MOODY'S
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Credit Opinion: Sparebanken Hedmark

Global Credit Research - 31 Mar 2015

Hamar, Norway

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa1

* Rating(s) within this class was/were placed on review on March 17, 2015

Contacts

Analyst	Phone
Efthymia Tsotsani/London	44.20.7772.5454
Kim Bergoe/London	
Sean Marion/London	

Key Indicators

Sparebanken Hedmark (Consolidated Financials)[1]

	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (NOK billion)	**49.9**	**47.4**	**44.1**	**43.1**	**41.8**	[4]**4.6**
Total Assets (EUR million)	**5,503.9**	**5,669.7**	**6,012.3**	**5,568.8**	**5,354.4**	[4]**0.7**
Total Assets (USD million)	**6,660.0**	**7,812.5**	**7,926.5**	**7,229.1**	**7,183.1**	[4]**-1.9**
Tangible Common Equity (NOK billion)	**6.5**	**5.9**	**5.5**	**5.1**	**4.8**	[4]**7.7**
Tangible Common Equity (EUR million)	**716.7**	**706.6**	**743.2**	**652.6**	**619.2**	[4]**3.7**
Tangible Common Equity (USD million)	**867.2**	**973.7**	**979.8**	**847.2**	**830.6**	[4]**1.1**
Problem Loans / Gross Loans (%)	**1.4**	**1.6**	**2.1**	**2.4**	**2.4**	[5]**2.0**
Tangible Common Equity / Risk Weighted Assets (%)	**17.7**	**19.1**	**22.2**	**20.6**	**19.3**	[6]**17.7**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**8.1**	**9.9**	**12.8**	**15.7**	**16.1**	[5]**12.5**
Net Interest Margin (%)	**2.3**	**2.4**	**2.3**	**2.4**	**2.3**	[5]**2.3**
PPI / Average RWA (%)	**2.0**	**2.2**	**2.3**	**1.7**	**2.6**	[6]**2.0**
Net Income / Tangible Assets (%)	**1.9**	**1.4**	**1.3**	**0.6**	**1.4**	[5]**1.3**
Cost / Income Ratio (%)	**56.8**	**57.8**	**60.0**	**64.3**	**52.2**	[5]**58.2**
Market Funds / Tangible Banking Assets (%)	**20.0**	**19.5**	**20.6**	**25.2**	**27.6**	[5]**22.6**
Liquid Banking Assets / Tangible Banking Assets (%)	**11.4**	**13.9**	**13.6**	**14.6**	**14.3**	[5]**13.6**
Gross Loans / Total Deposits (%)	**128.5**	**121.0**	**126.0**	**134.3**	**140.9**	[5]**130.1**

Source: Moody's

[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

Opinion

SUMMARY RATING RATIONALE

On 17 March, we placed Sparebanken Hedmark's long-term deposit ratings on review for upgrade. The bank's baa2 standalone baseline credit assessment (BCA), baa1 adjusted BCA and short-term ratings remain unchanged.

Sparebanken Hedmark's BCA of baa2 primarily reflects the bank's strong capital levels and stable retail banking operations, but is constrained by the bank's limited geographic reach and some borrower and industry lending concentrations.

The review was prompted by the implementation of Loss Given Failure (LGF) analysis (a component of Moody's new methodology for rating banks globally) in combination with a lowering of our current systemic (government) support assumptions. LGF takes into account the risks faced by the different debt and deposit classes across the liability structure if the bank were to enter resolution.

SPAREBANKEN HEDMARK'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

As a pure domestic bank, Sparebanken Hedmark's operating environment is in Norway, and the bank's Macro Profile is thus aligned with that of Norway at Very Strong-. Norwegian banks benefit from operating in an affluent and developed country with very high economic, institutional and government financial strength as well as low susceptibility to event risk. The main risks to the system stem from a high level of household indebtedness and domestic banks' reliance on market funding. However, these risks are offset by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared to GDP.

RATING DRIVERS

- Capital levels are the strongest among peers.

- The bank's asset quality metrics are still somewhat weaker than those of its Norwegian peers, although they have improved

- The bank's funding profile is underpinned by a sizeable deposit base but exhibits some reliance on market funding.

