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Bank of North Dakota

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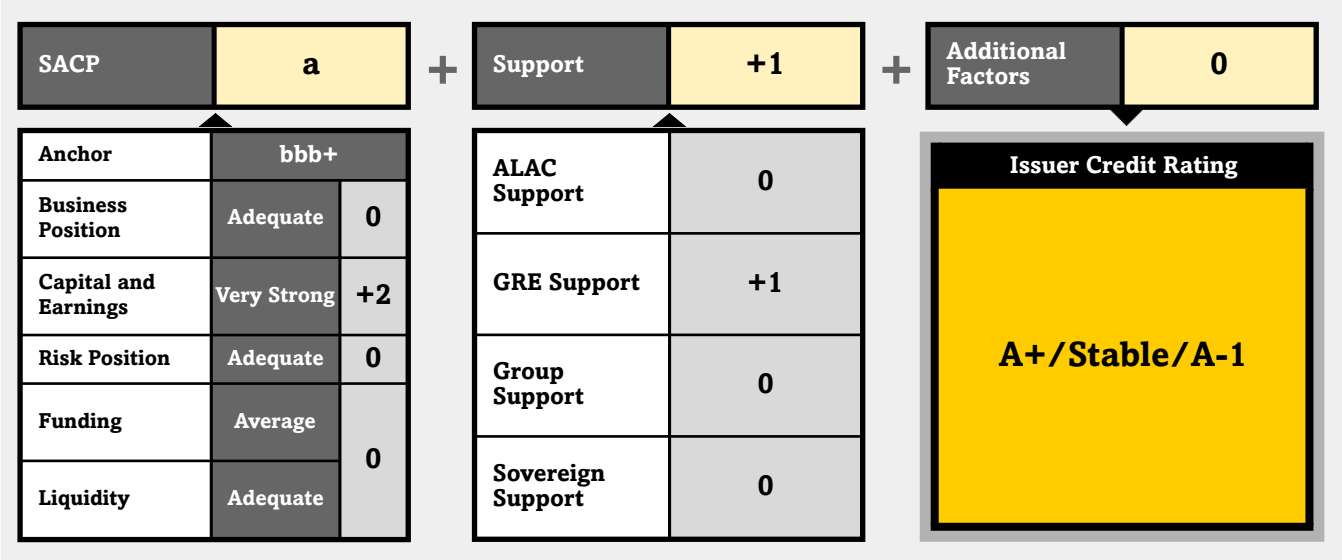
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Bank of North Dakota



Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • Stable ownership by the state of North Dakota since 1919 • Very strong risk-adjusted capital ratios • Strong 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 over the next two years 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 credit profile (SACP) on BND by one, or even two notches, the issuer credit rating and deposit ratings would be unchanged.

We could lower the SACP if the bank's asset quality deteriorates meaningfully, management's strategy becomes less conservative, 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 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 a few exceptions, the state government and all state agencies must, by state law, deposit all funds with BND. However, BND's concentration in North Dakota, low market share, and sizable exposure to the volatile energy and agricultural industries constrain the rating.

While the economic downturn from the COVID-19 pandemic has resulted in more nonperforming assets, BND has consistently maintained very low credit losses throughout previous economic downturns and energy market volatility. Additionally, BND has grown its very strong RAC ratio over the past several years to 22.7% as of June 30, 2020--well in excess of the 15% threshold we consider very strong. This high level of capital provides BND a strong buffer if credit losses were to exceed historical peak averages.

We assess the likelihood of extraordinary support from the state 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 '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 of the deposits for the state.

Anchor: 'bbb+' for a bank operating in the U.S., reflecting the highly competitive, diverse U.S. economy

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'. The trend on the economic risk score is negative, reflecting the economic downturn caused by the coronavirus pandemic and the possibility for a significant rise in credit losses if the duration of the recession is extended or the recovery is tepid. We balance those risks against the structural strengths of the U.S. economy--such as its diversification and resiliency--the extraordinary monetary and fiscal response to the pandemic, and expectations of a rebound over the next two years. An economic risk score of '4' by itself would not cause us to lower the 'bbb+' anchor but may be accompanied by negative rating actions on individual institutions. 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. The industry risk trend is stable.

