MOODY'S INVESTORS SERVICE

CREDIT OPINION

15 May 2018

Update

Rate this Research

**RATINGS**

**N.V. Bank Nederlandse Gemeenten**

| | |
|---|---|
| Domicile | Netherlands |
| Long Term Debt | Aaa |
| Type | Senior Unsecured - Fgn Curr |
| Outlook | Stable |
| Long Term Deposit | Aaa |
| Type | LT Bank Deposits - Fgn Curr |
| Outlook | Stable |

*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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# Bank Nederlandse Gemeenten N.V.

Semiannual update

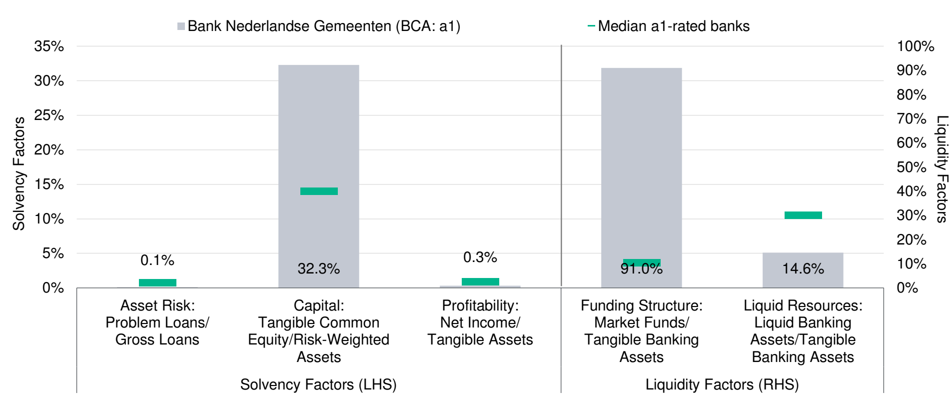
## Summary

On 4 May we affirmed the long-term deposit, issuer and senior unsecured debt ratings of N.V. Bank Nederlandse Gemeenten (BNG Bank) at Aaa with a stable outlook, and its short-term deposit and Commercial Paper ratings at Prime-1. We also affirmed the bank's baseline credit assessment (BCA) at a1, as well as its long-term and short-term Counterparty Risk Assessment (CR Assessments) at Aaa(cr) and Prime-1(cr) respectively.

The BCA of a1 reflects (1) the bank's role as the largest lender to the Dutch public sector; (2) its entrenched franchise in a niche market which results in exceptional stability in its fundamentals; (3) its very high asset quality because its portfolio is mostly comprised of loans to Dutch public entities; (4) its high capitalisation; and (5) its adequate funding profile and liquidity position with limited maturity mismatches.

BNG Bank's Aaa deposit and senior unsecured ratings reflect (1) the bank's a1 standalone credit strength; (2) the application of our Advanced Loss Given Failure (LGF) analysis, resulting in a two-notch LGF uplift from the bank's Adjusted BCA of a1, given its significant volume of senior unsecured debt; and (3) government support uplift of two notches, reflecting a very high support probability from the government of the Netherlands (Aaa stable), in view of the bank's public ownership and its role as one of the main providers of financing to the Dutch public sector. The Counterparty Risk Assessment of Aaa(cr)/Prime-1(cr) assigned to BNG Bank is four notches above the bank's BCA, reflecting the substantial volume of bail-in-able liabilities protecting its operating obligations and the very high probability of government support.

Exhibit 1
**Rating Scorecard - Key financial ratios**




*Source: Moody's Financial Metrics*

## Credit strengths

» Largest lender to the Dutch public sector, fully owned by Dutch public entities

» High asset quality, reflected in the very low level of non-performing loans

» Financial performance commensurate with the bank's public-policy role

» Large volume of senior debt, resulting in the bank's deposit and senior unsecured debt ratings benefiting from a very low loss given failure rate and a two-notch uplift from the BCA

» Very high probability of government support, resulting in a two-notch uplift for the bank's debt and deposit ratings

## Credit challenges

» Borrower concentration given the bank's narrow public-policy mandate

» Mismatches between assets and liabilities, mitigated by an ample liquidity portfolio and diverse funding

» Uncertainties about regulatory rules, which will apply to the computation of capital

## Rating outlook

We do not expect any significant change in BNG Bank's creditworthiness in the near-term, as reflected in the stable outlook on the bank's ratings. Our view is also underpinned by a benign economic environment in the Netherlands.

