

## CREDIT OPINION

21 June 2016

### Update

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#### RATINGS

##### SkandiaBanken AB

Domicile	Sweden
Long Term Rating	A2
Type	LT Bank Deposits - Fgn Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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## SkandiaBanken AB

### Semi-annual Update

#### Summary Rating Rationale

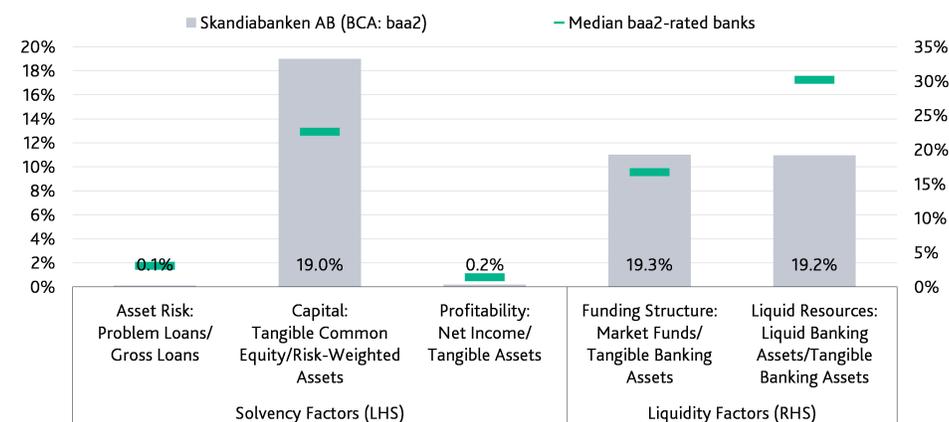
On 10 June 2016 we downgraded SkandiaBanken AB's baseline credit assessment (BCA) to baa2 from baa1, affirmed its a3 Adjusted BCA and its A2/Prime-1 long- and short-term deposit ratings with a negative outlook. We also assigned a long-term and short-term counterparty risk assessment (CRA) of Aa3(cr)/Prime-1(cr) to the bank.

SkandiaBanken's baa2 baseline credit assessment reflects the bank's strategic role as the banking arm of the Skandia Group, very low reported problem loan ratio, and reliance on retail deposit funding. The BCA is limited by the bank's limited standalone franchise strength, its strong loan growth and weak profitability.

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.

Exhibit 1

#### Rating Scorecard - Key Financial Ratios



Source: Moody's Financial Metrics

#### Credit Strengths

- » Growing importance in the wider Skandia Group
- » Strong asset quality
- » Strong capital and higher-than-peers leverage ratio
- » A retail-based funding profile and adequate liquidity given wholesale funding needs

- » SkandiaBanken's BCA supported by Sweden "Very Strong-" Macro Profile

## Credit Challenges

- » Limited standalone franchise
- » High lending growth
- » Lower-than-peers efficiency and weak profitability

## Rating Outlook

The negative outlook on SkandiaBanken's long-term deposit ratings reflects Moody's forward-looking view of the bank's balance sheet, given its plan to increase covered bonds issuance to support its planned growth. Moody's notes that, under its Advanced Loss Given Failure analysis, a lower proportion of senior unsecured would result in lower protection for junior depositors. A higher-than-expected loss for junior depositors could also result if the share of junior deposits is significantly below our assumption of 10% of total deposits.

## Factors that Could Lead to an Upgrade

SkandiaBanken's BCA could be upgraded following a significant improvement in its efficiency and profitability ratios and/or a slowdown in its growth rate, whilst maintaining its asset quality, capital and liquidity metrics. An upward movement in its BCA would likely result in an upgrade of its deposit ratings.

## Factors that Could Lead to a Downgrade

A weakening in the Swedish operating environment, impacting SkandiaBanken's ability to absorb losses via earnings and capital, along with an increased reliance on confidence-sensitive wholesale funding could lead to a lower BCA. A change in Moody's assessment of the probability of parental support could also lead to a lower Adjusted BCA. A downward movement in SkandiaBanken's BCA and Adjusted BCA would likely result in a downgrade of its deposit ratings.