Table 1

Bank of North Dakota Key Figures					
--Year-ended Dec. 31--					
(Mil. \$)	2020*	2019	2018	2017	2016
Adjusted assets	8,044	7,058	7,016	7,003	7,295
Customer loans (gross)	4,661	4,538	4,584	4,909	4,790
Adjusted common equity	948	941	852	822	863
Operating revenues	99	211	199	187	183
Noninterest expenses	15	29	29	30	31
Core earnings	80	176	158	145	136

*Data as of June 30.

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

Our assessment of BND's business position reflects BND's well entrenched history in North Dakota with a record of high profitability and robust credit quality, and good financial governance. However, factors like high geographic concentration, a very low proportion of noninterest income, lack of diversification by business, small domestic market share, and less regulatory oversight, relative to most banks, partially offset our business position assessment.

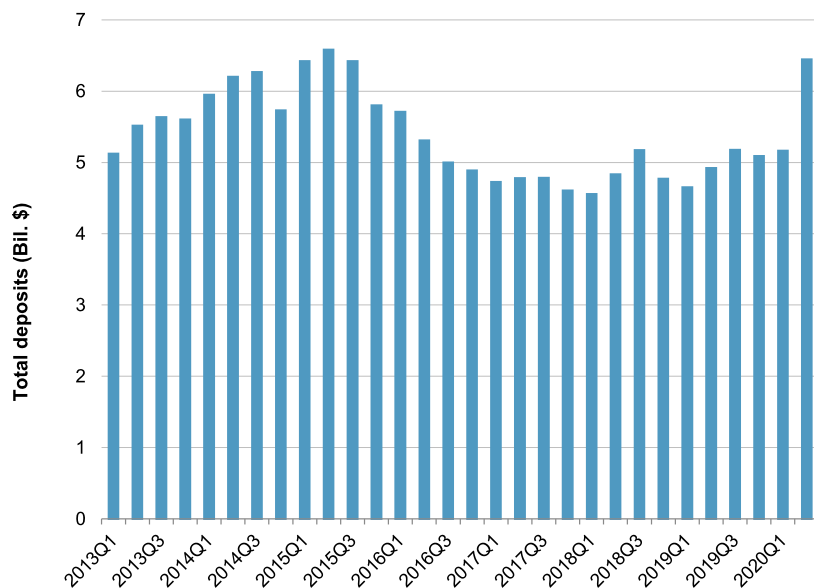
BND has a long, stable history in North Dakota. Headquartered in Bismarck, the state's capital, BND is the only state-owned lender in the continental U.S. The bank was established by the state legislature in 1919 in response to a shortage of lenders in the state willing to support the credit needs of North Dakota farmers and businesses. Driven by its primary role in financing economic development in the state, BND grew rapidly, particularly from 2012 onwards, when North Dakota became a hotbed of shale energy production.

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 North Dakota--supporting 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 identify borrowing needs.

Chart 1

Bank Of North Dakota Benefitted From Huge Influx Of Deposits Since The Onset Of Pandemic



Source: Company filings.

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Table 2

Bank of North Dakota Business Position					
	--Year-ended Dec. 31--				
	*2020	2019	2018	2017	2016
Total revenues from business line (currency in millions)	99	212	200	187	183
Commercial & retail banking/total revenues from business line	98.03	98.18	98.80	98.86	99.07
Corporate finance/total revenues from business line	0.02	0.11	(0.02)	(0.08)	0.04
Agency services/total revenues from business line	0.12	0.12	0.13	0.13	0.13
Payments and settlements/total revenues from business line	1.28	1.15	1.09	1.08	0.76
Asset management/total revenues from business line	N/A	N/A	N/A	N/A	N/A
Other revenues/total revenues from business line	0.55	0.45	0.00	N/A	N/A
Investment banking/total revenues from business line	0.02	0.11	(0.02)	(0.08)	0.04
Return on average common equity	17.33	18.77	18.80	17.09	16.76

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

Capital and earnings: Very strong capital ratios and good core earnings generation, though earnings will be pressured amid the coronavirus pandemic

We assess BND's capital and earnings as very strong given its high risk-adjusted capital ratios, strong core earnings

generation, and very low operating costs. Though the economic downturn associated with the coronavirus has hurt its earnings, we expect BND to remain profitable and maintain high capital levels.

S&P Global Ratings' RAC ratio was 22.7% as of June 30, 2020, among the highest in the banks we rate. We expect the RAC ratio to decline over the next several years owing to the challenging earnings environment and higher expected credit losses. However, we expect it to remain comfortably in the very strong category (above 15%) over the next two years.

