

Credit Opinion: Sparebanken Hedmark

Global Credit Research - 06 Mar 2013

Hamar, Norway

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*A2/*P-1
Bank Financial Strength	C-
Baseline Credit Assessment	(baa1)
Adjusted Baseline Credit Assessment	(baa1)

* Rating(s) within this class was/were placed on review on March 4, 2013

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Key Indicators

Sparebanken Hedmark (Consolidated Financials)[1]

	[2]12-12	[2]12-11	[2]12-10	[2]12-09	[2]12-08	Avg.
Total Assets (NOK billion)	44.1	43.2	41.8	41.5	42.4	[3]1.0
Total Assets (EUR million)	6,012.3	5,581.5	5,354.4	5,006.0	4,355.6	[3]8.4
Total Assets (USD million)	7,926.5	7,245.5	7,183.1	7,182.4	6,054.5	[3]7.0
Tangible Common Equity (NOK billion)	5.5	5.1	4.8	4.3	3.7	[3]9.9
Tangible Common Equity (EUR million)	743.2	652.6	619.2	521.0	384.0	[3]17.9
Tangible Common Equity (USD million)	979.8	847.2	830.6	747.5	533.8	[3]16.4
Net Interest Margin (%)	2.3	2.4	2.3	2.1	2.4	[4]2.3
PPI / Average RWA (%)	1.9	1.9	2.8	2.2	1.2	[5]2.0
Net Income / Average RWA (%)	1.6	1.4	2.5	1.1	0.1	[5]1.4
(Market Funds - Liquid Assets) / Total Assets (%)	17.4	21.8	23.5	25.9	27.0	[4]23.1
Core Deposits / Average Gross Loans (%)	80.8	74.7	71.4	67.0	66.1	[4]72.0
Tier 1 Ratio (%)	16.9	14.8	15.1	14.1	11.5	[5]14.5
Tangible Common Equity / RWA (%)	22.2	19.1	19.3	17.4	15.2	[5]18.7
Cost / Income Ratio (%)	64.6	63.6	50.3	55.6	69.6	[4]60.7
Problem Loans / Gross Loans (%)	2.1	2.4	2.4	2.2	1.4	[4]2.1
Problem Loans / (Equity + Loan Loss Reserves) (%)	11.6	14.4	14.7	14.9	10.5	[4]13.2

Source: Moody's

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

Opinion

SUMMARY RATING RATIONALE

Sparebanken Hedmark's C- standalone financial strength (BFSR), equivalent to a standalone credit assessment of baa1, primarily reflects Sparebanken Hedmark's robust local franchise, sound capital levels and stable retail banking operations but is constrained by the bank's limited geographic reach and some borrower and industry lending concentrations.

Sparebanken Hedmark's current global local currency (GLC) deposit rating of A2 receives a two-notch uplift from its baa1 standalone credit assessment. This is based on our assessment of a high probability of systemic support for the bank if necessary and its importance to the Norwegian market. Furthermore, we continue to factor in a low probability of support from its membership of the SpareBank 1 Alliance; however due to the reduction of the availability of Alliance support in light of the lowering of the standalone credit assessments of three of the four rated members of the SpareBank 1 Alliance, such support is no longer reflected in a notch of uplift.

Sparebanken Hedmark's ratings are on review for downgrade. The review will focus on evaluating the impact of the increased stake in Bank 1 Oslo Akershus to 40.5% from 12% in January 2013 on the bank's overall risk profile.

Unless otherwise stated, all figures shown are from the bank's latest annual and interim financial reports.

Rating Drivers

- The bank benefits from a robust local retail franchise in the Hedmark county in eastern Norway.
- The bank's asset quality metrics are still somewhat weaker than those of its Norwegian peers, although they have improved, but its capital levels are among the strongest in its peer group.
- The bank's funding profile is underpinned by a sizeable deposit base but exhibits some reliance on market funding.
- The bank's profitability is undermined by resilient core banking operations.
- Its membership in the SpareBank 1 Alliance provides the bank with cross selling opportunities, benefits from shared operations and risk management practices as well as a low probability of support from other member banks.

Rating Outlook

Sparebanken Hedmark's A2/P-1 long-term and short-term deposit ratings are under review for downgrade, as Moody's reassesses the risk involved with the bank's increased stake in Bank 1 Oslo Akershus (unrated).

The outlook on Sparebanken Hedmark's BFSR is stable, because it can map to more than one BCA within the C-BFSR category.

What Could Change the Rating - Up

Upward rating pressure is unlikely in the short-term, given the review for downgrade.

What Could Change the Rating - Down

The review on Sparebanken Hedmark's ratings will focus on evaluating the impact of the increased stake in Bank 1 Oslo Akershus on the bank's overall risk profile. More specifically, we will assess Sparebanken Hedmark's ability to manage the risks involved with its increased exposure to a new and more competitive market than its home market and exert control on the strategy of Bank 1 Oslo Akershus in a way that does not significantly impair its ability to generate stable earnings.

