MOODY'S INVESTORS SERVICE

Credit Opinion: SkandiaBanken AB

Global Credit Research - 20 Dec 2015

Sweden

Ratings

Category	Moody's Rating
Outlook	Negative
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	a3
Counterparty Risk Assessment	A1(cr)/P-1(cr)
Parent: Skandia Insurance Company Ltd.	
Outlook	Stable
Insurance Financial Strength	A2

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Key Indicators

SkandiaBanken AB (Consolidated Financials)[1]

	[2]**9-15**	[2]**12-14**	[2]**12-13**	[3]**12-12**	[3]**12-11**	**Avg.**
Total Assets (SEK million)	**118,219.0**	**114,918.0**	**98,597.0**	**84,638.0**	**76,767.0**	[4]**11.4**
Total Assets (EUR million)	**12,627.5**	**12,131.6**	**11,140.9**	**9,868.3**	**8,626.3**	[4]**10.0**
Total Assets (USD million)	**14,095.4**	**14,679.9**	**15,351.6**	**13,010.3**	**11,198.2**	[4]**5.9**
Tangible Common Equity (SEK million)	**6,786.0**	**5,036.0**	**3,907.0**	**3,169.0**	**2,726.3**	[4]**25.6**
Tangible Common Equity (EUR million)	**724.8**	**531.6**	**441.5**	**369.5**	**306.3**	[4]**24.0**
Tangible Common Equity (USD million)	**809.1**	**643.3**	**608.3**	**487.1**	**397.7**	[4]**19.4**
Problem Loans / Gross Loans (%)	**0.2**	**0.2**	**0.2**	**0.3**	**0.4**	[5]**0.2**
Tangible Common Equity / Risk Weighted Assets (%)	**15.5**	**12.1**	**10.9**	**10.5**	**9.9**	[6]**12.8**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**2.7**	**3.4**	**3.5**	**5.2**	**7.4**	[5]**4.4**
Net Interest Margin (%)	**1.3**	**1.3**	**1.2**	**1.4**	**1.4**	[5]**1.3**
PPI / Average RWA (%)	**1.2**	**1.5**	**0.7**	**1.2**	**0.3**	[6]**1.1**
Net Income / Tangible Assets (%)	**0.3**	**0.4**	**0.3**	**0.3**	**0.2**	[5]**0.3**
Cost / Income Ratio (%)	**71.3**	**67.0**	**81.0**	**78.2**	**94.1**	[5]**78.3**
Market Funds / Tangible Banking Assets (%)	**14.5**	**15.9**	**12.9**	**2.4**	**0.2**	[5]**9.2**
Liquid Banking Assets / Tangible Banking Assets (%)	**0.7**	**9.0**	**13.8**	**21.4**	**29.1**	[5]**14.8**
Gross loans / Due to customers (%)	**123.8**	**120.3**	**103.1**	**77.7**	**75.1**	[5]**100.0**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

We assign a baa1 baseline credit assessment (BCA), a3 adjusted BCA, and A2 long-term deposit ratings to Skandiabanken AB. We also assign a long-term and short-term counterparty risk assessment (CRA) of A1(cr)/Prime-1(cr) to the bank.

Skandiabanken's baa1 baseline credit assessment reflects the bank's (i) very strong asset quality, (ii) low-risk retail mortgage-oriented business model and, (iii) strategic role as the banking arm of the Skandia Group. The BCA is limited by the bank's limited standalone franchise strength, in addition to low profitability and efficiency associated with its Swedish operations. The bank benefits from a supportive insurance-parent (Skandia Insurance Company Ltd.; insurance financial strength rating A2 stable) which translates into an adjusted BCA of a3.

RATING DRIVERS

- Skandiabanken's BCA is supported by its Very Strong- Macro Profile

- Skandiabanken has a limited standalone franchise but plays a role in the wider Skandia group

- Asset quality is strong but lending growth is high

- Capitalisation is adequate relative to risks but low compared to other banks

- A track-record of weak profitability and low efficiency

- Funding profile is becoming more diversified, and unsecured market funding provides a cushion to depositors in a failure scenario

RATING OUTLOOK

Skandiabanken's long-term deposit ratings carry a negative outlook. The bank's Swedish business has a track-record of weak profitability owing to a material cost-base. The weak efficiency associated with the Swedish operations is likely to become more pronounced after the bank was separated from its relatively profitable Norwegian business in October 2015.

WHAT COULD CHANGE THE RATING - UP

Any upgrade of Skandiabanken's BCA would likely be accompanied by improved profitability without a significant increase in risk appetite. This is most likely to be achieved through cost containment combined with some level of lending growth.