The long-term deposit ratings could be also downgraded if Moody's considers that SkandiaBanken's changing liability structure results in a structural increase in risk for this instrument. This could be evidenced by a lower proportion of senior unsecured debt funding in the bank's liability structure and/or by a lower than expected volume of junior deposits.

## Key Indicators

Exhibit 2

### SkandiaBanken AB (Consolidated Financials) [1]

	3-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>2</sup>	12-12 <sup>3</sup>	Avg.
Total Assets (SEK million)	58216.0	58735.0	114918.0	98597.0	84638.0	-8.9 <sup>4</sup>
Total Assets (EUR million)	6301.8	6413.4	12131.6	11140.9	9868.3	-10.6 <sup>4</sup>
Total Assets (USD million)	7181.2	6966.9	14679.9	15351.6	13010.3	-13.8 <sup>4</sup>
Tangible Common Equity (SEK million)	3948.0	3921.0	5036.0	3907.0	3169.0	5.6 <sup>4</sup>
Tangible Common Equity (EUR million)	427.4	428.1	531.6	441.5	369.5	3.7 <sup>4</sup>
Tangible Common Equity (USD million)	487.0	465.1	643.3	608.3	487.1	0.0 <sup>4</sup>
Problem Loans / Gross Loans (%)	0.0	0.1	0.2	0.2	0.3	0.1 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	19.0	19.6	12.1	10.9	10.5	15.4 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	0.1	0.8	3.4	3.5	5.2	2.6 <sup>5</sup>
Net Interest Margin (%)	1.1	1.2	1.3	1.2	1.4	1.2 <sup>5</sup>
PPI / Average RWA (%)	0.6	0.2	1.5	0.7	1.2	0.7 <sup>6</sup>
Net Income / Tangible Assets (%)	0.2	0.8	0.4	0.3	0.3	0.4 <sup>5</sup>
Cost / Income Ratio (%)	84.8	95.7	67.0	81.0	78.2	81.3 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	19.2	19.3	15.9	12.9	2.4	13.9 <sup>5</sup>

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Liquid Banking Assets / Tangible Banking Assets (%)	7.9	11.4	9.0	13.8	21.4	12.7 <sup>5</sup>
Gross loans / Due to customers (%)	133.7	129.8	120.3	103.1	77.7	112.9 <sup>5</sup>

[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

Source: Moody's Financial Metrics

## Detailed Rating Considerations

The financial data in the following sections are sourced from SkandiaBanken's first quarter 2016 financials, unless otherwise stated.

### A Limited Standalone Franchise With Growing Importance in the Wider Skandia Group

SkandiaBanken is the banking arm of Skandia Insurance Company Ltd (A2, stable), the leading Swedish life insurer. With reported assets at-end 2015 of SEK59 billion and a 1.7% share of the Swedish mortgage market, the bank is relatively small.

The bank focuses almost exclusively on mortgage lending and sell its product on internet, by phone, and through the branch network of the wider Skandia insurance group (54 branches) and is essentially a monoline with a business model focused on mortgages. Its earnings are hence highly dependent on retail interest income, which represented 70% of its operating income in 2015. This structural dependence results in a one-notch qualitative downwards adjustment to the BCA in respect of Business Diversification, an adjustment shared with the majority of the Swedish mortgage lenders.

In line with the group's strategic plan, SkandiaBanken has significantly grown over the last years: in 2013 management set a target of doubling the lending volume in five years' time and, at end-2015, SkandiaBanken reported SEK45 billion of outstanding mortgage, a 46% volume increase since 2013 (excluding the Norwegian operations). 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 spun-off its Norwegian business, which had accounted for 54% of total lending at 30 September 2015 and was the most profitable part of the bank.