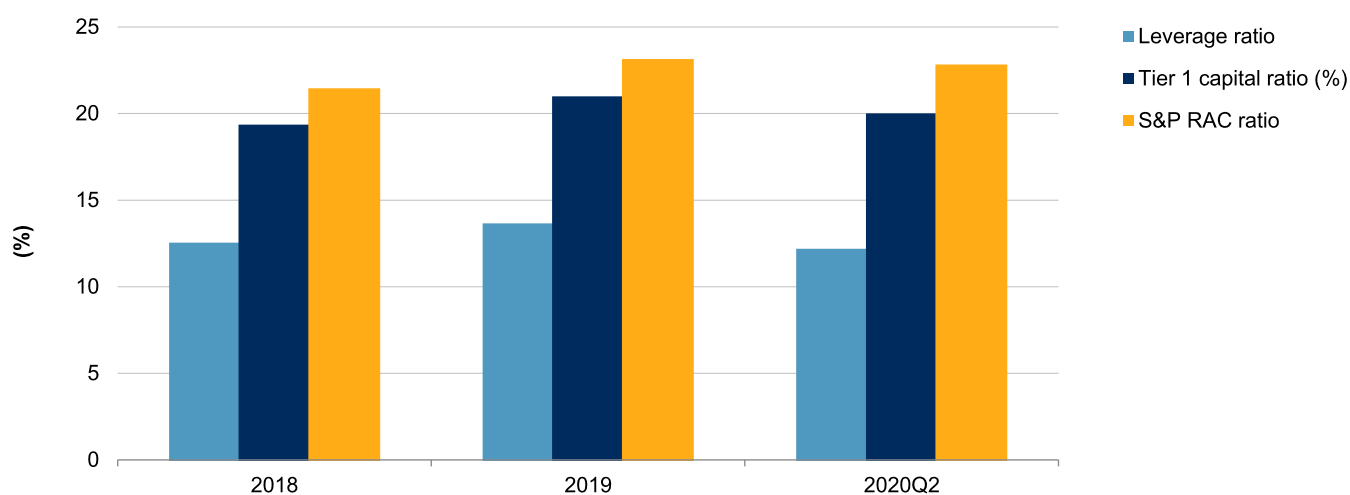
The bank is subject to annual appropriations to replenish the state's general and other funds. This somewhat constrains the bank's capital growth and flexibility. Historically, appropriations have fluctuated greatly depending on the state tax collections and health of the state's economy. In calendar-year 2019, the state of North Dakota appropriated a total of \$80.1 million from BND, out of BND's net income of \$169 million. For 2020 and 2021, the company expects total appropriations will be \$144 million and \$175 million, respectively, which exceeds our net income expectations and contributes to our expectation of a declining RAC ratio.

BND's earnings have been strong and consistent over the past few years, despite its heavy reliance on spread-based income. For the first half of 2020, earnings declined modestly as near-zero interest rates constrained net interest income (NII), though lower deposit costs provided partial offset. Noninterest income remains minimal as 97% of revenue is from NII. Positively, pre-provision net revenue continues to hold up, reflecting BND's strong core earnings capacity. Furthermore, BND's return on average assets remained very high at 2.11%.

We expect earnings to remain somewhat stable for the remainder of 2020 absent any material credit issues as the state economy rebounds. BND's very low operating costs, no deposit insurance premiums, and tax exemption bolster its earnings capacity.

Chart 2

Bank of North Dakota -- Capital Ratios Remain Very Strong



Source: Company filings, S&P Global Ratings.

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Table 3

Bank of North Dakota Capital And Earnings					
	--Year-ended Dec. 31--				
	*2020	2019	2018	2017	2016
Tier 1 capital ratio	19.96	20.94	19.30	18.97	20.09
S&P Global Ratings' RAC ratio before diversification	22.77	23.10	21.40	N/A	N/A
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Net interest income/operating revenues	97.98	97.19	97.05	97.10	96.67
Fee income/operating revenues	1.82	1.61	1.61	1.71	1.39
Market-sensitive income/operating revenues	0.13	1.20	1.14	(0.04)	0.09
Cost to income ratio	14.72	13.76	14.49	15.91	16.72
Preprovision operating income/average assets	2.23	2.59	2.43	2.20	2.07
Core earnings/average managed assets	2.11	2.50	2.26	2.03	1.85

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

Risk position: High proportion of government-guaranteed loans and low historical losses offset risks in energy and agricultural lending

Our assessment of BND's risk position balances the company's historically strong asset quality and strong allowance for credit losses with its substantial geographic and commercial concentrations, including 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 because of the economic downturn caused by the COVID-19 pandemic, energy market downturn, and ongoing stress in the agricultural sector.

