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Credit Opinion: Bank Nederlandse Gemeenten N.V.

Global Credit Research - 21 Nov 2014

The Hague, Netherlands

Ratings

Category	Moody's Rating
Outlook	Negative(m)
Bank Deposits	Aaa/P-1
Bank Financial Strength	B-
Baseline Credit Assessment	a1
Adjusted Baseline Credit Assessment	a1
Issuer Rating	Aaa
Senior Unsecured	Aaa
Commercial Paper	P-1

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Opinion

SUMMARY RATING RATIONALE

We assign Aaa long-term and P-1 short-term ratings to Bank Nederlandse Gemeenten N.V. (BNG Bank), which incorporates four-notch uplift for systemic support from the bank's a1 baseline credit assessment (BCA). The main drivers of the BCA are: (1) its role as the largest lender to the Dutch public sector; (2) its good standing in the capital markets and its central bank access; (3) solid financial fundamentals and prudent risk management and (4) some non-solvency-free lending, although the bulk of its lending carries a zero-risk weighting.

Unlike its Nordic peers, BNG Bank does not have a contractual guarantee from its key stakeholders or a comfort letter from its national government. However, in a stress scenario, Moody's anticipates a very high likelihood of support from the Dutch national government (Aaa stable). This is because of BNG Bank's mandate to fund the Dutch local government sector and the bank's importance to the social housing sector.

Rating Drivers

- Ownership structure emphasises BNG Bank's importance to the Dutch public sector

- BNG Bank is the largest lender to the Dutch public sector

- High asset quality reflected in the predominance of solvency-free lending

- Funding profile and liquidity position are adequate despite some maturity mismatches

- BNG Bank targets a 3% leverage ratio by the end of 2017

- BNG Bank's financial performance is commensurate with the bank's public-policy role

Rating Outlook

The outlook on BNG Bank's long-term rating is negative. It takes into account the recent adoption of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) regulation in the EU. In particular, this reflects that, with the legislation underlying the new resolution framework now in place and the explicit inclusion of burden-sharing with unsecured creditors as a means of reducing the public cost of bank resolutions, the balance of risk for banks' senior unsecured creditors has shifted to the downside. Although our support assumptions are unchanged for now, the probability has risen that they will be revised downwards to reflect the new framework. For further details, please refer to our Special Comment entitled "Reassessing Systemic Support for EU Banks," published on 29 May 2014.

What Could Change the Rating - Down

Downward pressure on BNG Bank's rating could result from (1) a downgrade of the Netherlands' sovereign rating; (2) a weakening of its ownership or support assumption; or (3) a weaker standing in the capital markets.

DETAILED RATING CONSIDERATIONS

The rating assigned to BNG Bank reflects the application of Moody's Global Banks methodology and the Government-Related Issuers: Methodology Update. In accordance with these methodologies, Moody's first establishes the baseline credit assessment (BCA) for the entity and then considers the likelihood of support coming from the local and/or national governments in order to avoid an imminent default by BNG Bank, should this extreme event ever arise.

Baseline Credit Assessment

OWNERSHIP STRUCTURE EMPHASISES BNG BANK'S IMPORTANCE TO THE DUTCH PUBLIC SECTOR

BNG Bank's by-laws restrict its ownership to the Dutch public sector. The central government holds a 50% stake in the bank, with the remaining 50% spread among Dutch municipalities and provinces and a district water board. This ownership structure has been stable since 1925 and is unlikely to change given BNG Bank's unchanged mandate to act as a lender to the Dutch public sector.

BNG BANK IS THE LARGEST LENDER TO THE DUTCH PUBLIC SECTOR

With a total portfolio of EUR91 billion at end-June 2014 and new loan production that ranged from EUR10 to 12 billion over the past three years, BNG Bank 's market share of lending to local governments has been in excess of 60%, while its market share of lending to housing associations and healthcare institutions (under the guarantee of the Waarborgfonds voor de Zorgsector or WFZ) is estimated to be around 50% to 55%. BNG Bank is particularly well positioned in lending to local governments where its market share in new loans granted reached 73% in 2013. The bank's closest competitor, Nederlandse Waterschapsbank N.V. (NWB Bank, Aaa negative, C+/a2 stable), has approximately 30% market share. We expect both banks to continue to dominate the Dutch public sector financing business, given their mandate, ownership and advantageous funding costs compared to commercial banks.

HIGH ASSET QUALITY REFLECTED IN THE PREDOMINANCE OF SOLVENCY-FREE LENDING

Despite market volatility, BNG Bank has consistently been able to lend to the Dutch public sector at advantageous rates, given its low funding costs compared to commercial banks. The bank's narrow public policy mandate translates into concentrations on the asset side of the balance sheet. However, these concentrations are mainly to Dutch local governments and housing associations that benefit from indirect guarantees on their liabilities from the central government, and thus do not entail any capital charge (EUR94 billion at year-end 2013 including off-balance-sheet exposures).

A small part (EUR9.2 billion or 9% of total loans and advances at year-end 2013) of the bank's lending is subject to a capital charge. These exposures consist of lending, for example, to public-private partnerships. Concentration risks on such loans are minimised and volumes are closely monitored. We understand that BNG Bank does not intend to further increase the share of such loans in its lending portfolio.

Approximately 1% of BNG Bank's loan book consists of exposure to other European countries, including small amounts of lending to customers in Portugal and Spain. Lending to entities in other countries is limited to 15% of the loan book as per the bank's guidelines. Moody's expects foreign lending to remain a small percentage of total lending, given the financial challenges facing some European countries.

