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Bank of North Dakota

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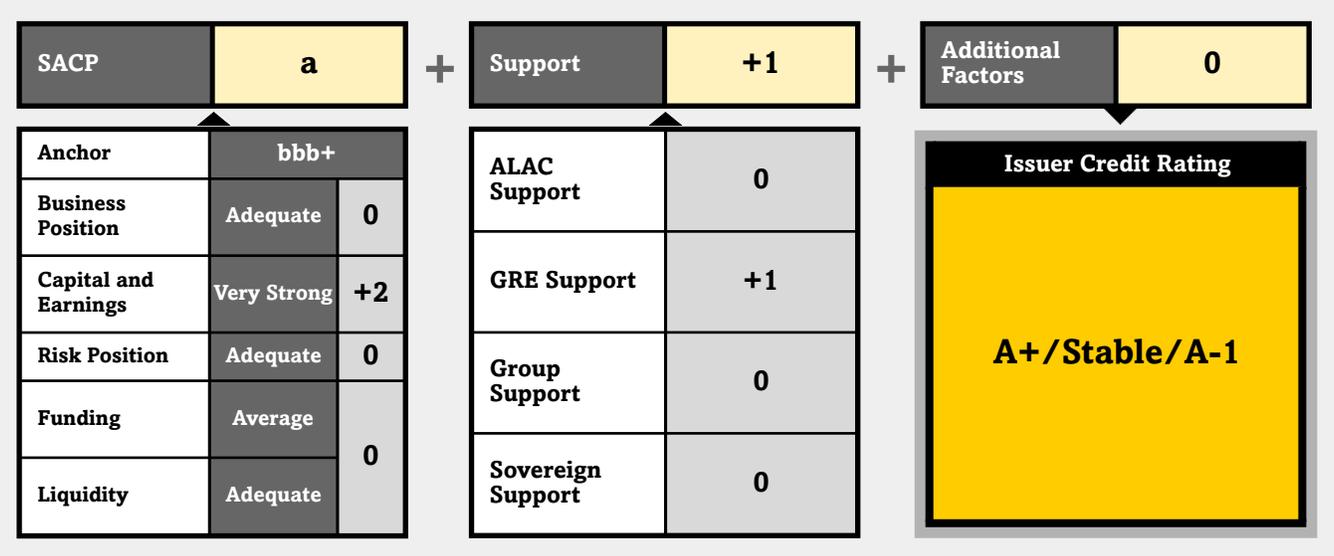
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Bank of North Dakota



Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • Ownership by the state of North Dakota since 1919 • Robust and stable capital ratios • High loan credit quality and conservative management 	<ul style="list-style-type: none"> • Geographic concentration in North Dakota • Direct and indirect lending exposure to energy and agriculture, which can be volatile sectors • 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 support the issuer credit and deposit ratings on BND. Given this relationship, even if we were to lower our stand-alone assessment of BND 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 such that its risk-adjusted capital (RAC) ratio drops below 15.0%. We are unlikely to raise the SACP in the near term given the cyclical nature of the state's revenue and the interdependence between the state and BND.

We would lower the ratings on BND's deposits in the next two years if we lower the rating on the state of North Dakota by one notch from the current 'AA+', and we would lower the issuer credit ratings on BND if we downgrade North Dakota 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. With few exceptions, the state government and all state agencies must, by state 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 sizable 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 a result, the 'A+' rating on the bank includes one notch of uplift from the company's SACP of 'a'.

The 'AA' rating on BND'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 anchor--the starting point for an issuer credit rating--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' (see "Banking Industry Country Risk Assessment: U.S.," published Sept. 25, 2018). We view the trends for both economic risk and industry risk as stable. We expect the economy to grow at roughly 2%-3% through 2020, house prices to rise in the mid-single digits, and banks' asset quality to deteriorate somewhat from the currently very benign conditions. We expect credit losses for the banking sector to equate to roughly 50 basis points in 2018 and then rise moderately in 2019 and 2020. 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. \$)	2018*	2017	2016	2015	2014
Adjusted assets	6,717.2	7,003.3	7,295.3	7,407.9	7,215.7
Customer loans (gross)	4,649.1	4,909.3	4,789.6	4,339.6	3,852.2
Adjusted common equity	877.2	821.8	863.5	747.3	645.3
Operating revenues	99.8	187.1	182.7	169.8	151.1
Noninterest expenses	14.9	29.8	30.6	26.7	32.2
Core earnings	81.9	145.3	136.2	130.7	111.0

*Data as of June 30.