## Factors that could lead to an upgrade

Upward pressure on BNG Bank's BCA could result from a lower reliance on wholesale funding, however this is unlikely given the bank's business model. An upgrade of the bank's BCA will not trigger any upgrade of the bank's deposit and senior unsecured ratings, which are already at Aaa.

## Factors that could lead to a downgrade

Downward pressure on BNG Bank's BCA could result from (1) a deterioration in the creditworthiness of the Dutch public sector; (2) a significant increase in the bank's non-0% risk weighted assets; (3) a significant increase in its funding gaps; or (4) a deterioration in its solvency. A downward movement of the bank's BCA could result in downgrades of all ratings. BNG Bank's ratings could also be downgraded if the ratings of the government of the Netherlands were downgraded.

## Profile

Founded in 1914 and headquartered in the Hague, Bank Nederlandse Gemeenten N.V. is a Dutch credit institution specialised in lending to (semi)-publicly owned institutions.

BNG Bank has no branches and does not provide financing to private customers. The bank's clients are mainly local authorities and public-sector institutions in the area of housing, healthcare, education and public utilities.

The bank's shareholders are Dutch public authorities exclusively; 50% of the bank's shares are held by the Dutch State and the remaining 50% are held by municipal authorities, provincial authorities and a district water board.

## Detailed credit considerations

### BNG Bank is the largest lender to the Dutch public sector, fully owned by Dutch public entities

BNG Bank's bylaws restrict its ownership to the Dutch public sector. This ownership structure has been stable since 1925 and is unlikely to change, given the bank's mandate to act as a lender to the Dutch public sector. The bank's long-term loan portfolio was €80 billion at year-end 2017, slightly down from €81.2 billion at year-end 2016, and total new long-term lending amounted to €9.5 billion in

2017, €0.7 billion lower than in 2016. Demand for loans from the public remained relatively low while prepayments increased. The bank's market share of lending to local governments, housing associations and healthcare institutions was around 55% in terms of outstanding loans and 71% in terms of long-term lending production in 2017 (versus 76% in 2016). We expect the bank to maintain its position in the Dutch public sector financing business, given its mandate, ownership and advantageous funding costs compared with those of commercial banks.

As a bank established with an explicit public-policy mandate, BNG Bank benefits from an entrenched franchise in a niche market. These conditions may result in exceptional stability in terms of asset quality, capital and profitability, supporting the bank's ongoing operating performance and resulting in a very low risk profile. This feature is reflected in a qualitative positive adjustment of one notch in our scorecard.

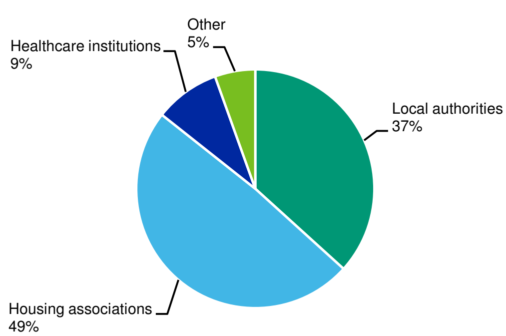
### High asset quality reflected in the very low level of non-performing loans

Despite market volatility, BNG Bank has consistently been able to lend to the Dutch public sector at advantageous rates, given the bank's low funding costs compared with those of commercial banks. The bank's narrow public-policy mandate translates into concentrations in its loan portfolio. However, these concentrations mainly relate to Dutch local governments and housing associations that benefit from guarantees on their liabilities from the central government (€86.7 billion at year-end 2017, including off-balance-sheet exposures), and, thus, do not entail any capital charge. The bank has also started export financing under the central government's Export Credit Guarantee.

A small share (€11.5 billion or 12% of total loans and advances, including off-balance-sheet exposures at year-end 2017) of the bank's lending is subject to a capital charge. These exposures consist of loans, for example, to public-private partnerships. Concentration risks in such loans are modest and volumes are closely monitored. The bank does not intend to materially increase its share of such loans in the foreseeable future.

