

RatingsDirect®

Bank of North Dakota

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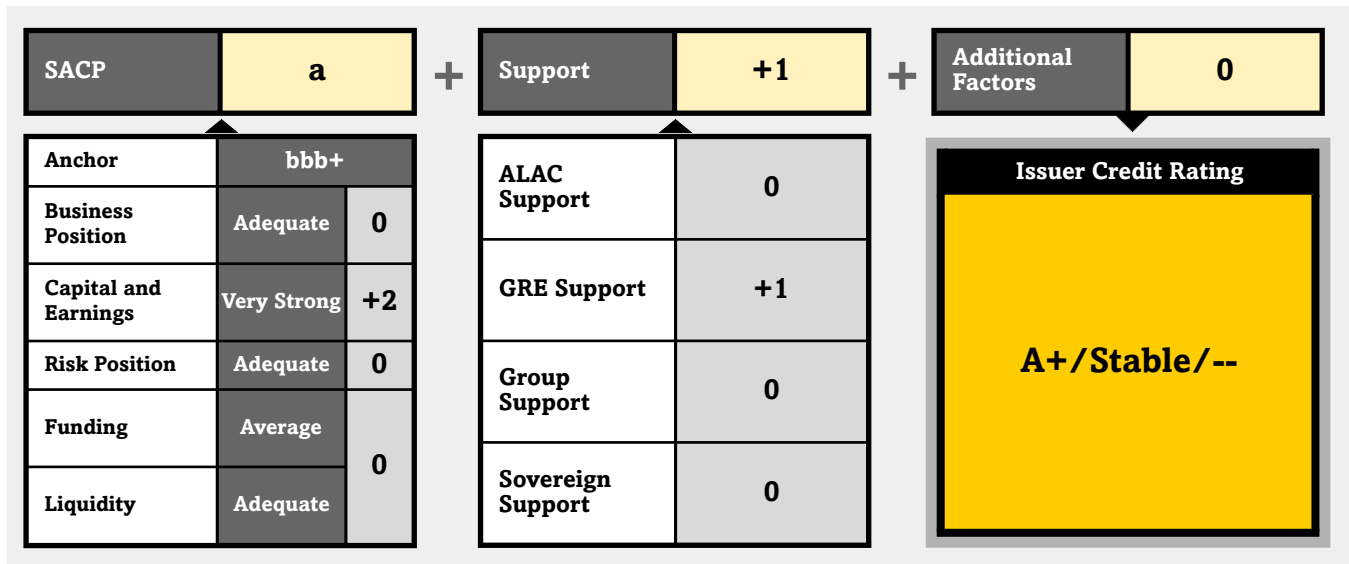
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Bank of North Dakota



Credit Highlights

Overview

Key strengths	Key risks
Very strong risk-adjusted capital ratio	Geographic concentration in North Dakota
Stable ownership by state of North Dakota since 1919	Direct and indirect lending exposure to energy and agriculture, which are cyclical sectors
Strong credit quality and conservative management	Subject to annual capital transfers paid to North Dakota's general fund

Bank of North Dakota (BND) has a century of stable operating performance as a state-owned bank focused on promoting commerce in North Dakota. The bank is unique as the only remaining state-owned bank in the continental U.S. It partners with private sector banks in providing credit to North Dakota based businesses, holds the deposits of the state and certain agencies, and provides disaster assistance lending through numerous programs. As a government-related entity (GRE), we see a high likelihood of support from the state of North Dakota if the bank experiences stress.

BND has one the highest risk-adjusted capital (RAC) ratios for rated U.S. banks. We expect the bank to maintain very strong capital levels, though capital ratios could decline if net income is less than capital transfers (dividends) to the state's general fund. The North Dakota legislature determines appropriations from the general fund every legislative session, and the amounts designated from BND's capital will vary based on the state's needs and BND's capital and liquidity levels. However, these dividends have typically not exceeded net income by a large enough amount to significantly impact capital levels.

