

## CREDIT OPINION

14 October 2016

Update

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### RATINGS

#### Sparebanken Hedmark

Domicile	Hamar, Norway
Long Term Debt	Not Assigned
Type	Not Assigned
Outlook	Not Assigned
Long Term Deposit	A1
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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## Sparebanken Hedmark

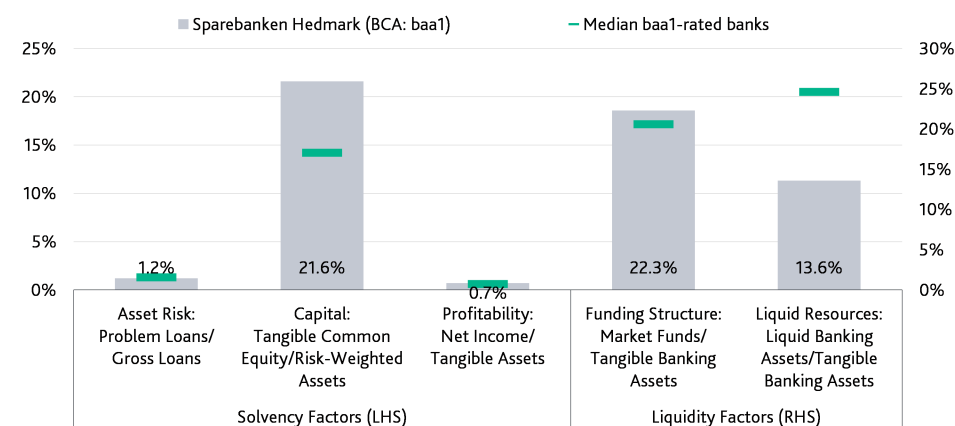
### Summary Rating Rationale

Sparebanken Hedmark's long-term deposit and issuer ratings were upgraded to A1 from A2 on 11 October 2016, while the bank's baseline credit assessment (BCA) was upgraded to baa1 from baa2. The bank's adjusted BCA, which incorporates affiliate support from the Sparebank 1 Alliance, was affirmed at baa1. The rating action followed the consolidation of the acquired Bank 1 Oslo Akershus (B1OA) into the bank's June 2016 financial statements and the resulting increased importance of the group to the Norwegian financial system. As a result, we now incorporate a moderate government support into the bank's ratings, which triggered the ratings upgrade. The bank's long-term Counterparty Risk Assessment (CR Assessment) has also been upgraded to Aa3(cr) from A1(cr), while all short-term ratings of P-1, including the short-term CR Assessment of P-1(cr), have been affirmed. The long-term ratings carry a stable outlook.

The bank's BCA was upgraded to baa1 from baa2 as we believe that the acquisition of B1OA benefits its standalone credit profile, and its overall franchise strength. The immediate benefits conferred to the bank include improvements in its asset quality position (problem loans ratio dropped to 0.7% in June 2016 from 1.2% in December 2015), as well as deeper loans and earnings geographical diversification, greater reach in the Oslo-Akershus area and opportunities for further expansion of its client base. Although the transaction has placed some downward pressure on the bank's capital and profitability metrics, we believe that such metrics are likely to recover over the medium term, while the combined group still boasts relatively strong financial metrics (CET1 ratio of 16% in June 2016) after becoming the fourth largest savings bank in Norway.

Exhibit 1

### Rating Scorecard - Key Financial ratios



Source: Moody's Financial Metrics

## Credit Strengths

- » Sparebanken Hedmark's ratings are supported by its Very Strong- Macro Profile
- » Solid capital levels, which are the strongest among peers
- » Asset risk metrics improve post acquisition, on the back of a lower credit risk portfolio
- » Large volume of deposits and junior debt resulting in deposit ratings benefiting from a very low loss-given-failure rate
- » Moderate probability of government support results in one additional notch of uplift for issuer and deposit ratings

## Credit Challenges

- » The bank's funding profile is underpinned by a sizeable deposit base but exhibits some reliance on market funding
- » Acquisition of Bank 1 Oslo Akershus exerts pressure on profitability, although we expect a gradual recovery

## Rating Outlook

The stable outlook on the bank's ratings reflects our view that the bank's financials will remain broadly resilient in the face of a modest slowdown in Norway's economic performance. We expect the underlying financial fundamentals of Sparebanken Hedmark to remain relatively strong and commensurate with its revised BCA of baa1.

