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Ratings

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Bank of North Dakota

Primary Credit Analyst:
Erik M Oja, New York 212-438-4314; Erik.Oja@spglobal.com

Secondary Contact:
Nikola G Swann, CFA, FRM, Toronto (1) 416-507-2582; nikola.swann@spglobal.com

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Bank of North Dakota

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

\+

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

\+

Additional Factors	0

Issuer Credit Rating

A+/Stable/A-1

Major Rating Factors

Strengths:	Weaknesses:
• Ownership by the state of North Dakota since 1919 • Robust and stable capital ratios • High loan credit quality and low net chargeoffs	• Geographic concentration in North Dakota • Lending exposure to the energy and agriculture industries • Subject to annual capital appropriation by the state

Outlook: Stable

The stable rating outlook on Bank of North Dakota (BND) reflects S&P Global Ratings' view that the entity's policy role and the link between the bank and the state of North Dakota supports the issuer credit and deposit ratings on BND. Given this relationship, even if we were to lower our stand-alone assessment of the bank by one or even two notches, the issuer credit rating and deposit ratings would remain unchanged.

We could lower the stand-alone credit profile (SACP) in the coming two years if the bank's asset quality deteriorates meaningfully, if the state's economy significantly weakens, or if capital appropriations by the state increase enough to impair BND's capital profile such that the risk-adjusted capital (RAC) ratio drops below 15.0%, from the current 19.8%. We are unlikely to raise the SACP in the near term given the cyclicality of the state's revenue and the interdependence between the state and BND.

We would lower the ratings on the bank's deposits in the next two years if we lowered the rating on the state by one notch, and we would lower the issuer credit ratings if we downgrade the state by more than two notches.

Rationale

The ratings incorporate BND's status as a state-owned financial institution that actively participates in activities that promote commerce, agriculture, and industry in North Dakota. The state government and all state agencies must by law deposit all funds with BND. We do not expect the state to change BND's special status under state law in the foreseeable future. However, BND's geographic concentration in North Dakota, low market share, and its sizeable exposure to the volatile energy and agricultural industries constrain the rating.

We assess the likelihood of extraordinary support from the state to the bank as high, based on our assessment of a very strong link between BND and the state, and an important role to the state for the bank, as defined in our government-related entity (GRE) criteria. The 'A+' rating on the bank includes one notch of uplift from the company's 'a' SACP, based on our assessment of the likelihood that the bank would receive extraordinary support from the state, should it come under stress.

The 'AA' rating on the bank's deposits--which the state explicitly backs--includes three notches of uplift from the SACP. We assess the likelihood of extraordinary support on deposits to be extremely high based on a very strong link between the state and the bank's deposits and the critical role the deposits play for the state.

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

Our criteria use the Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores to determine a bank's anchor SACP, the starting point for an issuer credit rating.

Our anchor for a bank operating mainly in the U.S. is 'bbb+', based on an economic risk score of '3' and an industry risk score of '3'. We view the trends for both economic risk and industry risk as stable. The U.S.'s diversified, high-income, and resilient economy underpins our assessment of economic risk. However, lending areas that have grown quickly in recent years--such as auto and corporate lending--represent potential risks. Our view of industry risk in the U.S. balances the regulatory enhancements made since the financial crisis, its high levels of core deposits, and deep capital markets against the risks and competition that come with the country's large nonbank financial system.

Table 1

Bank of North Dakota Key Figures

		--Year ended Dec. 31--			
(Mil. $)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	6,912.4	7,295.3	7,407.9	7,215.7	6,869.6
Customer loans (gross)	4,863.6	4,789.6	4,339.6	3,852.2	3,476.9
Adjusted common equity	824.9	863.5	747.3	645.3	551.7
Operating revenues	94.5	182.7	169.8	151.1	130.4
Noninterest expenses	14.2	30.6	26.7	32.2	36.2
Core earnings	77.3	136.2	130.7	111.0	94.2

*Data as of June 30.