While non-performing assets (NPAs) are typically higher at the bank, it rarely translates to high credit losses, and BND maintains a robust loan loss reserve. As of June 30, 2021, adjusted NPAs are 3.02% of loans and real estate owned, though over half of these loans are residential loans guaranteed by the federal government or student loans guaranteed by the state of North Dakota. BND has elevated exposures to cyclical industries such as energy and agriculture given its concentration in North Dakota, but credit losses have been minimal. Over the past 10 years, the net charge-off (NCO) rate has been under 15 basis points (bps) annually despite significant oil and agricultural commodity price

volatility, which we think reflects BND's strong credit selection and underwriting. Furthermore, the bank maintains a loan loss reserve of 2.32% of total loans and 3.42% of non-guaranteed loans--among the highest of rated U.S. banks.

Outlook

The stable rating outlook on Bank of North Dakota reflects S&P Global Ratings' view that over the next two years, the bank will continue its conservative strategy by maintaining very strong capital and appropriately managing its credit risk. In addition, the bank's policy role and link with 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 two notches, the issuer credit rating and deposit ratings would be unchanged.

Downside scenario

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 payouts to the state increase enough to impair BND's capital such that its RAC ratio drops below 15.0%.

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.

Upside scenario

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.

Key Metrics

Bank of North Dakota Key Ratios And Forecasts					
	--Fiscal year ended Dec. 31 --				
(%)	2022f	2021f	2020a	2019a	2018a
Growth in customer loans	(1.8)-(2.2)	(1.8)-(2.2)	4.8	(1.0)	(6.6)
Growth in total assets	0.1-0.2	18.2-22.2	9.7	0.6	0.2
Net interest income/average earning assets (NIM)	2.2-2.5	2.3-2.6	2.8	3.1	2.9
Cost to income ratio	20.9-21.9	19.5-20.6	16.1	13.8	14.5
Return on average common equity	13.4-14.8	13.6-15.1	15.2	18.8	18.8
Return on assets	1.3-1.7	1.4-1.7	1.9	2.4	2.3
New loan loss provisions/average customer loans	0.0-0.1	0.0-0.1	0.4	0.1	0.3
Gross nonperforming assets/customer loans	3.1-3.4	3.7-4.1	3.7	3.3	3.0
Net charge-offs/average customer loans	0.1-0.3	0.1-0.3	0.1	0.1	0.1
Risk-adjusted capital ratio	19.1-20.5	20.0-21.0	21.9	23.1	21.4

All figures are S&P Global Ratings-adjusted. f--Forecast. a--Actual. e--Estimate. NIM--Net interest margin.

Anchor: bbb+ Starting Point For U.S. Banks

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 U.S.'s diversified, high-income, and resilient economy underpins our assessment of economic risk, which we see on a stable trend given the ongoing economic recovery from the pandemic-related downturn.

Our view of industry risk in the U.S. balances the regulatory enhancements made after the global financial crisis, a high level of core deposits, and deep capital markets against the risks that come with the country's large nonbank financial system. The trend on industry risk is positive, reflecting an improving track record of bank regulation and the steady performance of banks over many years. We could positively revise the industry score as well as the anchor to 'a-' in the next two years if the stringency of regulation remains in place, the economy continues to grow, and banks maintain strong balance sheets. (See "How The Economy, Profitability, And Regulations Could Support Certain U.S. Bank Ratings", May 24, 2021)

Business Position: Unique Relationship With State And Conservative Management Strategy

BND's business position reflects the bank's well entrenched history in North Dakota, 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, small domestic market share, and less regulatory oversight relative to most banks roughly offset BND's positive factors.

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, when North Dakota became a large producer of shale energy.

BND acts as the agent of several state-legislated programs, a lender, a depository for state agency funds (which have grown substantially following the COVID-19 pandemic), 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 disaster relief programs to assist borrowers in stress and identify borrowing needs.

Capital And Earnings: Very Strong Capital Ratios And Good Earnings Generation

BND's capital and earnings assessment benefits from its high RAC ratio, strong core earnings generation, and very low operating costs. Though the decline in interest rates has lowered BND's net interest margin (NIM), we expect BND to remain profitable and maintain high capital ratios.