RECENT CREDIT DEVELOPMENTS

On 4 March 2013, Moody's downgraded the bank's long-term senior debt and deposit ratings of Sparebanken Hedmark to A2 from A1. We believe that, following the lowering of three Alliance members' standalone credit assessments in December 2012, the overall capacity within the Alliance to provide mutual support has somewhat diminished, which resulted in the removal of the notch of uplift previously factored in Sparebanken Hedmark's

ratings. Nonetheless, our assessment of mutual support within the Alliance continues to be underpinned by (1) a coherent Alliance strategy and a strong common brand name; (2) the increased importance for the member banks of the Alliance's joint product companies and covered bond funding companies; and (3) substantial financial inter-linkage between the banks. However, we consider that these elements of support are weaker than more explicit mechanisms in several other co-operative or mutualist groups in Europe and therefore believe that only modest levels of mutual support are available between Alliance members.

At the same time, Sparebanken Hedmark's A2/P-1 long term and short-term deposit ratings were placed on review for downgrade. The review will focus on evaluating the impact of the increased stake in Bank 1 Oslo Akershus to 40.5% from 12% in January 2013 on the bank's overall risk profile.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Sparebanken Hedmark's currently assigned ratings are:

FRANCHISE - WELL ESTABLISHED IN THE COUNTY OF HEDMARK

With regional loan and deposit market shares of 34% and 49% respectively, Sparebanken Hedmark enjoys a sound local market position in the county of Hedmark in eastern Norway. The national market share is however notably smaller at roughly 1-1.5% (based on total lending in the bank's counties of operation and in the whole country according to Statistics Norway). Sparebanken Hedmark's limited geographical diversification is the main constraint for the assessment of Sparebanken Hedmark's franchise value.

Whilst similar to other Norwegian savings banks, we do not deem Sparebanken Hedmark has pricing power against the two national market leaders, we view the competition in the county of Hedmark as slightly less fierce than in the rest of Norway. In addition, the bank benefits from its membership in the SpareBank 1 Alliance, consisting of 15 savings banks across Norway, together constituting one of the leading banking groups in Norway. The SpareBank 1 brand enjoys strong name recognition in a wide range of segments including life and non-life insurance and asset management.

INCREASED STAKE IN BANK 1 OSLO AKERSHUS COULD IMPACT THE BANK'S RISK PROFILE

Sparebanken Hedmark announced on 18 January 2013 that it will increase its stake in Bank 1 Oslo Akershus (unrated) to 40.5% from 12%, conditional upon approval from the regulator. The bank will purchase shares from SpareBank 1 SR-Bank (A2 stable, C-/baa2 stable), SpareBank 1 SMN (A2 stable, C-/baa2 stable) and SpareBank 1 Nord-Norge (A2 stable, C-/baa1 stable) and become the largest owner of the bank.

We understand that the transaction is an opportunity for Sparebanken Hedmark to expand the scope of its operations to the Oslo and Akershus region, which borders the Hedmark county. However, we believe that the financial strength of the bank after the transaction may be undermined by the somewhat higher risk profile of Bank 1 Oslo Akershus, which is characterised by (1) the rapid growth of its operations; (2) the competitive pressures in the Oslo-Akershus markets; (3) substantial exposure to real estate (loan book and brokerage activities); and (4) the lack of efficiency of its operations. Other downside risks involved in the transaction include the operating challenges in sharing control of the company: in our view, the success of the investment depends on whether Sparebanken Hedmark and Landsorganisasjonen (unrated), the other major shareholder following the transaction, can agree on a long-term strategy.

Bank 1 Oslo Akershus reported total assets of NOK29.2 billion or NOK41.4 billion including loans transferred to SpareBank 1 Boligkreditt at year-end 2012. The corresponding figures for Sparebanken Hedmark were NOK44.1 billion and NOK57 billion, respectively.

LIQUIDITY - SUBSTANTIAL DEPOSIT BASE, SOME RELIANCE ON MARKET FUNDING BUT LESS THAN MANY PEERS

Sparebanken Hedmark's deposit base, largely in the form of retail deposits (almost 65% at year-end 2012), accounted for almost 80% of on-balance-sheet funding. Whilst the bank is somewhat less reliant on market funds than some of its rated Norwegian peers, we view its sizeable usage of market funding as a source of risk because, in times of market stress, market funding can become more expensive or/and restricted.

Sparebanken Hedmark has increasingly used covered bond funding, which is done off-balance-sheet through SpareBank 1 Boligkreditt, a company specialised in issuing covered bonds which it jointly owns together with the other members of SpareBank 1 Alliance. At year-end 2012 Sparebanken Hedmark had transferred retail mortgages

worth NOK12.6 billion i.e. 26% of total loans to SpareBank 1 Boligkreditt. Whilst we positively view the diversification benefit of covered bond funding, we caution that extensive use of covered bond funding increases the amount of pledged assets unavailable for unsecured bondholders including depositors in a liquidation.

At year-end 2012 liquid assets accounted for just below 15% of total assets and comprised cash and deposits with the central bank and the securities portfolio (which includes senior bonds, covered bonds and limited equity investments). We note that holdings are concentrated on Norwegian securities, which could be a source of vulnerability from a concentration risk point of view.