WHAT COULD CHANGE THE RATING - DOWN

Skandiabanken's BCA could be negatively affected if the bank in the long-term fails to improve its efficiency and profitability in Sweden given that the bank has divested its profitable Norwegian business.

DETAILED RATING CONSIDERATIONS

The financial data in the following sections are sourced from Skandiabanken's financial statements including the Norwegian business which was divested in October 2015. We will review our assessment of the bank's financial profile following the publication of standalone financial statements of Skandiabanken excluding its divested Norwegian operations.

SKANDIABANKEN'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

Sweden's Very Strong- Macro Profile benefits from a competitive and diverse economy, robust public institutions and a stable political environment that supports consensus orientated policy making. However, we view Swedish households' debt levels (80% of which consist of mortgages) and the multi-year growth in household debt as key vulnerabilities to the financial system.

Although the banking system is concentrated around four banks, we believe that competition in the Swedish banking industry is healthy. On a negative note, Swedish banks are structurally reliant on market funding and that exposes them to swings in investor sentiment. This risk is, however, partially mitigated because (i) Sweden has its own currency and, (ii) domestic investors hold almost three quarters of the country's bonds.

- SKANDIABANKEN HAS A LIMITED STANDALONE FRANCHISE BUT PLAYS A ROLE IN THE WIDER SKANDIA GROUP

Skandiabanken is a small bank active in Sweden and Norway. In Sweden it reports a market share in lending of around 1%. It remains unclear if the bank's plans to grow in Sweden will bear fruit given the competitive household lending market in the country. In October 2015, Skandiabanken exited the Norwegian market, which accounted for 54% of total lending at 30 September 2015. Subsequently, the bank transferred the ownership of its Norwegian business to Skandia Liv, who sold off its majority ownership through an IPO of the standalone Norwegian entity, Skandiabanken ASA.

The bank focuses almost exclusively on mortgage lending, compared to the larger Swedish banks that provide a wider product offering both to households and companies. Skandiabanken does not operate its own branch network, a competitive disadvantage that weakens its standalone franchise strength. However, the bank benefits from its position within the Skandia Group which provides access to the group's large insurance customer base through the group's 54 branches. We consider that monetising insurance relationships has historically proved difficult for banks due to a lack of regular customer contact and intense competition in both Norway and Sweden.

- ASSET QUALITY IS STRONG BUT LENDING GROWTH IS HIGH

Skandiabanken's asset quality is strong, reflected by a problem loans ratio which tends to be around 20 basis points of gross lending. Lending consists almost exclusively of mortgages although the bank also offers products such as personal loans, credit cards and car loans (in Norway until October 2015). We consider its emphasis on retail mortgage lending as lower risk than corporate lending, although it leaves the bank exposed to the retail real estate market in Sweden.

More negatively, loan growth continues to be aggressive. In 2014, lending grew by 33% in Sweden and by 16% in Norway. We view the aggressive expansion and low mortgage book seasoning as risks because it is less clear how these mortgages, which have been originated during a period of very low interest rates, will perform in the future compared to a more seasoned loan portfolio. We also think that above average growth in a competitive market is associated with underwriting risks. Looking ahead, lending growth is likely to be high in Sweden as the bank seeks to address its efficiency and profitability challenges associated with its operations in that country.

Alike many Nordic banks, Skandiabanken's credit risk concentration is high in terms of borrower concentration. That said, the largest exposures originate from the bank's liquidity portfolio which is of high credit quality. Unlike most of its peers, Skandiabanken's industry exposure is extremely small due to its negligible corporate lending activities.

- CAPITALISATION IS ADEQUATE RELATIVE TO RISKS BUT LOW COMPARED TO OTHER BANKS

Skandiabanken reported a common equity Tier 1 ratio of 14.7% at end-September 2015, which is at the lower end compared to other Swedish financial institutions. We nevertheless consider the bank's capital position as adequate given its low risk profile.

The bank currently applies the standardised capital approach when calculating credit risks whilst many other Swedish banks use an internal-ratings based (IRB) approach that tends to drive up capital ratios.

Skandiabanken has a track record of receiving capital injections from its parent in order to enable its aggressive lending growth. For example, in September 2015 the bank received a SEK1.25 billion injection from its parent, the majority of which was retained in the Swedish entity following the separation from the Norwegian entity. Whilst such injections enable lending growth in order to achieve economies of scale and improved profitability, we consider the strategy as risky (see asset quality section above) as it could ultimately affect the bank's capitalisation negatively.

- A TRACK-RECORD OF WEAK PROFITABILITY AND LOW EFFICIENCY

Skandiabanken has a track-record of weak profitability compared with larger Swedish banks and Norwegian banks of similar size. The bank's weak profitability reflect its relatively low risk products and its policy of offering attractive interest rates in a competitive market, as well as its relatively high cost-base.