S&P Global Ratings' RAC ratio was 21.9% as of June 30, 2021, by our calculation, which is among the highest of rated U.S. banks. We expect the RAC ratio could decline modestly as earnings may not exceed capital transfers over the next several years. However, we expect the RAC ratio to remain comfortably in the very strong category (above 15%) over the next two years.

The bank makes capital transfers to the state's general fund and assists other state programs through dividend contributions. Historically, these dividends have fluctuated depending on the state's needs and the capital needs of the bank. In 2020, dividends were \$137.5 million out of BND's net income of \$141 million. For 2021 and 2022, the company expects total dividends will be \$75 million and \$128 million respectively, which are lower than our net income forecasts. However, total potential capital transfers of \$281 million from July 1, 2021 to June 30, 2023 could exceed these estimates and lead to a slight decline in capital ratios.

BND's earnings have been strong and consistent over the past few years, despite its heavy reliance on spread-based income. The company reported lower earnings in 2020 and the first half of 2021 as low interest rates constrained net interest income (NII). Noninterest income remains minimal as 97% of revenue is from NII. We expect a low single-digit decline in loan balances to lead to reduced net income in 2021 and 2022. Positively though, due to its low overhead expenses, BND's return on average assets remained very high at 1.63% through the first six months of 2021.

We expect earnings to remain somewhat stable for the remainder of 2021--absent any material credit issues--as the state economy continues to recover. BND's very low operating costs, tax exemption, and lack of deposit insurance premiums bolster its earnings capacity.

Risk Position: Concentrations In Cyclical Portfolios Offset By Low Historical Credit Losses

Our assessment of BND's risk position balances the company's historically strong asset quality and well-reserved allowance for credit losses with its substantial concentrations, including energy and agricultural lending. Overall, BND's asset quality remains strong, reflecting careful underwriting and good management of its concentrations. Though delinquencies saw a slight uptick due to the adverse economic conditions during the pandemic, asset quality held up well as oil prices stabilized and the economy was supported by the massive fiscal stimulus.

BND continues to have higher energy exposures than most rated U.S. banks as energy is an important sector in the North Dakota economy, though positively, the proportion of energy loans to total loans remained below the peak levels seen in 2013-2014. Direct energy lending (including oil services, refining, ethanol production, power generation, mining, energy marketing, and natural gas distribution) amounted to \$394 million as of June 30, 2021, which is slightly above 8% of total loans. Indirect energy lending, including commitments (such as hotel, multifamily, and municipal loans) to the state's oil-producing regions, were meaningful at 9% (\$434 million) of total loans. Energy prices have rebounded since the pandemic, and hotel occupancies in the oil-producing regions have improved. Unemployment rates have considerably improved in 2021 but remain higher than the pre-pandemic level. The rebound in energy prices has supported the direct and indirect energy loan portfolios' credit performance as oil production and employment in oil-producing geographies has improved from 2020.

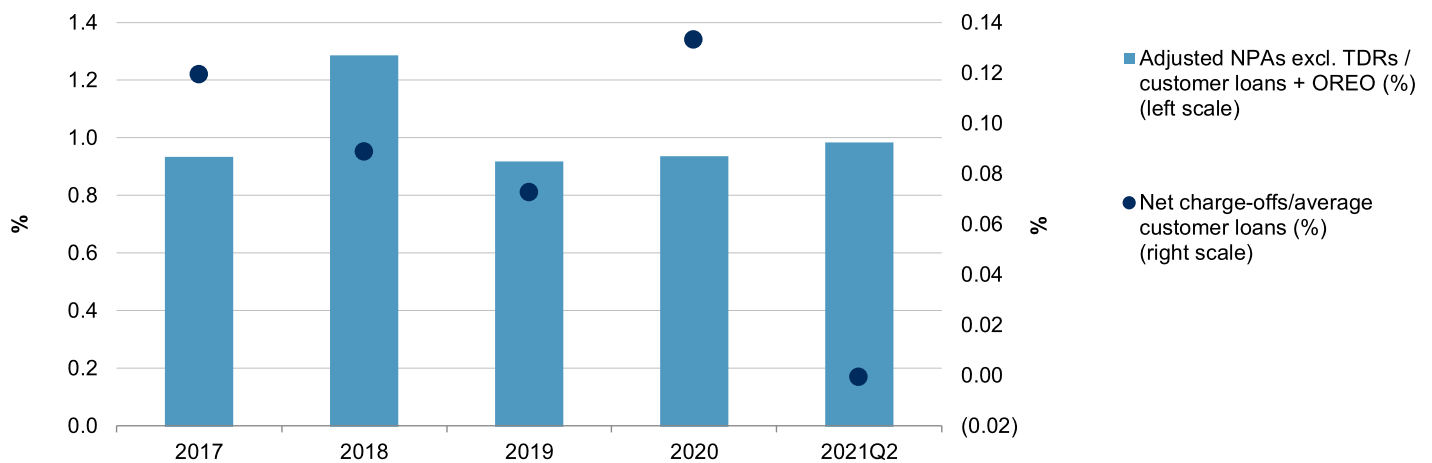
Overall, the level of gross NPAs has decreased 9 bps from a year ago, to 3.47%, due to a decrease in past due loans. The high degree of guarantees helps support the bank's credit quality, with 32% of the total loan portfolio either fully or partially guaranteed: residential loans by the federal government and student loans by the state of North Dakota. The commercial portfolio (excluding agriculture), which has the lowest level of guarantees, has generally maintained a