ASSET QUALITY & CAPITAL - PROBLEM LOAN RATIO SOMEWHAT ABOVE THAT OF ITS PEERS, BUT CAPITAL LEVELS AMONG THE HIGHEST

Asset quality metrics have somewhat improved in 2010-12; problem loans (defined as defaulted and doubtful commitments) decreased to 2.1% of on-balance-sheet loans at year-end 2012 from 2.5% at year-end 2010. Nonetheless, this ratio remains relatively high compared to its Norwegian rated peers.

Sparebanken Hedmark's loan portfolio benefits from a substantial proportion of retail loans, mostly in the form of mortgages (around 60% excluding loans transferred to SpareBank 1 Boligkreditt and close to 70% including them). While the performance in the bank's retail book has been particularly strong so far, we believe it could be undermined by less favourable interest rate and house price levels - especially given the high household indebtedness as the mortgage loans remaining on the bank's balance sheet have higher loan-to-values than those transferred to the Alliance's covered bond companies.

However, the property management and construction exposure, which we deem particularly vulnerable to a deterioration in the economy and increasing interest rates, is sizeable at close to 20% of on-balance-sheet loans. The rest of the portfolio is mainly to SMEs and diversified across industries. The bank also exhibits high borrower concentration, albeit somewhat lower than most of its Nordic rated peers.

Mitigating the somewhat weaker asset quality metrics relative to its Norwegian peers, Sparebanken Hedmark exhibits one of the strongest capital levels amongst its Norwegian rated peers. At year-end 2012, the Tier 1 ratio stood at 16.9%. Sparebanken Hedmark's capital consists only of retained earnings and we note that, as an institution without owners, its access to "pure" equity capital is limited, therefore it has less flexibility to enhance its capital base in the event of a crisis.

PROFITABILITY - UPWARD TREND ON LENDING MARGINS

Sparebanken Hedmark's main source of earnings is on net interest income, which represented around 70% of its 2012 operating income. Including commissions from SpareBank 1 Boligkreditt (which represent interest income on loans transferred to the covered bond company), this source of earning grew by 5% in 2012, as strong loan growth (+8% including loans transferred to covered bond companies) and improved lending margins (largely reflecting decreased NIBOR) more than offset downward pressure on deposit margins.

To some extent, the somewhat less intense competition in Hedmark has helped keeping net interest margins slightly higher than the national average. We expect further improvement in the bank's lending margins as there will likely be a general market effort to re-price loans upwards in light of expected increased regulatory capital requirements.

Cost efficiency is adequate, although the bank's cost-to-income ratio increased to almost 65% in 2012 compared to just over 60% a year earlier, largely reflecting the first full year of consolidation of Consis, a company providing accounting services (only seven months in 2011). Loan loss provisions have remained low in recent years and stood at NOK42 million in 2012, down from NOK50 million in 2011.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A2 to Sparebanken Hedmark. The rating is supported by its baa1 standalone credit assessment and the Aaa local currency deposit ceiling of Norway, which is considered the underlying support provider. Given the bank's importance to its region, and the region's importance to the national economy of Norway, Moody's assesses as high the probability of systemic support in the event of a stress situation. We are however likely to gradually reduce such unusual support uplift as such support mechanisms are phased out, as banks' standalone profiles improve, and as regulators globally consider implementing bank resolution regimes.

Foreign Currency Deposit Rating

Foreign currency deposit ratings are unconstrained given that Norway has a country ceiling of Aaa. Sparebanken Hedmark's foreign currency deposit rating is A2.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Ratings

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. An Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order

to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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 Factors

Sparebanken Hedmark

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C	
Factor: Franchise Value						D+	Neutral
Market share and sustainability			x				
Geographical diversification					x		
Earnings stability			x				
Earnings Diversification [2]							
Factor: Risk Positioning						C-	Neutral
Corporate Governance [2]	-	-	-	-	-		
- Ownership and Organizational Complexity	-	--	--	--	--		
- Key Man Risk	-	--	--	--	--		
- Insider and Related-Party Risks	-	--	--	--	--		
Controls and Risk Management		x					
- Risk Management			x				
- Controls	x						
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
Credit Risk Concentration	-	-	-	-	-		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management				x			
Market Risk Appetite		x					
Factor: Operating Environment						A-	Neutral
Economic Stability		x					
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						C+	
Factor: Profitability						C+	Neutral
PPI % Average RWA (Basel II)			2.19%				
Net Income % Average RWA (Basel II)		1.86%					
Factor: Liquidity						D+	Weakening
(Market Funds - Liquid Assets) % Total Assets			9.37%				
Liquidity Management				x			
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	15.60%						
Tangible Common Equity % RWA (Basel II)	20.22%						
Factor: Efficiency						C	Neutral

Cost / Income Ratio			59.47%				
Factor: Asset Quality						C+	Weakening
Problem Loans % Gross Loans			2.31%				
Problem Loans % (Equity + LLR)		13.56%					
Lowest Combined Financial Factor Score (15%)						D+	
<i>Economic Insolvency Override</i>						Neutral	
Aggregate BFSR Score						C	
Aggregate BCA Score						a3	
Assigned BFSR						C-	
Assigned BCA						baa1	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.



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