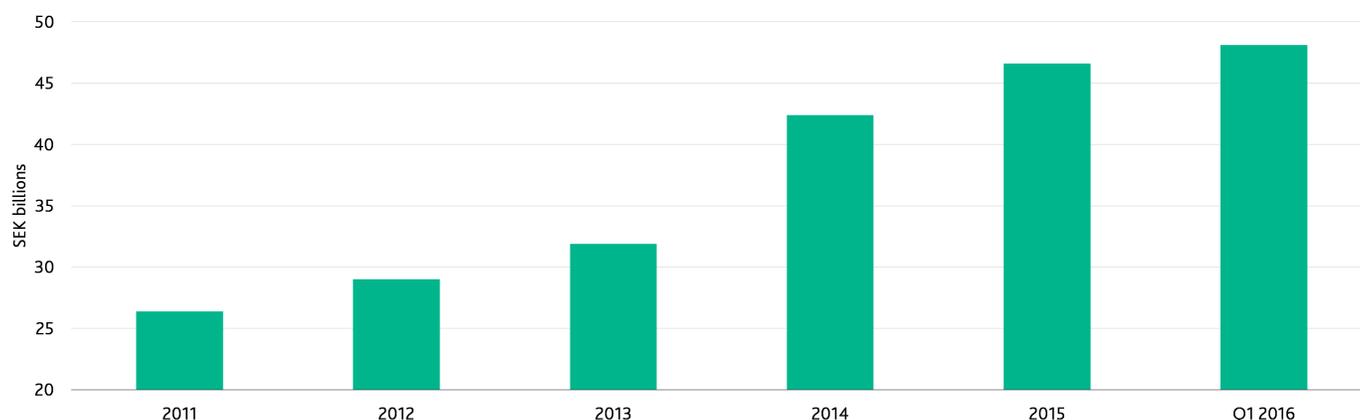
### Strong Asset Quality, But High Lending Growth

Our a3 Asset risk score reflects SkandiaBanken's very low problem loan ratio – in line with all the Swedish mortgage lenders – and its significant lending growth over the last years, a result of the strategic plan to increase the bank's market share and size (see Exhibit 3).

Exhibit 3

#### Outstanding Loans to the Public in the Swedish Business

Skandiabanken has experienced significant lending growth over the past few years



Source: Company reports

SkandiaBanken reported problem loans ratio at end-March 2016 was very low at 0.1%: in line with other Swedish mortgage lenders, its asset quality has benefitted from low interest rates, increasing property prices, and the Swedish households' ability to service their largely non-amortising debts.

The SEK48 billion lending book comprises almost entirely mortgages: at end-2015 lending to finance houses and vacation homes accounted for 60% of the total book and tenant-owner apartments for 38%, the remaining part was marginal. The large majority of the loans is concentrated in Stockholm.

In 2015 SkandiaBanken's gross lending was SEK6 billion and outstanding loan increased by 10%, mainly driven by the offer of competitive rates. In our view the bank's above-market growth of its mortgage book poses some risk because it is less clear how these mortgages, which have been originated during a period of very low interest rates and are for the majority base on variable interest rates, will perform in the future compared to a more seasoned loan portfolio.

### Strong Capital and Higher-than-peers Leverage Ratio

We view SkandiaBanken's capitalisation as strong given its business model focused on mortgages and the support from its parent, which offset the weak internal capital generation through capital injections. The parent supports SkandiaBanken's capital position through direct capital injections (SkandiaBanken received an unconditional capital contribution of SEK 1.7 billion in 2015 and SEK 981 million in 2014) and through tax contributions. Our aa3 assigned Capital score reflects this strength as well as our expectation of a negative trend, a consequence of the growth strategy.

SkandiaBanken reported a Common Equity Tier 1 ratio of 16.4% at end-March 2016; its TCE relative to risk-weighted assets under Moody's definition was 19% at the same date. This ratio is lower than peers' (median 21%) because it is calculated under the Standardised Approach for credit risk, whilst the majority of other rated Swedish banks use the Internal Ratings Based approach (IRB). SkandiaBanken is in the process of obtaining IRB approval, which should be implemented by 2018 and the bank currently manages its capital ratio on both standardised and IRB basis.