steady level of NPAs. We expect the proportion of guaranteed loans and loan portfolio diversification to decline over time as BND has exited the underwriting and servicing of new residential loans and has collaborated with another state agency, North Dakota Housing Finance Agency, which performs similar services.

Agricultural loans represented 15% of total loans and residential real estate loans represented 10% as of June 30, 2021. While 2020 net farm income was strong, primarily due to government programs, the state is experiencing one of its worst droughts in 2021, leading to poor crop yields. Positively, the proportion of agricultural NPAs and adversely classified loans has declined from its peak in 2020 and borrowers expect to benefit from crop insurance programs. The proportion of residential loans over 90 days past due spiked to 5.3%; however, nearly all residential delinquencies involve federally guaranteed loans.

Chart 1

Loan Losses Remain Minimal Despite Higher NPAs Than Most Peers
As of June 30, 2021



Source: S&P Global Ratings.
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Funding And Liquidity: Deposit Levels Continue To Bolster Funding And Liquidity

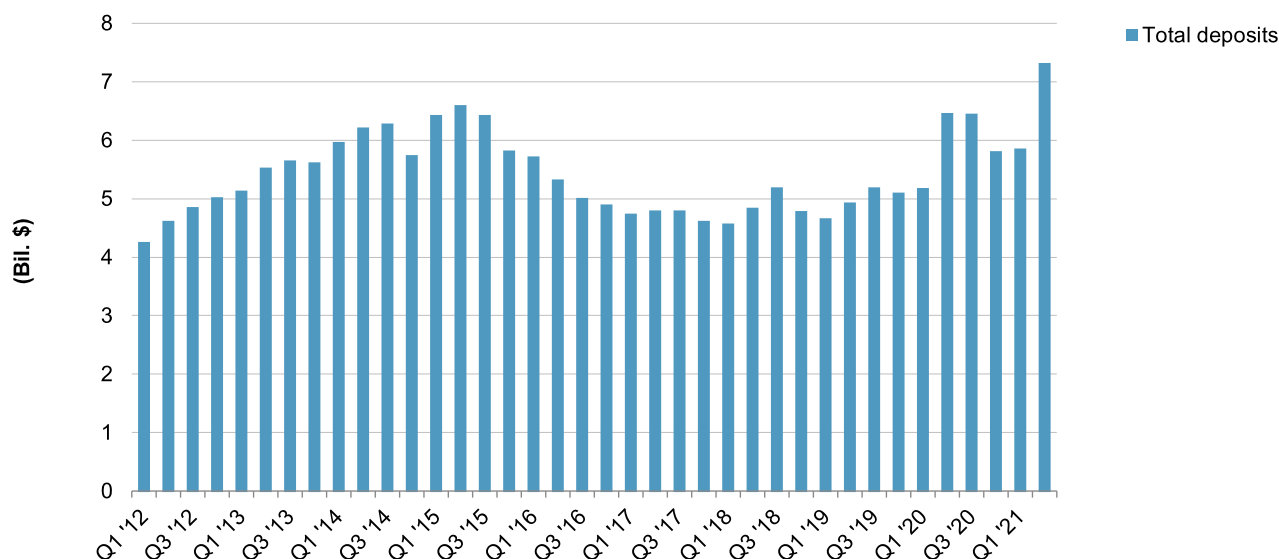
Our assessment considers the state-sourced captive deposits--mandated by legislation--as core to the bank. Throughout 2020 and the first half of 2021, BND experienced substantial deposit growth as government stimulus funds received by the state of North Dakota and its agencies were deposited at BND. As a result, funding metrics improved substantially. The loan-to-customer deposit ratio was 61% as of June 30, 2021, having improved from 78% at year-end 2020. Further, the stable funding ratio, calculated as available stable funding as a proportion of stable funding needs, rose to nearly 167% as of June 30, 2021, from 135% at year-end 2020. 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.