BND continues to have higher energy exposures than most rated U.S. banks. The proportion of energy loans to total loans remained below the peak levels of 2013-2014. Direct energy lending, amounting to \$284 million as of June 30, 2020, is slightly above 6% of total loans. Indirect energy lending, including commitments to the state's oil-producing regions, which includes hotel, multifamily, and municipal loans, were meaningful at 11% (\$504 million) of total loans. With lower energy prices, economic indicators in oil-producing regions are generally worse than the rest of the state. Unemployment is generally higher, resulting in higher hotel and residential vacancies and lower rent income. Positively, indirect oil-related exposures are substantially lower than the peak of \$776 million in 2016. Although oil prices remain low by historical standards, the rebound in prices from lows in April should provide support to the direct and indirect energy loan portfolios' credit performance as oil production and employment in oil-producing geographies improve from earlier this year.

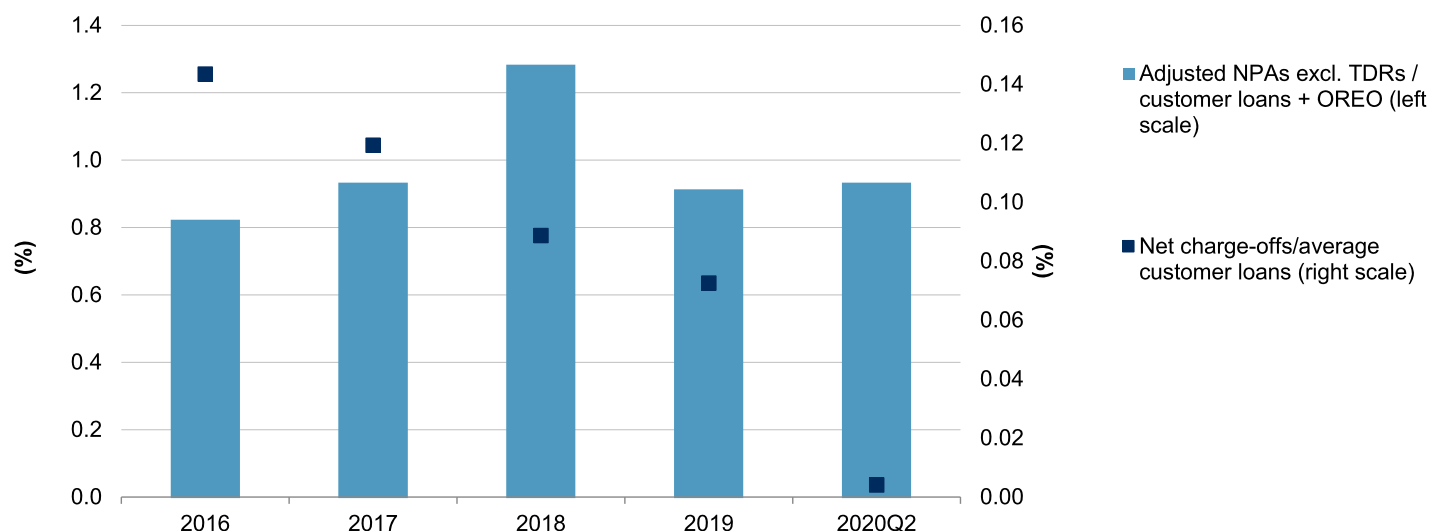
Overall, the level of gross nonperforming assets (NPAs) has increased 45 basis points (bps) from a year ago, to 3.56%, driven by an increase in past due loans. However, the high degree of guarantees helps support the bank's credit quality, with 36% of the total loan portfolio either fully or partially guaranteed; residential loans by the federal government, and student loans by the state. The commercial portfolio (excluding agriculture), which has the lowest level of guarantees, has generally maintained a steady level of NPAs.

BND reported higher delinquencies primarily in the farm loan and residential mortgage portfolios, attributable to the economic disruptions from the COVID-19 pandemic and the stress in the agricultural sector. Farm loans represent 16% of total loans and residential real estate loans represented 13% of total loans, as of June 30, 2020. The state's

agricultural economy has been affected by rainy conditions in 2019, as well as by the trade disputes between the U.S. and China. The proportion of residential loans over 90 days past due spiked to 4.1%. However, positively, nearly all residential delinquencies involve federally guaranteed loans.