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

Amid the stabilizing and slowly improving economic conditions in North Dakota, we expect the bank's business operations to remain stable. BND has a long and stable history in North Dakota, a state rated a relatively high 'AA+' by S&P Global Ratings. Negatives include concentration in one state, significant lending exposure to energy and

agriculture in North Dakota, and a low revenue contribution from noninterest fee income.

BND, headquartered in Bismarck, the capital of North Dakota, is the only state-owned lender located in the continental U.S. BND was formed in 1919 in response to a shortage of lenders in the state willing to support the credit needs of local businessmen and farmers. Driven by its primary role in financing economic development in the state of North Dakota, BND grew rapidly, particularly in 2012 onwards, when North Dakota became a hotbed of shale energy production. Most recently, the bank had just over \$6.7 billion in total assets and \$4.8 billion in deposits as of June 30, 2018. We expect the bank's deposits to stabilize near current levels mirroring the state's gradual recovery, after having declined from a peak of \$5.8 billion in 2015.

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.

BND's management closely monitors economic activity in the state and coordinates programs to assist borrowers in stress and to identify borrowing needs. Recent examples include BND's response to the recent droughts, when, in partnership with the leadership of the state, BND initiated two disaster relief programs to assist ranchers. BND is also increasing its efforts with borrowers for its BND-sponsored student loan programs.

Table 2

Bank of North Dakota Business Position					
	--Year ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
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)	99.8	187.1	182.7	169.8	151.1
Commercial & retail banking/total revenues from business line	98.6	98.9	99.1	98.8	98.3
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	0.2	(0.1)	0.0	0.2	0.4
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
Payments and settlements/total revenues from business line	1.1	1.1	0.8	0.9	1.2
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	0.2	(0.1)	0.0	0.2	0.4
Return on average common equity (%)	19.2	17.1	16.8	18.6	18.4

*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 good earnings generation offsetting projected capital appropriation. We expect our proprietary risk-adjusted capital (RAC) ratio to remain in the low-18% area over the next two years. The RAC ratio was 18.4% as of Dec. 31, 2017, in line with the 18.2% a year earlier and well within the range

we view as very strong.

We also see earnings trends positively contributing to BND's capital and earnings. We expect BND's low-cost deposit base, very low operating costs, and moderate loan growth to bolster profits. Furthermore, with only one office, BND does not have the overhead of a large branch network. The bank is tax exempt and does not pay any deposit insurance premiums.

We also expect BND to benefit from rising interest rates, since 97% of revenues in 2017 were spread-based. Although we expect a low-single-digit annual decrease in loans in 2018-2020, we project revenues will rise at a high-single-digit rate in 2018 and remain stable in 2019-2020, benefiting from a higher net interest margin.

The bank is a state agency, which puts some constraints on its capital flexibility. The bank is subject to an appropriation to the state's general and other funds. In 2017, North Dakota addressed a revenue shortfall through appropriation of nearly \$187 million of BND's undivided profits, up sharply from the \$17 million to \$28 million annually appropriated in the previous three years. Although the amount of capital fell in 2017, due to this large appropriation, the regulatory capital ratios held steady.

We expect the total appropriation will equal profits in 2018 and, thus, be neutral to capital levels. For 2019, we expect the total appropriation will be less than projected profits, with some earnings retained as capital.

Table 3

Bank of North Dakota Capital And Earnings					
	--Year ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
Tier 1 capital ratio	20.3	19.0	20.1	18.3	17.8
S&P Global Ratings RAC ratio before diversification	N/A	18.4	18.2	19.5	19.0
S&P Global Ratings RAC ratio after diversification	N/A	13.3	13.2	15.5	14.8
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	94.0	97.1	96.7	95.3	94.6
Fee income/operating revenues	1.5	1.7	1.4	1.8	2.0
Market-sensitive income/operating revenues	3.6	(0.0)	0.1	0.3	0.4
Noninterest expenses/operating revenues	14.9	15.9	16.7	15.7	21.3
Preprovision operating income/average assets	2.5	2.2	2.1	2.0	1.7
Core earnings/average managed assets	2.4	2.0	1.9	1.8	1.6

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

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

Our assessment of BND's risk position balances the company's historically strong asset quality with its substantial geographic and commercial concentrations, including in energy and agricultural lending.

Direct energy lending, amounting to \$297 million as of June 30, 2018, is slightly above 6% of total loans, but total exposures to the "oil country" were fairly sizable at over 15% of total loans, including commitments. Of the direct

energy loan portfolio, 22% is in services, and 27% is focused on energy marketing, production, and refining. The rest of the energy portfolio, nearly 50%, is oriented to mining, power generation, ethanol production, and natural gas distribution.