Business position: Unique relationship to the state and conservative management strategy

Our view of BND's business position reflects its long and stable history in North Dakota, a state we rate a relatively high 'AA+'; a growing labor force; and government spending controls that we view as effective. Negatives include concentration in one state, significant lending exposure to energy and agriculture in North Dakota, and low (3%) revenue contribution from fee income.

BND has a unique profile, 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 perceived shortage of lenders in the state willing to support local businessmen and farmers. BND has grown rapidly and had just over $6.9 billion in total assets as of June 30, 2017. Deposits were $4.8 billion, well above the second-largest depository bank operating in North Dakota, which had $2.3 billion of deposits in the state. BND's deposits are not insured by the Federal Deposit Insurance Corp. (FDIC), and it has no oversight from U.S. government authorities or banking regulatory bodies. The bank, however, has access to the Federal Reserve's deposit window.

The bank 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. 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 state of North Dakota's reliance on the energy and agriculture sectors has caused state general fund revenues to decline since peaking in 2013-2015. Annual tax revenues for the state have fallen since peaking in 2014, negatively affected by lower sales tax, oil tax, and income tax collections. This, in turn, has led to lower deposits at BND, down to $4.8 billion at June 30, from a peak of $5.8 billion at the end of 2015. Loan growth, too, has been affected, with growth falling from 12.6% in 2015, to 1.5% in the first half of 2017.

Table 2

Bank of North Dakota Business Position					
		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Loan market share in country of domicile	N/A	N/A	N/A	N/A	N/A
Deposit market share in country of domicile	N/A	N/A	N/A	N/A	N/A
Total revenues from business line (currency in millions)	94.5	182.7	169.8	151.1	130.4
Commercial & retail banking/total revenues from business line	98.7	99.1	98.8	98.3	98.8
Trading and sales income/total revenues from business line	0.0	0.0	0.0	0.0	0.0
Corporate finance/total revenues from business line	0.1	0.0	0.2	0.4	(0.0)
Brokerage/total revenues from business line	0.0	0.0	0.0	0.0	0.0
Insurance activities/total revenues from business line	0.0	0.0	0.0	0.0	0.0
Agency services/total revenues from business line	0.1	0.1	0.1	0.1	0.1
Asset management/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Other revenues/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Investment banking/total revenues from business line	0.1	0.0	0.2	0.4	(0.0)
Return on equity	18.1	16.8	18.6	18.4	18.6

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

Capital and earnings: Very strong capital ratios and good core earnings generation

We assess BND's capital and earnings as very strong based on the bank's moderate risk assets and good earnings performance. S&P Global Ratings' RAC ratio was 19.8% as of June 30, 2017. About 42% of the loan portfolio (mainly student loans and residential loans) benefited from full or partial state and federal guarantees as of June 30, 2017. We expect the bank's capital position to remain very strong (above a 15% RAC ratio) in the foreseeable future.

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 meaningfully erode 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. In 2017, the state addressed a revenue shortfall in 2015-2017 through appropriation of $100 million of BND's undivided profits. For 2017-2019, the state has budgeted an appropriation of BND's accumulated profits up to $140 million. In addition, the state appropriated up to an additional $31 million during 2017-2019 to fund various "buydown" loan programs.

Despite these potential capital reductions, we expect the bank's capital ratio to remain well above the 15% threshold required for a very strong capital and earnings assessment.

We also see earnings trends positively contributing to BND's very strong capital and earnings. Despite challenges from a relatively low net interest margin of 2.70% as of June 30, 2017, BND earned $77.3 million in the first half of 2017, a 4.1% increase from the prior-year period. This was driven by good loan growth. Because of its unique business model, BND's net interest income makes up about 97% of its revenues, with noninterest income accounting for only 3%.

We expect BND's low-cost deposit base, very low operating costs, and good loan growth to bolster profits. The bank is tax exempt and does not pay any deposit insurance premiums. Furthermore, with only one office, it does not have the overhead of a large branch network in deposit-taking.

