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Bank of North Dakota

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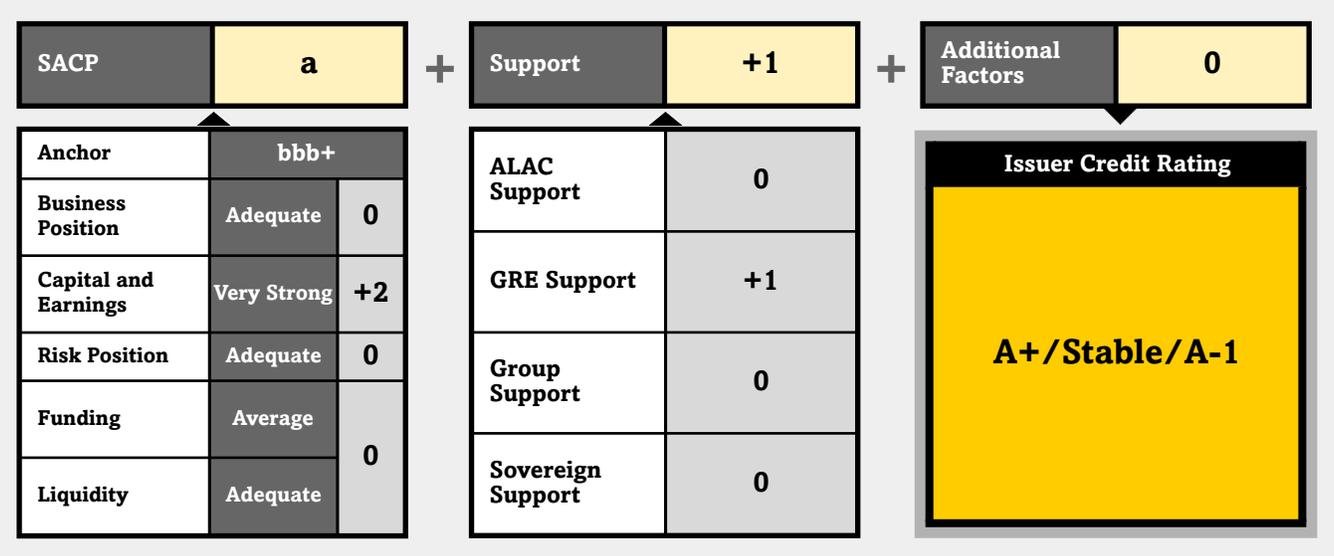
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Bank of North Dakota



Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • Stable ownership by the state of North Dakota since 1919 • Very strong 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 cyclicity 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, 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 the bank's important role to the state. As a result, the rating on the bank includes one notch of uplift from the company's SACP.

The 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: 'bbb+' for a bank operating in the U.S.

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 leveraged lending--represent potential risks. Our view of industry risk in the U.S. balances the regulatory enhancements made since the financial crisis--notwithstanding some recent changes to those regulations--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 (see "Banking Industry Country Risk Assessment: U.S.," published Oct. 9, 2019).

Table 1

Bank of North Dakota Key Figures					
--Year ended Dec. 31--					
(Mil. \$)	2019*	2018	2017	2016	2015
Adjusted assets	6,877.4	7,015.8	7,003.3	7,295.3	7,407.9
Customer loans (gross)	4,544.6	4,584.2	4,909.3	4,789.6	4,339.6
Adjusted common equity	927.6	851.7	821.8	863.5	747.3
Operating revenues	104.2	199.2	187.1	182.7	169.8
Noninterest expenses	14.4	28.9	29.8	30.6	26.7
Core earnings	86.8	158.4	145.3	136.2	130.7