## Factors that Could Lead to an Upgrade

Upward rating pressure could develop if Sparebanken Hedmark demonstrates: (1) Good sustainable asset quality and low impairments in its retail and corporate books; (2) comfortable liquidity on an on-going basis; and/or (3) stronger earnings generation without an increase in its risk profile. In addition, further upward pressure could emerge following the takeover of B1OA, if the bank is able to further strengthen its customer base, and enhance its product offering and franchise, which in turn will support the bank's revenues and profitability.

## Factors that Could Lead to a Downgrade

Future downward rating pressure could arise if: (1) Sparebanken Hedmark's problem loan ratio increases above our system-wide expectation of approximately 2%; (2) financing conditions become more difficult; (3) its risk profile increases, as a result of increased exposures to more volatile sectors, for example, resulting in asset quality deterioration; (4) the macroeconomic environment deteriorates more than Moody's estimates, leading to adverse developments in the Norwegian real-estate market; and/or (5) the macroeconomic environment deteriorates more than currently anticipated, leading to a lower Macro Profile.

Also, a reduction in the rating uplift as a result of our LGF analysis or a revision of our government support assumptions could lead to downward rating pressure. We intend to reassess our government support assumptions for all Norwegian savings banks, including Sparebanken Hedmark, once there is more clarity regarding the timing of the implementation of an official resolution regime through the enactment of a relevant local legislation. This is likely to be aligned with the EU's bank recovery and resolution directive (BRRD), as indicated by the domestic authorities in the past.

## Key Indicators

Exhibit 2

### Sparebanken Hedmark (Consolidated Financials) [1]

	6-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>3</sup>	12-12 <sup>3</sup>	Avg. <sup>4</sup>
Total Assets (NOK billion)	100.3	55.8	49.8	47.4	44.1	22.8 <sup>4</sup>
Total Assets (EUR million)	10,784.1	5,804.1	5,485.3	5,669.7	6,012.3	15.7 <sup>4</sup>
Total Assets (USD million)	11,980.6	6,304.9	6,637.5	7,812.5	7,926.5	10.9 <sup>4</sup>
Tangible Common Equity (NOK billion)	10.8	8.4	7.3	6.4	5.8	17.2 <sup>4</sup>

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

Tangible Common Equity (EUR million)	1,167	870.7	807.7	765.8	784	10.5 <sup>4</sup>
Tangible Common Equity (USD million)	1,296.5	945.8	977.4	1,055.2	1,033.6	5.8 <sup>4</sup>
Problem Loans / Gross Loans (%)	0.7	1.2	1.4	1.6	2.1	1.4 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	21.6	22.2	20	20.7	23.5	21.3 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	5	6.3	7.2	9.2	12.1	8 <sup>5</sup>
Net Interest Margin (%)	1.8	2.3	2.3	2.4	2.3	2.2 <sup>5</sup>
PPI / Average RWA (%)	1.5	1.9	2.2	2.2	2.3	1.9 <sup>6</sup>
Net Income / Tangible Assets (%)	0.7	1.4	1.9	1.5	1	1.3 <sup>5</sup>
Cost / Income Ratio (%)	62	59.7	54.5	58.6	60.7	59.1 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	24.2	22.3	19.7	19.5	20.6	21.3 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	15.5	13.6	11.5	13.9	13.6	13.6 <sup>5</sup>
Gross loans / Due to customers (%)	126.6	130.8	128.5	123.5	126	127.1 <sup>5</sup>

[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

Source: Moody's Financial Metrics

## Detailed Rating Considerations

### Sparebanken Hedmark's Ratings are Supported by its Very Strong- Macro Profile

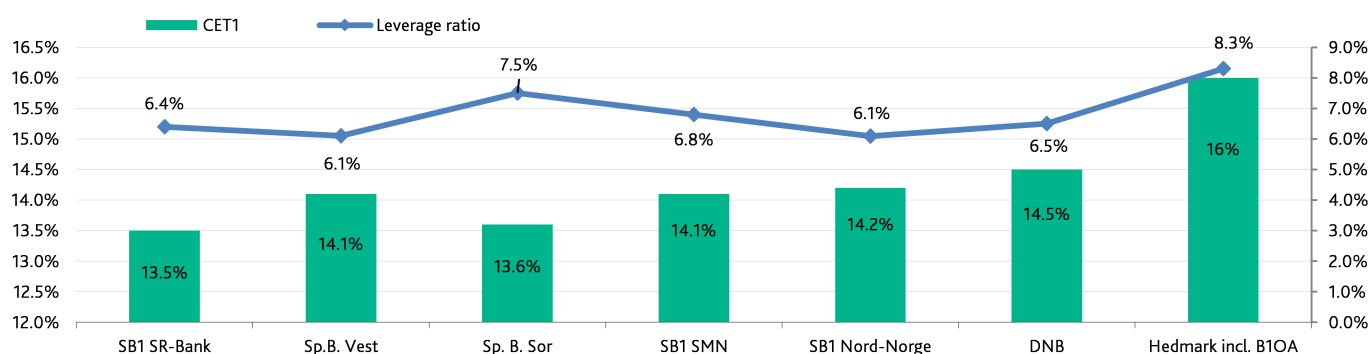
As a domestically oriented bank, Sparebanken Hedmark's operating environment is in Norway, and the bank's Macro Profile is thus aligned with that of Norway at Very Strong-. Norwegian banks benefit from operating in an affluent and developed country with very high economic, institutional and government 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.

