0
Corporate finance/total revenues from business line	0.6	(0.2)	(2.8)	(1.6)	0.1	0.2
Agency services/total revenues from business line	0.1	0.2	0.2	0.2	0.2	0.2
Payments and settlements/total revenues from business line	1.5	1.1	1.7	1.1	1.4	1.6
Investment banking/total revenues from business line	0.6	(0.0)	(2.8)	(1.6)	0.1	0.2
Return on equity	19.8	18.6	18.9	19.3	20.7	23.4

*Data as of June 30. N/A--Not applicable.

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Capital and earnings: Very strong capital ratio and high core earnings generation

We assess BND's capital and earnings as very strong, which reflects its moderate-risk asset mix (which benefits from government guarantees on some key portfolios) and an earnings performance that is higher than peers'. These strengths are reflected in Standard & Poor's RAC ratio, which was 15.2% as of June 30, 2014, and which we expect will remain above the 15% threshold over the next two years.

Because it is an arm of the state, we see some natural constraints on BND's capital flexibility, but we do not expect this to compromise the bank's capital strength in the near term. As a state-owned entity, the bank routinely pays a large appropriation to the state's general fund, which could limit capital generation. However, because of the state's strong financial performance, BND has not been required to pay large assessments of its earnings to the state's general fund since 2010. Its appropriations to the general fund amounted to about 16% of profits in 2014 as of August. In lieu of paying legislative assessments, the bank has made investments in infrastructure in political subdivisions that are experiencing large population growth.

The bank's regulatory capital ratios easily exceed the minimum requirements for a well-capitalized bank, with its Tier 1 risk-based capital ratio at 18.32% as of June 30, 2014. Its Tier 1 capital ratio remains above the current self-imposed benchmark of 8%, which the bank plans to raise to 8.5% by 2015. The quality of capital is strong, consisting mainly of retained earnings and common equity.

BND's earnings are strong, in our view, and support the bank's robust capital profile despite challenges from margin compression, which reflects growth and low-risk orientation in the bank's securities portfolio. The bank earned $57.5 million in the first half of 2014, a 34% increase from last year. We expect profits to increase because of the bank's strong and growing low-cost deposit base, extremely low operating costs, and North Dakota's strong economy. Our RAC ratio forecast conservatively factors in higher appropriations for the next two years and slower core earnings growth because of an uptick in credit provisions.

The bank is tax exempt and does not pay any deposit insurance premiums. With one office, it also does not have the overhead of a large branch network in deposit taking. As a result, BND's efficiency ratio was a peer-leading 17% as of March 31, 2014, and a fraction of the 61% average for all FDIC-covered banks. Because of its business and its captive customer base, BND's net interest income makes up the majority of its revenues, with noninterest income accounting for only 6% of revenues during the first half of 2014. We expect that the bank's low-risk balance sheet and the strength of the state's economy will generate sufficient profitability to support the bank's capital requirements over the medium term.

Table 3

Bank of North Dakota Capital And Earnings Ratios

		--Year ended Dec. 31--				
(%)	**2014***	**2013**	**2012**	**2011**	**2010**	**2009**
Tier 1 capital ratio	18.3	18.3	17.0	17.7	17.1	12.9
Standard & Poor's RAC ratio before diversification	N.M.	15.0	N.M.	5.7	N.M.	N.M.
Standard & Poor's RAC ratio after diversification	N.M.	12.6	N.M.	4.9	N.M.	N.M.
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	94.1	94.2	95.5	95.2	93.5	92.9

Table 3

Bank of North Dakota Capital And Earnings Ratios (cont.)						
Fee income/operating revenues	2.2	2.1	3.0	2.4	2.7	3.2
Market-sensitive income/operating revenues	0.6	0.2	(2.7)	(1.6)	0.0	0.1
Noninterest expenses/operating revenues	20.9	27.7	21.3	20.9	21.6	21.8
Preprovision operating income/average assets	1.6	1.5	1.5	1.7	1.9	1.8
Core earnings/average managed assets	1.6	1.5	1.4	1.5	1.6	1.6

*Data as of June 30. N.M.--Not meaningful.

Risk position: Adequate, with some structural constraints and potential emerging vulnerabilities

We assess BND's risk position as adequate. The fast pace of growth in the bank's securities book, which accelerated to 45% of total assets in the first half of 2014 from 15% in 2010 has raised the potential market risk exposure, in our view. In June, the bank executed its first interest-rate swap with Wells Fargo, and we expect a growing need for hedging and derivatives to provide an offset to interest-rate risk in the securities portfolio. Agency securities and mortgage-backed securities (MBS) represent nearly 65% and 35%, respectively, of the total securities portfolio. We note that management concentrates this book on very high quality securities, with an average life of about three years and average maturity of 4.76 years.

The bank supports its business goals and works with state agencies and private banks to promote its charter objectives. Despite its concentration in one state, BND maintains very strong asset quality. Because of agriculture's significant contribution to the state's economy, many loans, regardless of type, are also indirectly related to the agricultural sector.

Management continues to maintain its judicious credit standards and processes, even under strong local economic conditions. BND has a strong underwriting process and lends largely to entities that are regulated by the state or the federal government, and that meet its compliance criteria for the program. The $3.6 billion loan portfolio consists of commercial (38% of total portfolio), student loans (32%), residential (18%), farm (10%), and state institution loans (3%). As of March 31, 2014, 47% of the total loan portfolio was either fully or partially guaranteed, compared with 48% last year. The majority of student loans (98%) and residential loans (79%) are guaranteed. Further, the bank has started originating loans to residential borrowers in small communities and introduced a DEAL One student loan program for the residents of North Dakota with a view to fuel loan growth.