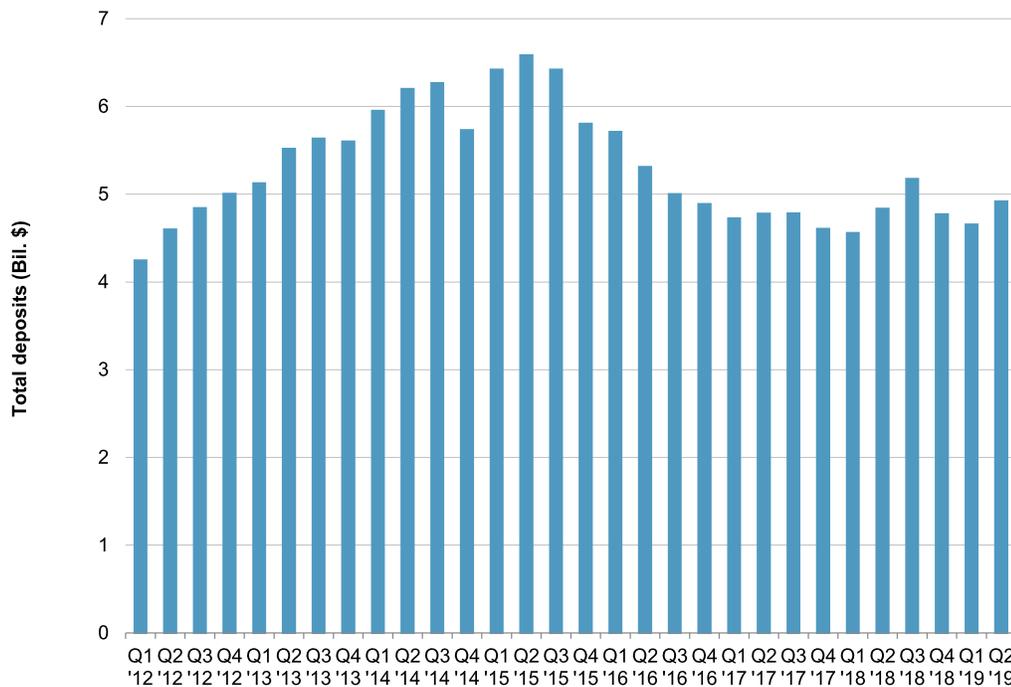
*Data as of June 30.

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

We expect the bank's business operations to reflect the slowly improving economic conditions in North Dakota. BND has a long and stable history in North Dakota. Partly offsetting negatives include concentration in one state, significant lending exposure to energy and agriculture, and a low revenue contribution from noninterest fee income.

BND, headquartered in Bismarck, the capital of North Dakota, is the only state-owned lender in the continental U.S. BND was established by the state legislature in 1919 in response to a shortage of lenders in the state willing to support the credit needs of farmers and business in the state. Driven by its primary role in financing economic development in the state of North Dakota, BND grew rapidly, particularly from 2012 onwards, when North Dakota became a hotbed of shale energy production. We expect the bank's deposits, which were \$4.9 billion at June 30, to stabilize near current levels, mirroring the state's gradual recovery, after having declined from a peak of \$6.3 billion in 2015.

Chart 1
Bank Of North Dakota's Deposits Have Stabilized And Recovered



Source: S&P Global Ratings.
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BND 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. Examples include BND's disaster relief programs to assist ranchers afflicted by drought conditions, as well as increased efforts with borrowers for its BND-sponsored student loan programs.