- Profitability strong, but shift towards non-core banking operations renders revenue profile less stable

- Large volume of deposits and junior debt resulting in deposit ratings benefiting from a very low loss-given-failure rate and a likely two-notch uplift versus its BCA

- Low probability of government support likely resulting in no additional uplift versus BCA for debt and deposits

Rating Outlook

The review for upgrade on Sparebanken Hedmarks's long-term deposit ratings was prompted by changes arising from the implementation of our new methodology, and specifically our advanced Loss Given Failure analysis, which applies to institutions subject to an operational resolution regime. While not subject to the EU's Bank Recovery and resolution Directive (BRRD), we expect that Norway - as an European Economic Area (EEA) member - will seek to introduce legislation or other tools that include mechanisms similar to those in the BRRD. Our expectations are based on publicly stated comments from Norwegian authorities as well as the government's track record of mirroring EU banking regulations. Our advanced LGF analysis on Sparebanken Hedmark's long-term deposit ratings prompted the review for upgrade. The review will focus on the liability structure, in particular the amount of deposits, senior long-term debt outstanding and the amount of debt subordinated to it.

We consider the probability of government support for Sparebanken Hedmark's long-term deposits to be low, and hence expect there will be no uplift from its unsupported rating level. We expect the long-term deposit rating to be affirmed.

What Could Change the Rating - Up

As stated in the Summary Rating Rationale the review on Sparebanken Hedmark's ratings was prompted by the implementation of our new banking methodology.

What Could Change the Rating - Down

After the above mentioned review is completed, future downward rating pressure could arise from (1) deterioration in Sparebanken Hedmark's funding position, e.g. reduced ability to access capital markets or deposit outflows; and/or (2) higher-than-expected losses in its loan book, or losses stemming from its ownership interests. In addition, downwards pressure could be exerted on the ratings due to external factors, such as a less supportive macroeconomic environment and/or substantially adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

CAPITAL LEVELS ARE THE STRONGEST AMONGST ITS PEERS

Sparebanken Hedmark exhibits the strongest capital levels amongst its Norwegian rated peers. At December 2014, the Tangible Common Equity (TCE) to risk weighted assets (RWA) ratio stood at 17.7% (in line with updated capital regulations). The bank's capital consists only of retained earnings and our assigned Capital score reflects that, as an institution without owners, its access to pure equity capital is limited. However, the bank is planning to issue equity certificates equivalent to 60% of its primary capital, as decided on 26 March 2014 by the Supervisory Board (subject to regulatory approval), which we view positively as it could improve access to capital markets. Nevertheless, we believe that there is a degree of uncertainty regarding Sparebanken Hedmark's expansion plans, following the increase of its stake in Bank 1 Oslo Akershus (unrated) to 40.5% in 2014 from 12.0% in 2013, which could put pressure in its capital base.

BANK'S ASSET QUALITY METRICS ARE STILL SOMEWHAT WEAKER THAN THOSE OF ITS NORWEGIAN PEERS, ALTHOUGH THEY HAVE IMPROVED

The bank's asset quality metrics improved somewhat in the 2010-14 period; its problem loan ratio (as measure by impaired loans as a percentage of total loans) decreased to just below 1.4% of on-balance-sheet loans at end-December 2014 from 2.5% at year-end 2010. Nonetheless, this ratio remains relatively high compared to larger rated Norwegian savings banks.

Sparebanken Hedmark's loan portfolio benefits from a substantial proportion of retail loans, mostly in the form of mortgages (close to 60% excluding loans transferred to SpareBank 1 Boligkreditt and almost 70% including them). While the performance of the bank's retail book has been particularly strong in recent years, any more significant slowdown in the economy we expect that would undermine the bank's asset quality - also because the mortgage loans remaining on the bank's balance sheet have higher loan-to-values than those transferred to the SpareBank 1 Alliance's covered bond companies.

Our assigned Asset Risk score also reflects the bank's exposure to the property management and construction sectors, which are particularly vulnerable to less favorable economic conditions due to declining oil and gas prices as well as falling investment levels, is sizeable at 20% of on-balance-sheet loans. The rest of the portfolio is mainly focused on SMEs and diversified across industries. The bank also exhibits high borrower concentration, albeit somewhat lower than most of its Nordic rated peers.

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

Sparebanken Hedmark's funding position is underpinned by a substantial deposit base, which accounted for almost 80% of on-balance-sheet funding at end-December, while over 60% of the bank's deposits originate from the retail sector.

As reflected in our methodology, we globally reflect the relative stability of covered bonds compared to unsecured market funding through a standard adjustment in our scorecard. Sparebanken Hedmark has increasingly used covered bond funding, which is done off-balance-sheet through specialised companies it jointly owns together with the other members of SpareBank 1 Alliance (SpareBank 1 Boligkreditt for residential mortgages and SpareBank 1 Næringskreditt for commercial mortgages). At end-December 2014, Sparebanken Hedmark had transferred retail mortgages worth NOK15.4 billion to SpareBank 1 Boligkreditt and NOK0.6 billion commercial mortgages to SpareBank 1 Næringskreditt (i.e., equivalent to 28.6% of total loans).