Table 3

Bank of North Dakota Capital And Earnings

		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Tier 1 capital ratio	19.4	20.1	18.3	17.8	18.3
S&P RAC ratio before diversification	19.8	18.2	19.5	19.0	15.0
S&P RAC ratio after diversification	13.8	13.2	15.5	14.8	12.6
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Double leverage	N.M.	N.M.	N.M.	N.M.	N.M.
Net interest income/operating revenues	96.7	96.7	95.3	94.6	94.2
Fee income/operating revenues	1.7	1.4	1.8	2.0	2.1
Market-sensitive income/operating revenues	0.1	0.1	0.3	0.4	0.2
Noninterest expenses/operating revenues	15.0	16.7	15.7	21.3	27.7
Preprovision operating income/average assets	2.3	2.1	2.0	1.7	1.4
Core earnings/average managed assets	2.2	1.9	1.8	1.6	1.4

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

Risk position: Slower growth, high credit quality, and low historical losses offset risk concentrations in energy and agricultural lending

As a reflection of good economic conditions in the state of North Dakota and partly because of the oil boom, BND grew loans rapidly in 2014 (up 10.8%), 2015 (up 12.6%), and in 2016 (up 10.3%)--much faster than the mid-single-digit growth of loans generated by the U.S. banking industry. Such rapid loan growth poses credit quality risk, as well as operational and other risks. However, loan growth in the first half of 2017 was just 1.5%, reflecting energy and agricultural downturns. In addition, asset growth has been much lower than loan growth. BND's total asset growth peaked at 11.7% in 2013. It slowed to 5.0% in 2014 and 2.7% in 2015 as BND shrank its available-for-sale investment securities portfolio, its other primary investment besides loans held for investment. Assets fell 1.5% in 2016 and have fallen 5.2% so far in 2017. We view the recently lower loan and asset growth rate as contributing to lower risk, which we see as positive for the rating.

As of June 30, loans are about 70% of assets, and cash and securities 30%. This represents a meaningful decrease from the 53%/47% allocation at the end of 2014, a change we view as increasing risk, thus a negative to the rating. Although BND's $4.9 billion loan portfolio appears reasonably well-diversified across business types, with commercial lending consisting of 42% of the total portfolio, student loans 29%, residential real estate 15%, and agricultural loans 14%, there are concentrations. Energy lending, with $280 million of loans at June 30, is equal to nearly 6% of BND's total lending. A quarter of the energy portfolio is in services, a historically volatile type of lending that is most exposed to energy price declines. About 30% of energy lending is focused on energy marketing, production, and refining. The rest of the energy portfolio is oriented on mining, power generation, and ethanol production.

As of June 30, 2017, BND's total oil country exposures to energy were fairly sizeable at 15% of total loans, including commitments. With the drop in oil prices starting in December of 2014, BND saw many oil service-related companies pull out of the Bakken fields, leading to lower rig counts. BND also noted that commercial real estate projects experienced lower rental rates and higher vacancies as laborers left the oil fields. Recent trends have been more positive, with an increase in fracking and higher rig counts over the last few months, which have led to lower rental vacancies. It's unclear how sustainable this is.

In addition, farm loans represent 14% of BND's total loans. The state's agricultural economy has been affected by drought conditions in western North Dakota. As of July 2017, BND has determined that 36% of its total farm loan exposure is in areas classified as having severe or extreme drought conditions. BND has noted that drought conditions have recently eased.

BND has been successful in keeping credit quality of its loans high, contributing to our adequate risk assessment. Nonaccrual loans were a fairly acceptable 0.44% of total loans in the first half of 2017, while loans delinquent greater than 90 days were 1.36%, also fairly good. The student loan portfolio has the highest 90-day delinquency rate, at 3.36%, followed by residential at 1.85%, commercial at 0.51%, and farm at 0.28%. The high degree of guarantees helps maintain credit quality, with 40% of the portfolio either fully or partially guaranteed, mostly by the federal government.