The reported regulatory leverage ratio was 5.5% at end-2015, which is higher than peers; under Moody's definition, SkandiaBanken's TCE relative on total tangible assets was 6.8% at end-March 2016.

### Lower-than-peers Efficiency and Weak Profitability

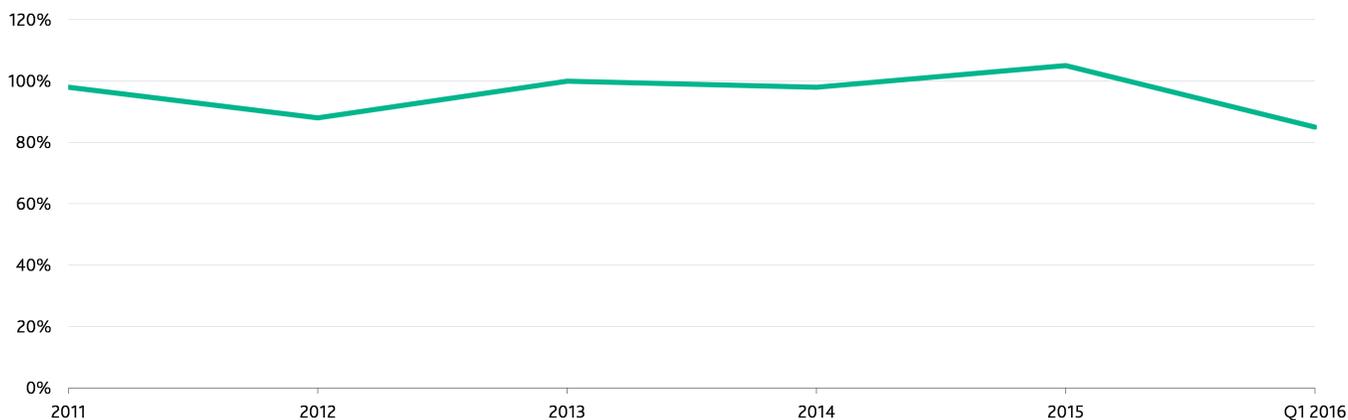
The b3 Profitability score reflects SkandiaBanken's weaker-than-peers profitability, a consequence of its relatively low risk products, its aggressive pricing strategy, and its low efficiency. The sale of the Norwegian part of the business, which was more efficient and profitable, was credit negative for the bank. We expect weak profitability to persist over the outlook period.

SkandiaBanken's reported cost-income ratio was 85% in 1Q16 compared with 84% in 1Q15 and 105% in 2015 (see Exhibit 4). Under the "Apollo" program – a cost-savings plan for the whole group – SkandiaBanken plans to reduce its cost base through outsourcing in the next four years. We expect however only marginal improvements in the bank's efficiency ratio over the outlook period despite the growth in lending and the achievement of economies of scale.

Exhibit 4

#### Cost-income Ratio for Skandiabanken's Swedish Operations

Skandiabanken has maintained high cost-income ratio over several years



Source: Moody's Financial Metrics

SkandiaBanken reported pre-tax income was SEK28 million in 1Q16 compared with SEK25 million in 1Q15 (exclusive of the Norwegian business), driven by a 4% growth of the mortgage book to SEK48 billion in the quarter. As a result of the high cost-income ratio, we expect weak profitability to persist over the next 12-18 months.

### **A Retail-based Funding Profile and Adequate Liquidity Given Wholesale Funding Needs**

Our score a2 Funding Structure score captures SkandiaBanken's high share of retail deposits as a proportion of its assets, as well as our expectation of an increasing reliance on wholesale funding to support balance sheet growth, although mainly via covered bonds issuances.