### Solid Capital Levels, Which Are the Strongest Among Peers

At end-June 2016 the combined group remains the strongest capitalized bank among savings banks in Norway with a Tangible Common Equity (TCE) to risk weighted assets (RWA) ratio at 21.6% and a common equity Tier 1 (CET1) ratio of 16%, although reduced from 17.2% in December 2015. The bank targets to have at least 16% CET1 ratio on an on-going basis, aiming to be Norway's most solid regional savings bank having a leverage ratio of 8.3% in June 2016 (see Exhibit 3).

Exhibit 3

### Sparebanken Hedmark is the best capitalised regional bank with a very high leverage ratio among peers as of 30 June 2016



Source: Company reports

We expect the bank will be able to maintain the combined group's CET1 capital ratio at around 16% through retained earnings, a relatively conservative dividend payout over the next 2-3 years and by discontinuing capital-intensive activities that fall outside the bank's core business. In addition, the bank plans to conduct an IPO and list on the Oslo Stock Exchange in 2017, which will improve its

capacity and access to capital. Through this action, the bank will be able to increase its visibility in the international capital markets by tapping a much larger investor base, given that currently the bank has only six shareholder groups.

We believe that the bank has strong capital buffers relative to its peers, a distinctive feature of the bank in the last few years, which will also allow the bank to grow its balance sheet and leverage opportunities in the Oslo-Akershus region that now operates. We assign a capital score of aa2 compared to aa1 suggested by the scorecard's historical ratio, because we use the bank's CET1 of 16% achieved at end-June 2016 as a proxy for the forecast ratio in the consolidated capital score.

#### Asset Risk Metrics Improve Post Acquisition, on the Back of a Lower Credit Risk Portfolio

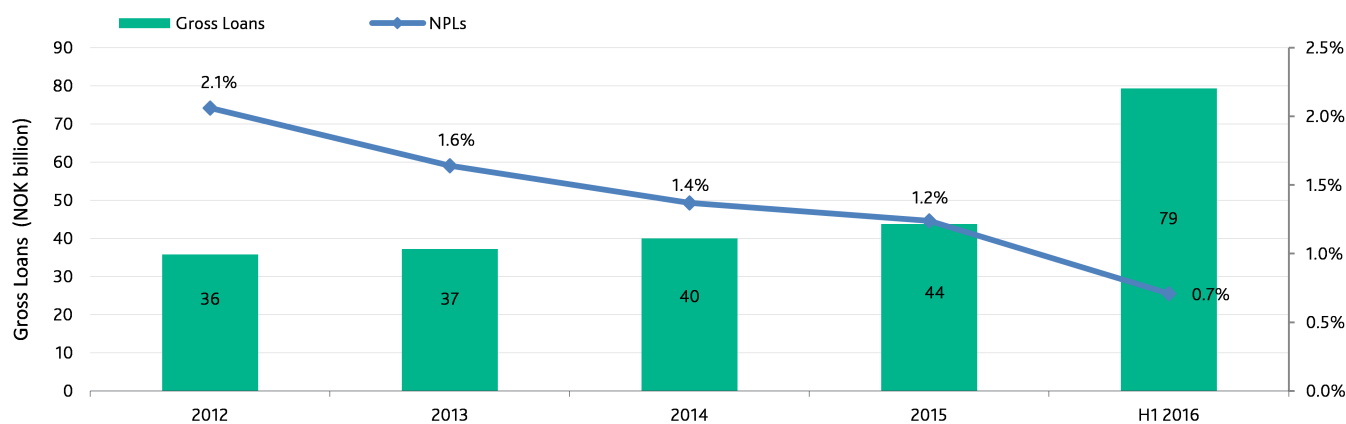
In line with our previous expectation, Sparebanken Hedmark's asset quality has improved with overall problem loans for the group reducing to around 0.7% of gross loans (excluding covered bond loans) in June 2016 from 1.2% in December 2015 (see Exhibit 4). This was mainly driven by the strong asset quality of the acquired B1OA's with a very low level of problem loans (0.2% in 2015) on the back of its predominantly retail mortgages credit profile with very low LTVs.