Table 2

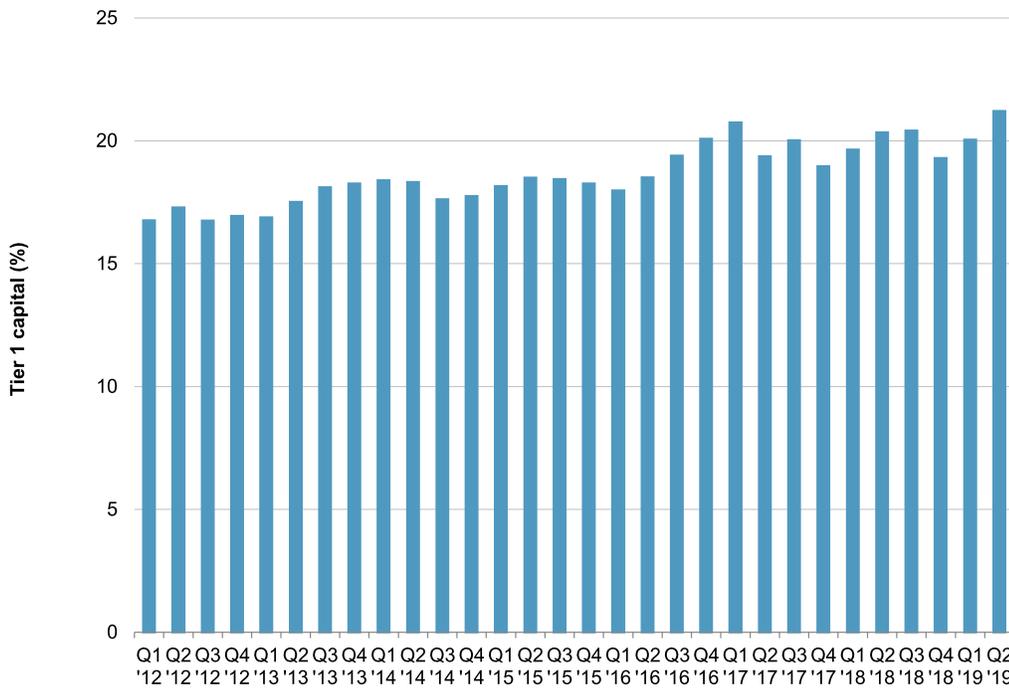
Bank of North Dakota Business Position					
	--Year ended Dec. 31--				
(%)	2019*	2018	2017	2016	2015
Loan market share in country of domicile	N/A	N/A	N/A	N/A	N/A
Deposit market share in country of domicile	N/A	N/A	N/A	N/A	N/A
Total revenues from business line (currency in millions)	104.7	200.3	187.1	182.7	169.8
Commercial & retail banking/total revenues from business line	98.1	98.8	98.9	99.1	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	0.2	(0.0)	(0.1)	0.0	0.2
Brokerage/total revenues from business line	N/A	0.0	0.0	0.0	0.0
Insurance activities/total revenues from business line	N/A	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	1.1	0.8	0.9
Asset management/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Other revenues/total revenues from business line	0.5	0.0	N/A	N/A	N/A
Investment banking/total revenues from business line	0.2	(0.0)	(0.1)	0.0	0.2
Return on average common equity	19.3	18.8	17.1	16.8	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 our S&P Global Ratings RAC ratio of nearly 24% at June 30, plus our expectation that BND's good earnings generation will continue in our two-year forecast horizon. Due to improving state tax collections, we expect the state to make capital appropriations at a lower level than BND's profits in this period. We therefore expect the RAC ratio to remain comfortably in the very strong category (above 15%) over the next two years. BND's regulatory capital ratios are also high, including the Tier 1 Capital ratio (see chart 2).

Chart 2
Bank Of North Dakota's Capital Ratios Are High And Rising



Source: S&P Global Ratings.
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However, with the Fed embarking on a series of rate cuts, we expect BND to face some revenue headwinds, given that more than 97% of revenues are spread-based, and only about 3% are fee-based. Also, with several state initiatives already completed, we expect a low-single-digit annual decrease in loans in 2019-2021.

We expect BND's very low operating costs, low provisions, no deposit insurance premiums, and tax exemption, to bolster profits. With only one office, BND does not have the overhead of a large branch network. Overall, we see earnings trends positively contributing to BND's capital and earnings.

Since the bank is a state agency, it is subject to an annual appropriation to replenish the state's general and other funds. This puts some constraints on the bank's capital growth and flexibility. In calendar-year 2018, the state of North Dakota appropriated a total of \$128.6 million from BND, out of BND's net income of \$158.5 million. For 2019 and 2020, assuming an improving state economy, and stable state spending, we expect total appropriations from BND will be about \$125 million, significantly less than our profit forecasts. Thus we expect capital levels and ratios will rise in the next two years.

Historically, appropriations have fluctuated greatly. In 2017, following a shale oil downturn, state tax collections suffered, and the state made a large appropriation of \$186.9 million, compared to BND's profits of \$128.6 million. In contrast, the state appropriated an average of just \$22 million per year in 2014-2016, out of net income that ranged

from \$111 million to \$136 million per year.

Table 3

Bank of North Dakota Capital And Earnings					
	--Year ended Dec. 31--				
(%)	2019*	2018	2017	2016	2015
Tier 1 capital ratio	21.2	19.3	19.0	20.1	18.3
S&P Global Ratings' RAC ratio before diversification	23.6	21.4	N/A	N/A	N/A
S&P Global Ratings' RAC ratio after diversification	17.1	15.5	N/A	N/A	N/A
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	98.2	97.0	97.1	96.7	95.3
Fee income/operating revenues	1.6	1.6	1.7	1.4	1.8
Market-sensitive income/operating revenues	0.2	1.1	(0.0)	0.1	0.3
Noninterest expenses/operating revenues	13.8	14.5	15.9	16.7	15.7
Preprovision operating income/average assets	2.6	2.4	2.2	2.1	2.0
Core earnings/average managed assets	2.5	2.3	2.0	1.9	1.8

*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.

Overall, BND's asset quality remains strong, reflecting careful underwriting and concentration management, though there have been some increases in loan delinquencies due to ongoing stress in the agricultural sector.