Chart 3

Bank Of North Dakota -- Asset Quality



Source: Company filings, S&P Global Ratings.

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Table 4

Bank of North Dakota Risk Position

	--Year-ended Dec. 31--				
	*2020	2019	2018	2017	2016
Growth in customer loans	5.41	(1.01)	(6.62)	2.50	10.37
Total diversification adjustment/S&P Global Ratings' RWA before diversification	36.58	37.30	38.31	N/A	38.39
Total managed assets/adjusted common equity (x)	8.49	7.50	8.24	8.52	8.45
New loan loss provisions/average customer loans	0.21	0.13	0.25	0.25	0.35
Net charge-offs/average customer loans	0.00	0.07	0.09	0.12	0.14
Gross nonperforming assets/customer loans + other real estate owned	3.56	3.26	3.04	2.74	2.63
Loan loss reserves/gross nonperforming assets	60.39	64.63	66.40	63.07	62.44

*Data as of June 30.

Funding and liquidity: Benefited from a high inflow of deposits since the start of the pandemic

Our assessment considers the state-sourced captive deposits--mandated by legislation--as core to the bank. In the first half of 2020, BND experienced substantial deposit growth as government stimulus funds received by the state of North Dakota and its agencies were deposited at BND. As a result, funding metrics improved substantially. The

loan-to-deposit ratio was 70% as of June 30, 2020, and improved significantly from 88% at year-end 2019. Further, the stable funding ratio, calculated as available stable funding as a proportion of stable funding needs, rose to nearly 150% as of June 30, 2020, from 126% at year-end 2019. Positively, the bank has no brokered deposits and short-term wholesale funding is manageable at only 6% of the funding base, as of June 30, 2020. However, we expect the funding metrics to deteriorate modestly in the second half of the year, as government agencies withdraw their stimulus-related deposits and spend their budgeted amounts.

There is some concentration given that captive certificates of deposit have generally accounted for a significant portion of the company's total balance sheet funding. However, we expect this proportion to decline as state agencies withdraw their stimulus-related funds. We expect the company to increase its proportion of Federal Home Loan Bank (FHLB) advances. We view this as slightly negative to the rating.

BND's key indicators of liquidity were adequate as of June 30, 2020. Given the large deposit inflows in the first half of the year, the ratio of broad liquid assets to short-term wholesale funding improved to 7.7x as of June 30, 2020, from 2.6x at year-end 2019. The company had roughly \$3.4 billion of liquid assets, or 42% of total assets as of June 30, 2020. 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 FHLB advances, federal funds borrowings, loan sales, and repurchase agreements. BND has access to the Federal Reserve discount window and direct interbank lending and borrowing.

Support: 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 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.

Table 5

	Bank Of North Dakota Funding And Liquidity				
	--Year-ended Dec. 31--				
	*2020	2019	2018	2017	2016
Core deposits/funding base	91.97	82.68	74.72	73.57	73.56
Customer loans (net)/customer deposits	70.39	88.29	97.83	106.31	99.91
Long-term funding ratio	95.03	87.65	83.34	82.89	83.19

Table 5

Bank Of North Dakota Funding And Liquidity (cont.)					
	--Year-ended Dec. 31--				
	*2020	2019	2018	2017	2016
Stable funding ratio	148.75	125.71	117.83	109.71	117.02
Short-term wholesale funding/funding base	5.60	14.26	18.99	19.40	19.10
Broad liquid assets/short-term wholesale funding (x)	7.73	2.57	1.82	1.49	1.78
Net broad liquid assets/short-term customer deposits	51.21	33.78	26.06	16.07	25.41
Short-term wholesale funding/total wholesale funding	69.76	82.35	75.13	73.41	72.24

*Data as of June 30.

Additional rating factors: None

We do not consider any additional rating factors.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- 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: 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
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- North Dakota Building Authority; Appropriations; General Obligation; Moral Obligation, Oct. 14, 2020
- Comparative Statistics: U.S. Banks (October 2020), Oct. 12, 2020
- Rating Component Scores For U.S., Canadian, And Bermudian Banks (September 2020) Sept. 30, 2020
- What Lies Ahead For U.S. Bank Provisions For Loan Losses, Aug. 12, 2020
- North Dakota's Deep Reserves, Structural Budget Allows Near-Term Credit Stability While Longer-Term Pressures Persist, May 14, 2020

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 9, 2020)*

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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