The combined loan book profile of the bank is now geared towards retail borrowers, mostly residential mortgages, accounting for around 75% of total loans including covered bond loans, with no exposure to the oil sector. This would be supportive to the bank's asset quality, limiting the downside risks from credit impairments, given the traditionally very low loss rates for residential mortgages in Norway.

Both banks' problem loans ratio has been historically low and it has been on an improving trend during 2015-16, with the 3 year average historical ratio in our scorecard at 0.9% in June 2016 down from 1.4% in December 2015 for Sparebanken Hedmark on a standalone basis.

Exhibit 4

#### Sparebanken Hedmark's asset risk metrics post acquisition



Note: H1 2016 is based on fully consolidated balance sheet of B1OA

Source: Company reports and Moody's Financial Metrics

Nonetheless, we note that the bank has some concentration in the commercial real estate (CRE) sector with 12.1% of its total loans, including covered bond loans, while around 1.3% of total loans are towards the building and construction sector as of June 2016. The concentration towards these two sectors, which is common among all Norwegian savings banks, raises somewhat the bank's credit profile and makes it vulnerable to potential property prices volatility in the market.

We assign an asset risk score of a3, incorporating four notches of negative adjustment to reflect the bank's exposure to CRE, building and construction sectors, as well as geographical concentration in its regional home market in Norway. We make similar adjustments in the scores of other rated Norwegian savings banks as well.

#### Acquisition of Bank 1 Oslo Akershus Exerts Pressure on Profitability, Although we Expect a Gradual Recovery

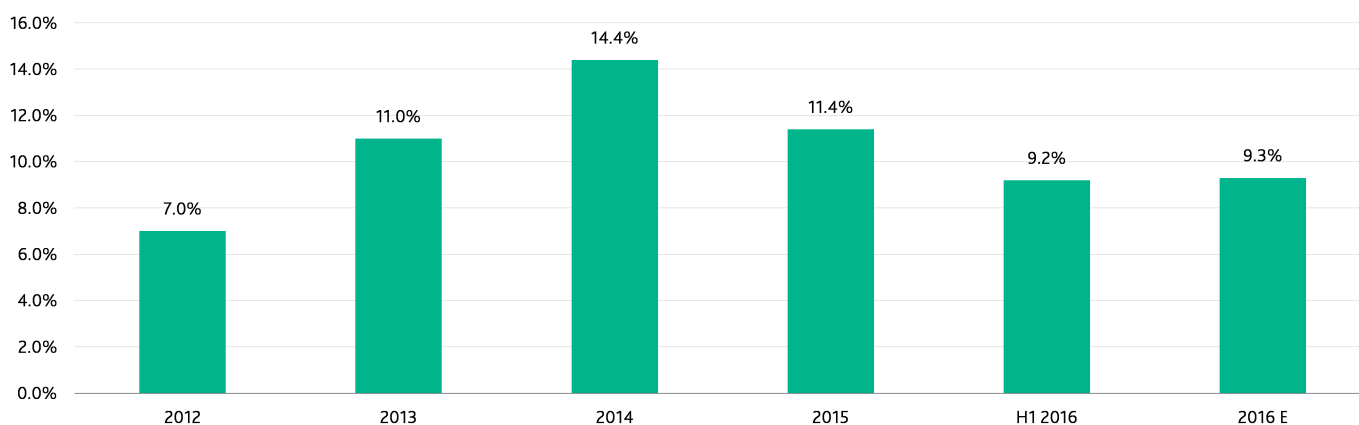
The take-over of B1OA exerted some downward pressure on Sparebanken Hedmark's profitability metrics. B1OA's standalone earnings profile is weaker than Sparebanken Hedmark's as the bank operates in a more competitive area than Hedmark, resulting in significantly

lower margins and a higher cost base. As a result, there is some softening of the combined entity's profitability metrics, with return on tangible assets dropping significantly to 0.79% in June 2016 from 1.67% in December 2015 (excluding assets transferred to covered bond companies).