BNG Bank's securities portfolio (€16.7 billion at year-end 2017) mainly consists of highly rated securities. The portfolio is primarily invested in government debt, bonds with government guarantees and covered bonds. At year-end 2017, this portfolio is mainly composed of securities rated from Aaa to A (92%) and securities in the Baa range (6%). Non-investment-grade securities only represent 2% of the portfolio (€294 million or around 8% of the bank's CET1 capital at year-end 2017). BNG Bank's overall exposures to the GIIPS[1] economies through both its loan and securities portfolios amounted to €1.8 billion (or 52% of its CET1 capital at year-end 2017), down from €2.4 billion at year-end 2016 (or 74% of its CET capital). Exposures were primarily in the form of covered bonds, asset backed securities and residential mortgage-backed securities.

Exhibit 2
**Breakdown of long-term loan portfolio at year-end 2017 (€80billion)**




*Source: company disclosures*

The bank's non-performing loans totalled €38 million, representing 4 basis points of its loans and advances at year-end 2017, reflecting its high asset quality.

These factors result in an Asset Risk score of aa1.

### Funding profile and liquidity position are adequate

BNG Bank is almost entirely wholesale funded and, therefore, relies on capital markets for its financing. The bank deploys a diversified funding strategy by issuing debt in multiple currencies and markets, with a view to reaching out to a wide array of investors. BNG Bank's asset and liability management entails some maturity mismatches.

Nevertheless, maturity mismatches could have negative implications for the bank's interest margins (whereby the bank's spreads would rise significantly for a prolonged period and imply an increase in the refinancing cost of outstanding loans). However, at year-end 2017, the loan book is virtually match-funded and refinancing risks over a two-to-three year horizon are very limited. Additionally, the risks implied by the gaps, if any, are under check:

» Due to the limited optionality in its books, all cash flows are highly predictable except for collateral posting needs on derivatives.

» Liquidity risk is managed through Euro commercial paper and US commercial paper programmes, and the coverage of gaps by a comfortable liquidity buffer constituting highly liquid assets eligible to the liquidity coverage ratio (LCR) of €12.8 billion at year-end 2017. The bank also has immediate drawing capacity of €9.8 billion on the European Central Bank collateralised by public-sector loans already pledged by BNG Bank at the central bank at year-end 2017. If necessary, the vast majority of BNG Bank's loan book qualifies for central bank funding.

» The funding gaps are maintained within reasonable limits and by BNG Bank's good standing in the capital markets. As bonds issued by a promotional bank (an institution where lending to the public sector represents more than 90% of total loans), the securities issued by BNG Bank are classified under the level 1 category assets (the highest quality of the High-Quality Liquid Assets). BNG Bank's bonds are also eligible for the European Central Bank's public-sector purchase programme aimed at stimulating the economy. These measures have further enhanced financial institutions' appetite for the bank's securities. At year-end 2017, BNG Bank's LCR was 207% and its net stable funding ratio was 130%, in compliance with the EU prudential requirements.

These factors are reflected in the bank's Combined Liquidity score of baa2.

### BNG Bank's leverage ratio is compliant with the minimum regulatory requirements

BNG Bank's capitalisation is commensurate with its low-risk assets. The bank's Common Equity Tier 1 capital ratio stood at 30% at year-end 2017, compared to a regulatory requirement of 8.875% for 2018[2]. At year-end 2017, BNG Bank's Tier 1 leverage ratio was 3.5% (year-end 2016: 3%), already above the expected minimum regulatory requirement of 3%. The bank's Tier 1 capital includes €733 million of Additional Tier 1 capital securities issued in 2015 and 2016.

The European Commission is proposing amendments to the Capital Requirements Regulation, published at the end of November 2016, which states that public development institutions' exposures to regional governments, local authorities or public-sector entities in relation to public-sector investments should be excluded from the denominator of the leverage ratio[3]. While the final outcome remains uncertain, BNG Bank's leverage ratio, based on its current capital base, could be substantially in excess of the 3% threshold if this rule were to be implemented and applicable by the institution. For more details, please refer to European lenders to local governments: adequate capitalisation despite expected relaxation in leverage requirements, published in March 2017.