Although oil prices have recovered since early 2016, credit quality effects linger in the state, and with BND. Since 2016, BND has experienced a slight increase in loan delinquencies in its residential and commercial lending portfolios. Recent oil production trends have been more positive, with an increase in fracking and higher rig counts over the last few months, which have led to improved real estate metrics, including lower rental vacancies, a positive for future credit trends. Nearly all residential delinquencies represent federally guaranteed loans.

Farm loans represent over 14% of BND's total loans. The state's agricultural economy has been affected by drought conditions, as well as by the imposition of tariffs on soybeans.

Overall, BND's credit quality remains consistent with our expectations. We believe BND's recent sale of the federal student loan portfolio should help lower the bank's delinquency metrics, as this portfolio has historically generated higher delinquency rates in recent years. The high degree of guarantees helps support the bank's credit quality, with 38% of the total loan portfolio either fully or partially guaranteed: residential loans by the federal government, and student loans by the state.

Table 4

Bank of North Dakota Risk Position					
	--Year ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
Growth in customer loans	(10.6)	2.5	10.4	12.7	10.8
Total diversification adjustment/S&P Global Ratings RWA before diversification	N/A	N/A	38.4	N/A	N/A
Total managed assets/adjusted common equity (x)	7.7	8.5	8.4	9.9	11.2
New loan loss provisions/average customer loans	0.1	0.2	0.4	0.3	0.2
Net charge-offs/average customer loans	0.1	0.1	0.1	0.0	0.0
Gross nonperforming assets/customer loans plus other real estate owned	2.9	2.7	2.6	2.0	2.1
Loan loss reserves/gross nonperforming assets	64.1	63.1	62.4	79.6	71.6

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

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

Our assessment considers the state-sourced captive deposits--mandated by legislation--as core to the bank. Nevertheless, economic softness in the state has caused deposits to decrease--since hitting a peak in mid-2015--because of tax revenue declines. Since deposits have declined at a faster rate than loans, the loan-to-deposit ratio increased to 96% as of June 30, 2018, from 75% at year-end 2015. During the same period, the stable funding ratio fell to 120% from 142%. We expect these trends to stabilize as the state's economy gradually stabilizes.

Captive certificates of deposit have accounted for more than 50% of the company's total balance sheet funding in recent years, a proportion we expect to decline slightly over the next two years. We expect the company to increase the proportion of its money market deposit accounts and negotiable order of withdrawal accounts to further compensate for the decline in captive deposits. We see this as slightly negative to the rating.

Key indicators of liquidity were satisfactory as of June 30, 2018. The ratio of broad liquid assets to short-term wholesale funding was 2.57x, and net broad liquid assets constituted 28% of short-term customer deposits and are more in line with peers. The company had roughly \$2.1 billion of liquid assets, or 30.6% of total assets as of June 30, 2018. 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 and direct interbank lending and borrowing.

Table 5

Bank of North Dakota Funding And Liquidity					
	--Year ended Dec. 31--				
(%)	2018*	2017	2016	2015	2014
Core deposits/funding base	80.8	73.6	73.6	82.7	87.4
Customer loans (net)/customer deposits	97.0	106.3	99.9	77.6	66.2
Long term funding ratio	89.8	82.9	83.2	91.2	93.6
Stable funding ratio	120.1	109.7	117.0	141.9	157.8
Short-term wholesale funding/funding base	11.8	19.4	19.1	9.8	7.1
Broad liquid assets/short-term wholesale funding (x)	2.6	1.5	1.8	4.2	6.5
Net broad liquid assets/short-term customer deposits	28.7	16.1	25.4	47.2	55.6
Short-term wholesale funding/total wholesale funding	61.5	73.4	72.2	56.6	56.3
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.

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

Based on our criteria for government-related entities, we incorporate one notch of uplift into our issuer credit rating 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--is extremely high, as characterized by a very strong link between the state and the bank's deposits and the critical role the deposits play. 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. These guarantees serve a central purpose of maintaining trust and financial market stability, in our view.

We believe defaulting on the deposits would have a critical impact on the government. A default on these state-guaranteed deposits has never happened in the bank's nearly 100-year history.

Additional rating factors: None

We do not consider any additional rating factors.

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
- 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

Related Research

- North Dakota; Appropriations; General Obligation; Moral Obligation; School State Program, Sept. 26, 2018

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 17, 2018)

Bank of North Dakota

Issuer Credit Rating

A+/Stable/A-1

Issuer Credit Ratings History

19-Feb-2016

A+/Stable/A-1

06-Dec-2011

AA-/Stable/A-1+

Ratings Detail (As Of October 17, 2018) (cont.)

30-Jul-2009	A+/Stable/A-1
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Sovereign Rating

United States	AA+/Stable/A-1+
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*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.

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