Through June 30, the bank has seen a decline in the nonaccrual loans ratio, adjusted nonperforming assets (NPA) ratio, net charge-off (NCO) ratio, and total loan delinquencies. The decline in delinquencies was more pronounced in its student loan portfolio after the sale of the historically higher delinquent Federal student loan portfolio.

That said, BND reported higher delinquencies in the farm loan portfolio, primarily attributable to an increase in past due Direct Farm Real Estate Loans and stress in the agricultural sector. Farm loans represent over 15% of BND's total loans, as of June 30. The state's agricultural economy has been affected by drought conditions, as well as by the trade disputes between the U.S. and China.

Offsetting this, recent oil production trends have been more positive, with an increase in fracking and higher rig counts over the last few months. This has also led to improved real estate metrics, including lower hotel and residential vacancies in the oil producing regions, a positive for future credit trends. Nearly all residential delinquencies involve federally guaranteed loans. The high degree of guarantees helps support the bank's credit quality, with 37% of the total loan portfolio either fully or partially guaranteed: residential loans by the federal government, and student loans by the state.

BND has grown energy loans at a moderate pace since 2016. The proportion of energy loans to total loans remained

below peak the levels of 2013-2014. Direct energy lending, amounting to \$306 million as of June 30, 2019, is slightly under 7% of total loans, but total exposures to the oil producing regions, which includes hotels and apartments, were fairly sizable at 15% of total loans, including commitments.

Table 4

Bank of North Dakota Risk Position					
	--Year ended Dec. 31--				
(%)	2019*	2018	2017	2016	2015
Growth in customer loans	(1.7)	(6.6)	2.5	10.4	12.7
Total diversification adjustment/S&P Global Ratings' RWA before diversification	38.4	38.3	N/A	38.4	N/A
Total managed assets/adjusted common equity (x)	7.4	8.2	8.5	8.4	9.9
New loan loss provisions/average customer loans	0.1	0.3	0.2	0.4	0.3
Net charge-offs/average customer loans	(0.0)	0.1	0.1	0.1	0.0
Gross nonperforming assets/customer loans + other real estate owned	3.1	3.0	2.7	2.6	2.0
Loan loss reserves/gross nonperforming assets	68.1	66.4	63.1	62.4	79.6

*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. Through mid-2019, funding metrics have improved as the loan-to-deposit ratio declined to 92%, from 98% in 2018, and the stable funding ratio rose to 125%, from 120% in 2018. We expect these metrics to improve further as the state's economy benefits from higher oil prices, though we are mindful of the impact that higher tariffs may have on the agricultural economy.

Captive certificates of deposit have generally accounted for a significant portion of the company's total balance sheet funding in recent years. However, we expect this proportion to continue 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 for BND were satisfactory as of June 30, 2019. The ratio of broad liquid assets to short-term wholesale funding was 2.7x, and net broad liquid assets constituted 33% of short-term customer deposits. The company had roughly \$2.3 billion of liquid assets, or 34% of total assets as of June 30, 2019. 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--				
(%)	2019*	2018	2017	2016	2015
Core deposits/funding base	81.5	74.7	73.6	73.6	82.7
Customer loans (net)/customer deposits	92.1	97.8	106.3	99.9	77.6
Long-term funding ratio	88.9	83.3	82.9	83.2	91.2

Table 5

Bank of North Dakota Funding And Liquidity (cont.)					
	--Year ended Dec. 31--				
(%)	2019*	2018	2017	2016	2015
Stable funding ratio	124.6	117.8	109.7	117.0	141.9
Short-term wholesale funding/funding base	12.8	19.0	19.4	19.1	9.8
Broad liquid assets/short-term wholesale funding (x)	2.7	1.8	1.5	1.8	4.2
Net broad liquid assets/short-term customer deposits	33.4	26.1	16.1	25.4	47.2
Short-term wholesale funding/total wholesale funding	69.2	75.1	73.4	72.2	56.6
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 the state of North Dakota would provide 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 in the state's public finances. 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 arrangements serve to maintain trust in and the financial stability of both BND and the state's finances, 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 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 Public Finance Authority; Appropriations; General Obligation; Moral Obligation; School State Program, July 2, 2019
- With Oil Price Volatility, Recent Economic Gains In U.S. Oil-Producing States Are At Risk, March 12, 2019

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 25, 2019)*

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+

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

Sovereign Rating

United States 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.

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