Reported retail deposits were SEK36 billion at end-March 2016, or 62% of total balance sheet. The large majority of these retail deposits are internet-based because the bank does not have its own branch network and, in our view, they are more price and confidence sensitive compared to deposits sourced through branches. SkandiaBanken reported a loan-to-deposit ratio was 134% at end-March 2016 compared with 120% at end-2014. The SEK12 billion gap between customer loans and deposits at end-March 2016 – a result of the sustained growth in mortgage lending – is funded mainly with the issuance of debt securities: SEK11 billion covered bonds, SEK3 billion senior unsecured funding, and SEK0.9 billion subordinated debt.

We expect the bank to continue increasing its reliance on confidence sensitive wholesale funding to support its balance sheet growth, a credit negative. This is however mitigated by the fact that most of the issuance will be in SEK-denominated covered bonds, which in our view are less confidence-sensitive than senior unsecured bonds because they benefit from a deep local market. We reflect this feature by treating covered bonds denominated in local currency as retail funding, an adjustment shared with most other Swedish banks.

SkandiaBanken's liquidity position is adequate given its wholesale funding needs, as captured by our baa2 assigned Liquid Resources.

The liquid resources/tangible banking assets ratio was 19.2% at end-2015 and reported liquidity reserves were SEK11 billion at the same date, which account for 61% of the outstanding debt. The portfolio consists mainly of cash and balances with central banks, and highly rated government securities and secured and unsecured debt issued by financial institutions, mostly Nordics. SkandiaBanken reported a Liquidity Coverage ratio (LCR) of 233% at end-2015.

### **Supportive Operating Environment as Expressed by the Very Strong- Macro Profile for Sweden**

As a domestic bank, SkandiaBanken's operating environment is determined by Sweden (Aaa, stable) and its Macro Profile is thus aligned with Sweden at Very Strong-. Swedish banks benefit 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.

## **Notching Considerations**

### **Affiliate Support**

The a3 Adjusted BCA incorporates Moody's assessment of a very high probability of support from the bank's parent Skandia Insurance Company Ltd. (Insurance Financial Strength A2/Stable) in the event of need.

### **Loss Given Failure**

We apply our advance loss-given-failure analysis on SkandiaBanken as the bank is subject to the EU Bank Recovery and Resolution 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). SkandiaBanken's long-term deposit ratings consequently receive a one-notch uplift to A2.

## Government Support

Owing to the relatively small size of its retail operations, we assume a low probability of government support for SkandiaBanken's long-term deposit ratings.

## Counterparty Risk Assessment

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, and liquidity facilities. The CR Assessments is distinct from debt and deposit ratings in that they consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default.

SkandiaBanken's CR Assessment is positioned at Aa3(cr) and P-1(cr), based on the cushion against default provided by junior deposits, senior unsecured, and subordinated debts and does not benefit from any government support, in line with deposits and senior unsecured debt ratings.

## Rating Methodology and Scorecard Factors

Exhibit 5

### SkandiaBanken AB

Macro Factors						
Weighted Macro Profile	Very Strong -	100%				
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	0.1%	aa1	← →	a3	Loan growth	
Capital						
TCE / RWA	19.0%	aa1	← →	aa3	Expected trend	Expected trend
Profitability						
Net Income / Tangible Assets	0.2%	b1	← →	b3	Return on assets	
Combined Solvency Score		a1		baa1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	19.3%	a2	← →	a2	Expected trend	Market funding quality
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	19.2%	baa2	← →	baa2	Stock of liquid assets	
Combined Liquidity Score		a3		a3		
Financial Profile				baa1		
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				baa2		

Affiliate Support notching	2
Adjusted BCA	a3

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Counterparty Risk Assessment	3	0	aa3 (cr)	0	Aa3 (cr)	--
Deposits	1	0	a2	0	A2	A2

Source: Moody's Financial Metrics

## Ratings

Exhibit 6

Category	Moody's Rating
<b>SKANDIABANKEN AB</b>	
Outlook	Negative
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	a3
Counterparty Risk Assessment	Aa3(cr)/P-1(cr)
<b>PARENT: SKANDIA INSURANCE COMPANY LTD.</b>	
Outlook	Stable
Insurance Financial Strength	A2

Source: Moody's Investors Service

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