Positively, the bank has no brokered deposits and short-term wholesale funding is manageable at only 7% of the funding base as of June 30, 2021. However, we expect funding metrics to decline modestly over the next year as government agencies withdraw their stimulus-related deposits and spend their budgets.

BND's liquidity metrics have improved as of June 30, 2021. 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 7.5x as of June 30, 2021, from 3.8x at year-end 2020. The company had roughly \$4.5 billion of liquid assets, or 43% of total assets as of June 30, 2021--among the highest for regional U.S. bank peers. Liquid assets include cash due from banks, federal funds sold, and unpledged securities. We believe BND has an adequate liquidity contingency plan, which includes Federal Home Loan Bank availability of \$1.3 billion, Federal Reserve Discount Window availability of \$26 million, unused federal funds lines of \$180 million, and unused repurchase agreements of \$1.1 billion.

Chart 2

Bank of North Dakota's Deposits Remain Elevated Following COVID-19 Fiscal Stimulus



Source: S&P Global Ratings.

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Support: One Notch Of Uplift For The Issuer Credit Rating And Three Notches For The Bank's Deposits

Based on our criteria for GREs, 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 government.

The 'AA' 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 there is 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 BND and state 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.

Environmental, Social, And Governance

BND's exposure to environmental risk is somewhat higher than the U.S. bank average because of its lending in the energy industry, which is a significant part of North Dakota's economy. Direct energy exposure is about 8% of total loans and indirect exposure (loans in oil-producing regions) is an additional 9%. Social factors compare somewhat positively to peers since BND funds multiple state initiatives, including education and disaster loan programs. Additionally, the bank does not participate disproportionately in lending categories we view as socially sensitive, such as lending to nonprime consumers, which can lead to elevated regulatory and reputational risks if not properly managed. Lastly, BND benefits from adequate governance and disclosure practices compared with peer institutions, despite its unique position as a state-owned bank.

Key Statistics

Table 1

Bank of North Dakota Key Figures					
	--Year-ended Dec. 31--				
(Mil. \$)	2021*	2020	2019	2018	2017
Adjusted assets	9,238	7,744	7,058	7,016	7,003
Customer loans (gross)	4,722	4,757	4,538	4,584	4,909
Adjusted common equity	957	944	941	852	822
Operating revenues	89	188	211	199	187
Noninterest expenses	15	30	29	29	30
Core earnings	69	141	176	158	145

*Data as of June 30.

Table 2

Bank of North Dakota Business Position					
	--Year-ended Dec. 31--				
(%)	2021*	2020	2019	2018	2017
Total revenues from business line (currency in millions)	89.54	189.06	211.95	200.29	187.05
Commercial & retail banking/total revenues from business line	97.72	97.88	98.18	98.80	98.86
Trading and sales income/total revenues from business line	0.00	0.00	0.00	0.00	0.00
Corporate finance/total revenues from business line	0.02	0.02	0.11	(0.02)	(0.08)
Brokerage/total revenues from business line	0.00	0.00	0.00	0.00	0.00
Insurance activities/total revenues from business line	0.00	0.00	0.00	0.00	0.00
Agency services/total revenues from business line	0.15	0.14	0.12	0.13	0.13
Payments and settlements/total revenues from business line	1.54	1.37	1.15	1.09	1.08
Other revenues/total revenues from business line	0.57	0.58	0.45	0.00	N/A
Investment banking/total revenues from business line	0.02	0.02	0.11	(0.02)	(0.08)
Return on average common equity	14.94	15.25	18.77	18.80	17.09