Hovering around 100%, Skandiabanken's cost-to-income ratio for its Swedish operations has consistently been considerably higher compared with other Swedish and Norwegian banks. Excluding the Norwegian business, the bank's cost-to-income ratio stood at 104% at end-September 2015 (94% a year earlier), driven mainly by staff and administration expenses.

Following the divestment of its Norwegian business, we expect efficiency to be under pressure because of the weak efficiency associated with the Swedish operations. We understand that Skandiabanken intends to improve its profitability by cutting costs and by increasing lending volume, mainly to customers of the wider Skandia group. Including Norway, the bank group reported a cost-to-income ratio of 65% in 2014 (71% at 30 September 2015) compared to 77% in 2013, but this improvement mainly comes from the Norwegian branch which Skandiabanken now has divested. In December 2015, Skandiabanken announced that it will write down around 60% of its intangible assets, or SEK246 million, related to its extensive IT renewal. The write down signals lower expected returns on the investments the bank made on its new IT and digital banking platform. Skandiabanken's decision highlight the challenges it faces in delivering on its IT strategy, putting pressure on the bank to achieve its planned cost savings in the coming years.

- FUNDING PROFILE IS BECOMING MORE DIVERSIFIED

Skandiabanken has traditionally been almost exclusively deposit-funded, with deposits at year end-2012 amounting to 97% of total funding. In 2013 the bank issued its first covered bonds which were denominated in both SEK and NOK. The bank's funding profile becomes more diversified as it issues covered bonds which we view positively. In addition, the shift to secured funding can support its profitability. However, a material increase in market funding would expose the bank to fluctuations in investor sentiment; a credit negative.

The bank's deposits are purely internet-based and we believe that such deposits are less sticky than deposits originated through more traditional bank branch channels, because internet deposits have tended to be more price and confidence sensitive compared to deposits attracted in a branch through a face-to-face interaction.

Although Skandiabanken's liability structure may change given the divestment of its Norwegian branch, we do not expect any material change in terms of proportion of deposit funding or wholesale funding as a result of the divestment.

The bank held a liquidity reserve of SEK17.6 billion - 16% of liabilities - at end-September 2015. The portfolio consists mainly of cash and balances with central banks, government securities and both secured and unsecured bank securities. Much of the portfolio is of very strong credit strength which we view positively. The portfolio also contains unrated securities. We understand that these securities mainly consist of Nordic regional and local government bonds.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We apply our advance loss-given-failure analysis on Skandiabanken as the bank is subject to the EU Bank Resolution and Recovery Directive (BRRD), which we consider to be an Operational Resolution Regime. For this analysis we assume that equity and losses stand at 3% and 8%, respectively, of tangible banking assets in a failure scenario. We also assume a 25% run-off of "junior" wholesale deposits and a 5% run-off in preferred deposits. Moreover, we assign a 25% probability to junior deposits being preferred to senior unsecured debt. These are in line with our standard assumptions. Given the bank's focus on retail deposits, we assume the bank's junior deposits to account for 10% of total deposits.

We believe that Skandiabanken's deposits are likely to face low loss-given-failure, due to the loss absorption provided by subordinated debt and senior unsecured debt (should deposits be treated preferentially in a resolution). In addition, the bank has a large deposit base, meaning that any losses would be spread over a large base, thus translating into low losses for the individual depositor. Skandiabanken's long-term deposit ratings consequently receive a one-notch uplift to A2.

GOVERNMENT SUPPORT

Our ratings assigned to Skandiabanken do not contain uplift due to government support.

COUNTERPARTY RISK ASSESSMENT

We assign a long-term and short-term CR assessment of A1(cr) and P-1(cr) respectively.

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

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Rating Factors

SkandiaBanken AB

Macro Factors	
Weighted Macro Profile	**Very Strong -**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	0.2%	aa1	←→	a1	Loan growth	
Capital						
TCE / RWA	15.5%	aa2	↓↓	baa1	Risk-weighted capitalisation	Expected trend
Profitability						
Net Income / Tangible Assets	0.3%	ba2	←→	ba2	Return on assets	
Combined Solvency Score		a1		baa1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	15.9%	a2	←→	a1	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	9.0%	ba2	←→	ba2	Stock of liquid assets	
Combined Liquidity Score		baa2		baa1		

Financial Profile	**baa1**

Qualitative Adjustments	**Adjustment**
Business Diversification	-1
Opacity and Complexity	0
Corporate Behavior	0

Total Qualitative Adjustments	**-1**
Sovereign or Affiliate constraint	Aaa
Scorecard Calculated BCA range	**baa1 - baa3**
Assigned BCA	**baa1**
Affiliate Support notching	**1**
Adjusted BCA	**a3**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	1	0	a2	0	A2	A2

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