Whilst we positively view the diversification benefit of covered bond funding, its extensive use increases the amount of pledged assets unavailable for unsecured bondholders including depositors in a liquidation. Our assessment of the bank's funding structure reflects our view that Sparebanken Hedmark has some reliance on market funds -.a common feature at Nordic banks - but to a lesser degree than peers: market funding accounted for 20% of the bank's tangible assets at end-December 2014 (27% when adjusting for covered bonds) and has been stable over the years

At end-December 2014, liquid assets accounted for 11.4% of tangible assets and, according to the bank, cover funding needs for 18 months (assuming 6% lending growth and 2.6% growth in deposits). The portfolio consists of cash and deposits with the central bank, senior bonds, covered bonds and limited equity investments. The holdings are concentrated on Norwegian securities, which could be a source of vulnerability from a concentration risk point of view, but is positive in terms of currency risk.

PROFITABILITY STRONG BUT SHIFT TOWARDS NON-CORE BANKING OPERATIONS RENDERS REVENUE PROFILE LESS STABLE

Sparebanken Hedmark's main source of earnings is net interest income, although to a lesser degree than previously representing around 47% of its 2014 operating income compared to 66% in 2013. This shift is a result of higher contribution from non-core banking operations such as net asset revaluations and contribution from partly owned companies. In addition, the bank realized gains from the sale of the payment system Nets Holding ASA as well as from the sale of its credit card portfolio.

The bank's cost-to-income ratio (according to Moody's adjusted metrics) was 57% in 2014, slightly higher than the average of the Norwegian rated peers; while loan loss provisions remained low at NOK66million in 2014, in line with NOK72 million in 2013. Sparebanken Hedmark reported a net profit of NOK1.04 billion over 2014. Moody's adjusted annualised return on tangible assets was at 1.86%, higher than both the 2013 level and the three-year average due to increased contribution from equity stakes.

In our view, the increased stake in Bank 1 Oslo Akershus renders Sparebanken Hedmark's revenue profile less stable, because it increases the portion of revenue stemming from ownership interests and exposes Sparebanken Hedmark to the volatility in Bank 1 Oslo Akershus's profitability. Bank 1 Oslo Akershus's credit profile is generally weaker than that of Sparebanken Hedmark, in particular because of (1) the rapid growth in its loan book (although we note that the growth slowed down in 2014); (2) lack of efficiency of its operations; and (3) its substantial exposure to the real-estate sector through both its lending and brokerage activities.

Our assigned Profitability score reflects our expectations that the growth of Sparebanken Hedmark's profitability will slow over the coming year as we do not expect a continuation of margin increases. All else being equal, we would not anticipate the bank's corporate loan losses to remain at their current level as we expect Norway to experience a slightly tougher bank operating environment in 2015-2016 compared to recent years.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We expect that Norway will seek to introduce legislation or other tools that include mechanisms similar to those in the EU Bank Resolution and Recovery Directive (BRRD). We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These metrics are in line with our standard assumptions.

For Sparebanken Hedmark's long-term deposit ratings, our review will consider the likely impact on loss-given-failure of the combination of their own volume and the amount of debt subordinated to them. We expect this will result in Preliminary Rating Assessment (PRA) of two notches above the BCA, reflecting very low loss-given-failure.

GOVERNMENT SUPPORT

The expected implementation of resolution legislation has caused us to reconsider the probability that government support would benefit certain creditors.

With regional loan and deposit market shares of around 33% and 52%, respectively, Sparebanken Hedmark has a sound local market position in the county of Hedmark in eastern Norway. The national market share is however notably smaller at roughly 0.9% in terms of loans and 1.6% in terms of deposits (based on total on-balance sheet lending in the bank's counties of operation and in the whole country according to Statistics Norway). Therefore we now expect a low probability of government support for debt and deposits, likely resulting in zero notches of uplift to the PRA.

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.

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Rating Factors

Sparebanken Hedmark

Macro Factors	
Weighted Macro Profile	**Very Strong -**

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	1.7%	aa3	←→	a3	Geographical concentration	Sector concentration
Capital						
TCE / RWA	17.7%	aa2	←→	a2	Expected trend	
Profitability						
Net Income / Tangible Assets	1.5%	aa3	↓↓	ba1	Earnings quality	Expected trend
Combined Solvency Score		aa3		baa1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	20.0%	a2	↓↓	baa3	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	11.4%	baa3	←→	baa3	Stock of liquid assets	
Combined Liquidity Score		baa1		baa3		

Financial Profile	**baa2**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	Aaa
Scorecard Calculated BCA range	**baa1 - baa3**
Assigned BCA	**baa2**
Affiliate Support notching	**1**
Adjusted BCA	**baa1**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	--	--	--	--	A2 RUR Possible Upgrade	A2 RUR Possible Upgrade

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