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

Table 3

Bank of North Dakota Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2021*	2020	2019	2018	2017
Tier 1 capital ratio	20.12	19.20	20.94	19.30	18.97
S&P Global Ratings' RAC ratio before diversification	21.92	21.92	23.10	21.40	N/A
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Net interest income/operating revenues	97.14	98.11	97.19	97.05	97.10
Fee income/operating revenues	2.51	2.14	1.61	1.61	1.71
Market-sensitive income/operating revenues	0.25	(0.37)	1.20	1.14	(0.04)
Cost to income ratio	17.22	16.06	13.76	14.49	15.91
Preprovision operating income/average assets	1.74	2.13	2.59	2.43	2.20
Core earnings/average managed assets	1.63	1.90	2.50	2.26	2.03

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

Table 4

Bank of North Dakota Risk Position					
	--Year-ended Dec. 31--				
(%)	2021*	2020	2019	2018	2017
Growth in customer loans	(1.46)	4.82	(1.01)	(6.62)	2.50
Total diversification adjustment/S&P Global Ratings' RWA before diversification	36.76	36.70	37.30	38.31	N/A
Total managed assets/adjusted common equity (x)	9.65	8.20	7.50	8.24	8.52
New loan loss provisions/average customer loans	0.19	0.36	0.13	0.25	0.25
Net charge-offs/average customer loans	(0.00)	0.13	0.07	0.09	0.12
Gross nonperforming assets/customer loans + other real estate owned	3.47	3.73	3.26	3.04	2.74
Loan loss reserves/gross nonperforming assets	67.65	59.92	64.63	66.40	63.07

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

Table 5

Bank of North Dakota Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2021*	2020	2019	2018	2017
Core deposits/funding base	92.00	87.75	82.68	74.72	73.57
Customer loans (net)/customer deposits	60.78	78.44	88.29	97.83	106.31
Long-term funding ratio	93.99	90.61	87.65	83.34	82.89
Stable funding ratio	167.35	135.41	125.71	117.83	109.71
Short-term wholesale funding/funding base	6.69	10.65	14.26	18.99	19.40
Broad liquid assets/short-term wholesale funding (x)	7.53	3.75	2.57	1.82	1.49
Net broad liquid assets/short-term customer deposits	59.39	41.68	33.78	26.06	16.07
Short-term wholesale funding/total wholesale funding	83.64	86.95	82.35	75.13	73.41

*Data as of June 30.

Related Criteria

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- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
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- Rating Component Scores For U.S., Canadian, And Bermudian Banks (September 2021), Sept. 30, 2021
- U.S. Regional Banks Report Higher Second-Quarter Earnings After Large Reserve Releases, Aug. 17, 2021
- Fed Stress Test Results Give Banks Room To Release The Capital They Built Up During The Pandemic, June 28, 2021
- Credit FAQ: What's Behind The Proposals To Update Our Financial Institutions And BICRA Methodologies, June 8, 2021
- The Basel Capital Compromise For Banks: Better Buffers, Elusive Comparability, June 3, 2021
- Credit FAQ: How The Economy, Profitability, And Regulations Could Support Certain U.S. Bank Ratings, May 24, 2021
- Various Rating Actions Taken On Large U.S. Banks And Consumer-Focused Banks Based On Favorable Industry Trends, May 24, 2021

- Various Rating Actions Taken On U.S. Regional Banks Based On Improving Economy And Favorable Industry Trends, May 24, 2021
- Rating Actions Taken On Three Puerto Rican Banks On Better-Than-Expected Financial Performance, April 21, 2021

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, 2021)*

Bank of North Dakota

Issuer Credit Rating A+/Stable/--

Issuer Credit Ratings History

19-Feb-2016 A+/Stable/--

06-Dec-2011 AA-/Stable/--

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

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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