We, therefore, assign a Capital score of aa1 despite the high nominal leverage.

### BNG Bank's financial performance is in line 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 and comply with regulatory capital requirements. However, the bank must also balance out this growth objective with the provision of efficient, low-cost funding to local governments and their related sectors.

While BNG Bank recorded relatively stable net income until 2013, the bank's bottom-line profit was relatively volatile over the past few years, essentially owing to changes in market value and one-off changes in valuation methods of financial instruments. While we expect rising expenses, driven by the increasing regulatory reporting requirements and the low-interest-rate environment, to continue to constrain BNG Bank's profitability, the bank's business model, dominant position in the market and close relationship with its clients (who are also its shareholders) will continue to provide it with sufficient flexibility in setting up margins, thereby preserving the necessary level of profits.

BNG Bank's net interest margin has consistently been around 30 basis points to 40 basis points because the bank benefited from advantageous funding rates. BNG Bank further improved its net interest result in 2017 thanks to attractive short-term funding rates in US$ and long-term funding raised at an average weighted spread under the swap rate. However, the prolonged decline in interest rates has weighed on the return on invested capital, further exacerbated by the negative market interest rates on short-term instruments.

Like most other specialised lenders, BNG Bank's costs are low relative to its total assets. The bank's cost-to-income ratio was around 18% in 2017 including regulatory costs.

These factors are reflected in the bank's Profitability score of ba1.

## Support and structural considerations

### Loss Given Failure (LGF) analysis

Despite its ownership and public mandate, BNG Bank falls in the scope of the EU Bank Resolution and Recovery Directive, which we consider to be an operational resolution regime. We assume residual tangible common equity of the lower of the current amount and 3%, post-failure losses of 8% of tangible banking assets, a 25% run-off in junior wholesale deposits and a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. The proportion of deposits considered junior is 26%. These are in line with our standard assumptions.

Our LGF analysis indicates a very low loss given failure for the bank's deposits and senior unsecured debt, leading to a two-notch uplift to the bank's Adjusted BCA.

### Government support considerations

Despite the objectives of and limitations on government support embedded in the Bank Resolution and Recovery Directive, the scope of which includes BNG Bank, we expect a very high probability of government support for the bank's deposits and senior unsecured debt, resulting in a two-notch uplift for both debt classes. Owing to the bank's ownership and public-policy mission, its potential for receiving support is considerably greater than that of commercial banks, which are expected to be affected by a bail-in.

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 risks. BNG Bank was designated as a domestic systemically important bank in 2015.

### Counterparty Risk (CR) Assessment

*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 both the likelihood of default and the expected financial loss, 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 (for example, swaps), letters of credit, guarantees and liquidity facilities.*

#### BNG Bank's CR Assessment is positioned at Aaa(cr)

The CR Assessment, prior to government support is positioned three notches above the Adjusted BCA of a1, based on the buffer against default provided to the senior obligations represented by the CR Assessment by subordinated instruments. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

The CR Assessment also benefits from one notch of systemic support. This reflects our view that any support provided by governmental authorities to a bank that benefits senior unsecured debt or deposits is very likely to benefit operating activities and obligations reflected by the CR Assessment as well, consistent with our belief that governments are likely to maintain such operations as a going concern in order to reduce contagion and preserve a bank's critical functions.

### About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating methodology and scorecard factors

Exhibit 3

**N.V. Bank Nederlandse Gemeenten**

| **Macro Factors** | | |
|---|---|---|
| **Weighted Macro Profile** | **Strong +** | **100%** |