The company's credit quality was strong, with nonperforming assets, including those 90 days past due, declining to 1.82% as of June 30, 2014, from 2.59% at the end of 2013. The actual exposure to risk is somewhat mitigated because of the high percentage of guaranteed loans in the student-loan and residential portfolios. The company's annualized charge-off ratio was a low 0.02% as of June 30, 2014, unchanged from its 2013 year-end rate, but it has been declining steadily since its peak in 2010. In March 2014, restructured loans decreased to 1.22% from March 31, 2013, when it was 1.49% and the biggest exposures were generated by the commercial loan portfolio, which largely does not benefit from guarantees. Due to the underperformance of a couple of large loans, BND's nonaccruals have increased to near state average levels in recent years of 0.42%. Notably, BND's total allowance as a percentage of total loans is 1.46%, higher than the state average of 1.33% as of March 31, 2014, and 2.74% as a percentage of nonguaranteed loans. Though it did not take any provisions during the first two quarters, we expect provisions to increase through the second half of 2014, mainly reflecting the increased exposure to nonguaranteed commercial loans.

Table 4

Bank of North Dakota Risk Position Ratios						
		--Year ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010	2009
Growth in customer loans	8.1	6.1	9.5	6.4	3.7	3.6
Total diversification adjustment / Standard & Poor's RWA before diversification	N.M.	19.1	N.M.	15.78	N.M.	N.M.
Total managed assets/adjusted common equity (x)	12.4	12.5	13.8	13.6	12.3	14.7
New loan loss provisions/average customer loans	N.M.	N.M.	0.1	0.4	0.4	0.4
Net charge-offs/average customer loans	0.0	0.0	0.1	0.2	0.3	0.2
Gross nonperforming assets/customer loans plus other real estate owned	1.8	2.6	3.5	3.0	2.3	2.0
Loan loss reserves/gross nonperforming assets	78.2	57.5	45.3	58.3	71.2	78.8

*Data as of June 30. N.M.--Not meaningful.

Funding and liquidity: Average and adequate, with a unique depositor base

We consider the bank's funding as average and its liquidity as adequate. As the only state-owned bank in the nation, BND's funding is distinct from other commercial banks. State law requires that all state funds and funds of state institutions deposit with BND. Given the stickiness of the state-sourced captive deposits, we consider them as "core" to the bank. As of March 31, 2014, we estimated core deposits accounted for nearly 74% of total deposits. The total loan-to-deposit ratio was 58%, down from 60% in the year-ago period. Other key measures of funding that measure reliance on short-term wholesale funding are much lower than peers, whereas BND's stable funding ratio is much higher than peers.

The bank regularly conducts liquidity tests, and its sources of liquidity exceed the uses. Key indicators of liquidity--such as broad liquid assets to wholesale funding--are comfortably higher than peers, offsetting the constraints on its ability to identify the full range and size of its contingent liabilities. The bank retains access to additional funding from the Federal Home Loan Bank of Des Moines, and it can borrow from the Federal Reserve discount window. The bank can also enter into a repurchase agreement using the securities in its $3.1 billion available-for-sale investment portfolio as collateral, which are mostly government agency securities.

Table 5

Bank of North Dakota Funding And Liquidity Ratios						
		--Year ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010	2009
Core deposits/funding base	90.8	88.7	88.0	84.1	82.7	79.8
Customer loans (net)/customer deposits	57.5	61.2	64.5	70.4	90.5	90.9
Long term funding ratio	96.1	94.2	95.5	94.1	93.7	91.0
Short-term wholesale funding/funding base	4.2	6.4	4.9	6.4	6.9	9.6
Short-term wholesale funding/total wholesale funding	45.7	56.4	40.5	40.3	39.8	47.7

*Data as of June 30.

Support: One notch of uplift for the issuer credit rating and three notches for the bank's deposits

Based on our criteria for GREs, we incorporate one notch of uplift into our issuer credit ratings on BND to reflect our view that it's highly likely that North Dakota would provide timely and sufficient extraordinary support to BND, if necessary. We base this view on BND's important role in promoting the state's economic development and its very strong link to the state's government.

Our ratings on the deposits of the Bank of North Dakota--which we rate 'AA+'--factor in our assessment that the likelihood of support from the state for these obligations would be extremely high, which is higher than the likelihood of support we ascribe to the bank's senior unsecured obligations. Such a view is predicated on the guarantee the state has on the bank's deposits but not on the bank's other obligations. We attach a very strong link and critical role to the bank's deposits, which supports its primary role in financing economic development in North Dakota.

Additional rating factors: None

No additional factors affect the ratings.

Related Criteria And Research

Related Criteria

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Sept. 18, 2014
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	**3**	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	**bbb+**	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of October 2, 2014)	
Bank of North Dakota	
Counterparty Credit Rating	AA-/Stable/A-1+

Ratings Detail (As Of October 2, 2014) (cont.)	
Certificate Of Deposit	
Local Currency	AA+/A-1+
Counterparty Credit Ratings History	
06-Dec-2011	AA-/Stable/A-1+
30-Jul-2009	A+/Stable/A-1
08-Jun-2009	A/Stable/A-1
Sovereign Rating	
United States of America (Unsolicited Ratings)	AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.