Table 4

Bank of North Dakota Risk Position

	--Year ended Dec. 31--				
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	3.1	10.4	12.7	10.8	6.1
Total diversification adjustment / S&P RWA before diversification	43.3	N/A	25.9	28.5	19.1
Total managed assets/adjusted common equity (x)	8.4	8.4	9.9	11.2	12.5
New loan loss provisions/average customer loans	0.1	0.4	0.3	0.2	N.M.
Net charge-offs/average customer loans	0.1	0.1	0.0	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	2.9	2.6	2.0	2.1	2.6
Loan loss reserves/gross nonperforming assets	57.0	62.4	79.6	71.6	57.5

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

Funding and liquidity: A funding profile driven by cyclical factors and satisfactory liquidity

Historically, the state-sourced captive deposits have been fairly sticky, and we consider them as "core" to the bank. However, the recent tax revenue declines and budget cuts that were mandated to state agencies have caused a loss of deposits for BND. The loan-to-deposit ratio increased to 102% from 88% a year ago (reflecting deposit declines combined with a continuing loan growth). During this period, the stable funding ratio fell to 115% from 127%. We expect these trends to stabilize based on gradual stabilization in the state's economy.

As of June 30, 2017, the bank's funding composition consisted of captive certificates of deposit (CDs; 48%), money market deposit accounts and negotiable order of withdrawal accounts (21%), noninterest-bearing deposits (7%), federal funds purchased (4%), Federal Home Loan Bank advances (18%), and noncaptive CDs (2%).

Key indicators of liquidity were satisfactory as of June 30, 2017. The ratio of broad liquid assets to short-term wholesale funding was 1.9x, and net broad liquid assets constituted 22% of short-term customer deposits. These two liquidity measures have decreased significantly from last year's levels of 2.7x and 36%, respectively, and are now more in line with peers. The company had roughly $1.7 billion of liquid assets, or 26% of total assets. This number includes cash due from banks, federal funds sold, and the securities portfolio. We believe BND has an adequate liquidity contingency plan, which includes Federal Home Loan Bank advances, fed funds borrowings, loan sales, and repurchase agreements. BND has access to the Fed discount window.

Table 5

Bank of North Dakota Funding And Liquidity

		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	77.8	73.6	82.7	87.4	88.7
Customer loans (net)/customer deposits	101.3	99.9	77.6	66.2	61.2
Long term funding ratio	87.0	83.2	91.2	93.6	94.2
Stable funding ratio	114.7	117.0	141.9	157.8	166.7
Short-term wholesale funding/funding base	14.8	19.1	9.8	7.1	6.4
Broad liquid assets/short-term wholesale funding (x)	1.9	1.8	4.2	6.5	7.6
Net broad liquid assets/short-term customer deposits	22.2	25.4	47.2	55.6	59.1
Short-term wholesale funding/total wholesale funding	66.8	72.2	56.6	56.3	56.4

Table 5

Bank of North Dakota Funding And Liquidity (cont.)					
		--Year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Narrow liquid assets/3-month wholesale funding (x)	N/A	N/A	N/A	N/A	N/A

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

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 is highly likely that North Dakota would provide 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.

The rating on the bank's deposits includes three notches of uplift from the SACP and reflects our assessment that the likelihood of extraordinary 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. State 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.

We believe defaulting on the deposits would have a critical impact for the government. Because the law requires all monies of the state and state institutions to be deposited with BND, these guarantees serve a central purpose of maintaining trust and financial market stability, in our view. Also, a default on these state-guaranteed deposits has never happened in the bank's nearly 100-year-old history.

Additional rating factors: None

No additional factors affect the ratings.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

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 November 7, 2017)

Bank of North Dakota	
Counterparty Credit Rating	A+/Stable/A-1
Counterparty Credit Ratings History	
19-Feb-2016	A+/Stable/A-1
06-Dec-2011	AA-/Stable/A-1+
30-Jul-2009	A+/Stable/A-1
Sovereign Rating	
United States of America	AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.