| **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 | ←→ | aa1 | Quality of assets | Long-run loss performance |
| Capital | | | | | | |
| TCE / RWA | 32.3% | aa1 | ←→ | aa1 | Risk-weighted capitalisation | Nominal leverage |
| Profitability | | | | | | |
| Net Income / Tangible Assets | 0.3% | ba2 | ←→ | ba1 | Earnings quality | |
| Combined Solvency Score | | aa3 | | aa3 | | |
| Liquidity | | | | | | |
| Funding Structure | | | | | | |
| Market Funds / Tangible Banking Assets | 91.0% | caa3 | ←→ | baa3 | Term structure | Market funding quality |
| Liquid Resources | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 14.6% | ba1 | ←→ | a3 | Additional liquidity resources | |
| Combined Liquidity Score | | b3 | | baa2 | | |
| Financial Profile | | | | a2 | | |
| Business Diversification | | | | 1 | | |
| Opacity and Complexity | | | | 0 | | |
| Corporate Behavior | | | | 0 | | |
| Total Qualitative Adjustments | | | | 1 | | |
| Sovereign or Affiliate constraint: | | | | Aaa | | |
| Scorecard Calculated BCA range | | | | aa3-a2 | | |
| Assigned BCA | | | | a1 | | |
| Affiliate Support notching | | | | 0 | | |
| Adjusted BCA | | | | a1 | | |

| **Balance Sheet** | **in-scope (EUR million)** | **% in-scope** | **at-failure (EUR million)** | **% at-failure** |
|---|---|---|---|---|
| Other liabilities | 13,546 | 11.5% | 14,105 | 11.9% |
| Deposits | 5,472 | 4.6% | 4,914 | 4.2% |
| Preferred deposits | 4,049 | 3.4% | 3,847 | 3.3% |
| Junior Deposits | 1,423 | 1.2% | 1,067 | 0.9% |
| Senior unsecured bank debt | 94,923 | 80.3% | 94,923 | 80.3% |
| Dated subordinated bank debt | 31 | 0.0% | 31 | 0.0% |
| Preference shares (bank) | 733 | 0.6% | 733 | 0.6% |
| Equity | 3,548 | 3.0% | 3,548 | 3.0% |
| Total Tangible Banking Assets | 118,253 | 100% | 118,253 | 100% |

| Debt class | De Jure waterfall | | De Facto waterfall | | Notching | | LGF Notching Guidance vs. Adjusted BCA | Assigned LGF notching | Additional notching | Preliminary Rating Assessment |
|---|---|---|---|---|---|---|---|---|---|---|
| | Instrument volume + subordination | Sub-ordination | Instrument volume + subordination | Sub-ordination | De Jure | De Facto | | | | |
| Counterparty Risk Assessment | 84.8% | 84.8% | 84.8% | 84.8% | 3 | 3 | 3 | 3 | 0 | aa1 (cr) |
| Deposits | 84.8% | 3.6% | 84.8% | 83.9% | 2 | 3 | 2 | 2 | 0 | aa2 |
| Senior unsecured bank debt | 84.8% | 3.6% | 83.9% | 3.6% | 2 | 2 | 2 | 2 | 0 | aa2 |

| 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 | aa1 (cr) | 1 | Aaa (cr) | -- |
| Deposits | 2 | 0 | aa2 | 2 | -- | Aaa |
| Senior unsecured bank debt | 2 | 0 | aa2 | 2 | Aaa | Aaa |

*Source: Moody's Financial Metrics*

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **N.V. BANK NEDERLANDSE GEMEENTEN** | |
| Outlook | Stable |
| Bank Deposits | Aaa/P-1 |
| Baseline Credit Assessment | a1 |
| Adjusted Baseline Credit Assessment | a1 |
| Counterparty Risk Assessment | Aaa(cr)/P-1(cr) |
| Issuer Rating | Aaa |
| Senior Unsecured | Aaa |
| Commercial Paper | P-1 |

*Source: Moody's Investors Service*

## Endnotes

1 Greece, Italy, Ireland, Portugal and Spain

2 This ratio includes 4.5% Pillar 1 requirement, 1.75% Pillar 2 requirement, 0.75% phased-in Systemic Risk buffer and 1.875% phased in Capital Conservation buffer. The fully-loaded requirement is expected to be 9.75% as the Systemic Risk and Capital Conservation buffers will reach their final levels of 1% and 2% respectively

3 Article 429a(d) of the European Commission's proposal for a Regulation of the European Parliament and the Council, dated 23 November 2016

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CLIENT SERVICES

| | |
|---|---|
| Americas | 1-212-553-1653 |
| Asia Pacific | 852-3551-3077 |
| Japan | 81-3-5408-4100 |
| EMEA | 44-20-7772-5454 |

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