BNG Bank's securities portfolio mainly consists of highly rated securities. The portfolio is primarily invested in government debt, bonds with government guarantees, and covered bonds. At end-June 2014, it was 82% composed of securities rated from Aaa to A, 13% of securities in the Baa range and 4% of non-investment grade securities. However, we do not see the below-investment-grade investments (around 18% of the bank's shareholder's equity) as a major threat to BNG Bank's solvency.

BNG Bank's overall exposures to the GIIPS economies through both the loan and securities portfolios amounted to EUR3.1 billion (or 86% of its shareholder's equity at end-June 2014). Exposures were primarily in the form of covered bonds, ABS and RMBS.

Loans in arrears and impaired loans totalled EUR114 million representing 0.1% of the bank's loans and advances at end-June 2014, reflecting the bank's high asset quality. Impairments only come from the portfolio subject to solvency requirements.

FUNDING PROFILE AND LIQUIDITY POSITION ARE ADEQUATE DESPITE SOME MATURITY MISMATCHES

BNG Bank is almost entirely wholesale-funded and therefore relies on capital markets for its financing. It employs a diversified funding strategy by issuing debt in multiple currencies and markets to a wide array of investors. This diversified strategy is prudent and similar to the one used by its specialised lender peers.

We note that BNG Bank's asset and liability management entails some maturity mismatches. This policy helps the bank to maintain low pricing on the financing provided to the Dutch public sector despite the very long maturity of the loans. We believe that the risks implied by these gaps are under check:

-- Liquidity risk is managed through the coverage of gaps within the one-year bucket (around EUR5 billion based on our estimation at year-end 2013) by a comfortable liquidity buffer composed of highly liquid assets (EUR 6.3 billion unecumbered market value at year-end 2013) and immediate drawing capacity on the ECB collateralised by public sector loans already pledged by BNG Bank at the central bank (EUR8.8 billion after haircut at year-end 2013). While the collateral already recorded at the ECB is calibrated on the level of short-term gaps, we note that the bank is able to use its whole portfolio of 0% risk-weighted loans (i.e. the vast majority of its portfolio) as collateral for refinancing at the ECB. This provides substantial additional liquidity in case of need.

-- Maturity mismatches could have negative implications on BNG Bank's interest margins where the bank's spreads would rise significantly for a prolonged period of time and imply an increase in the refinancing cost of outstanding loans. Given the relatively thin margins of BNG Bank, the bank's room for manoeuver in such a scenario could be limited. We nevertheless believe that this risk is mitigated by the fact that the funding gaps are maintained within reasonable limits and by BNG Bank's good standing in the capital markets. The recent decision of the European Commission to include bonds issued by « promotional banks » - designating banks where lending to the public sector represents more than 90% of total loans - within the level 1 category assets (the highest quality) for the calculation of the Liquidity Coverage Ratio (LCR) is also a positive development for BNG Bank. It will likely further enhance financial institutions' appetite for debt issued by the Bank.

At end-June 2014, both BNG Bank's LCR and Net Stable Funding Ratio (NSFR) were above 100%, in compliance with EU prudential requirements ahead of schedule.

BNG BANK TARGETS A 3% LEVERAGE RATIO BY THE END OF 2017

BNG Bank's capitalisation is adequate in relation to its low-risk assets. Its Common Equity Tier 1 ratio stood at 24.3% at end-June-2013, compared to 23.7% at year-end 2013. The favourable outcome of the European Central Bank's comprehensive assessment for BNG confirms the bank's robustness based on its high asset quality.

Due to the very low risk weight of exposures to the local public sector, this high capital ratio translates into high leverage, although BNG Bank `s leverage ratio is rather robust relative to its European peers at 2.3% as of 30 June 2014. The rules to be applied by the public sector financing entities in Europe are still to be agreed upon in the European Union based on a report to be submitted by the European Banking Authority (EBA) by 31 December 2016. Given their lower risk-profile and specific business model, these entities could eventually be imposed a lower leverage ratio than other commercial banks. Meanwhile, BNG Bank targets a 3% leverage ratio by the end of 2017 and reduced its dividend payout ratio since 2011 to 25% from 50% in order to achieve this objective. We also understand that the bank could issue Additional Tier 1 capital (AT1) in order to comply with this target.

BNG BANK'S FINANCIAL PERFORMANCE IS COMMENSURATE WITH THE BANK'S PUBLIC POLICY ROLE

Like other government-related specialised lenders, BNG Bank must generate sufficient profits to grow its capital in line with its portfolio expansion and to comply with higher regulatory capital requirements. However, it must also balance this growth with the provision of efficient, low-cost funding to local governments and their related sectors.

BNG Bank has recorded relatively stable net income over the past five years. Net income of EUR 283 million in 2013 is slightly lower than in 2012 and, as before, largely due to value adjustments related to financial instruments. Moody's expects BNG Bank's net income to remain stable in the medium term because its business model is unlikely to change.

BNG Bank's net interest margin (NIM) is consistently around 30 to 40 basis points as it continues to benefit from advantageous funding rates despite recent volatility in the financial markets. This is largely in line with peers. Like most other specialised lenders, BNG Bank's costs are low relative to its total assets. Cost-to-income ratio was around 11% in both 2013 and 2012.

Support Considerations

We assign a very high likelihood of support from the Dutch national government and public sector, resulting in four notch uplift from the bank's BCA of a1 . This stems from the importance of the local government sector to the overall Dutch economy and BNG Bank's role as the principal financier to those local governments. The very high support assumptions include the support that would come (1) from the Dutch public sector (including the central government) acting as the shareholder of the bank, and (2) from the government stepping in to address systemic risk.

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