Sparebanken Hedmark's main source of earnings is net interest income (including fees from loans transferred to the covered bond company), representing over 59% of its operating income at end June 2016. The bank's cost-to-income ratio (according to Moody's adjusted metrics) was almost 62% at end June 2016, slightly higher than the average of the Norwegian rated peers, while loan loss provisions remained low at 0.10% of average loans from 0.13% reported at end 2015.

We expect that the bank's profit metrics, including its net interest margins will gradually recover, with the contribution of cost synergies that will come about, estimated by the bank at around NOK75 million per annum. We note that the bank aims to have a long-term target of 10% return on equity (RoE), while the current pro-forma consolidated return on equity stands at 9.2% as of end June 2016 (see Exhibit 5).

Exhibit 5

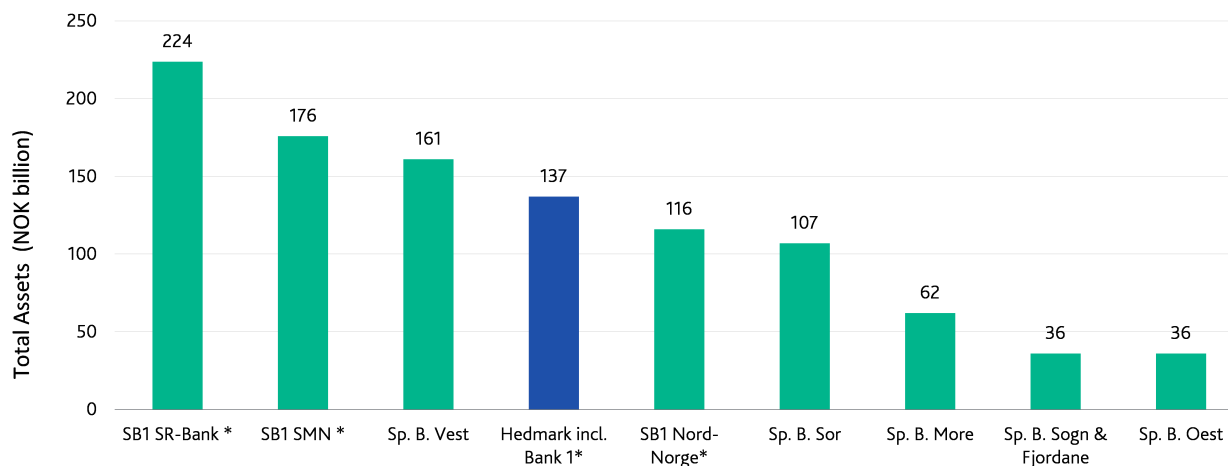
**Sparebanken Hedmark's return on equity (RoE)**

Note: H1 2016 is based on proforma consolidated displayed as it would be at 100 per cent ownership in Bank 1 Oslo Akershus from January 1, 2016.

Source: Sparebanken Hedmark reports

We also expect that over the medium term, the bank's earnings will get a boost from its increased client base and cross-selling opportunities, as well as the bank's capacity now to expand in the more wealthy Oslo-Akershus region. The bank had already a dominant position in the Hedmark region with market share in both retail and corporate of around 50%, and now adds around 8% retail market share and 5% in corporates in the Oslo-Akershus area. As the fourth largest Norwegian bank now (see Exhibit 6), Sparebanken Hedmark will also have the potential to participate in bigger syndications along with other banks, and also attract more business from larger borrowers in the market.

Exhibit 6

**Combined Sparebanken Hedmark and Bank 1 Oslo Akershus is Norway's 4th Savings bank as of 30 June 2016**

Note: \*SpareBank 1 Alliance banks include assets transferred to Covered Bond companies  
 Source: Moody's Financial Metrics and Companies' reports

**Liquidity - Substantial Deposit Base, Some Reliance on Market Funding but Less Than Many Peers**

Sparebanken Hedmark's funding profile has not changed in any significant way compared to prior the acquisition in December 2015, with market funding reliance to be around 31% of total tangible banking assets in June 2016, mainly driven by the issuance of covered bonds. The bank's funding position is underpinned by a substantial deposit base, which accounted for over 70% of on-balance-sheet funding at end-June 2016, with nearly 57% of the bank's deposits originated from the retail sector.

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-June 2016, Sparebanken Hedmark had transferred retail mortgages worth NOK34.8 billion to SpareBank 1 Boligkreditt and NOK1.2 billion commercial mortgages to SpareBank 1 Næringskreditt (i.e., equivalent to 31.2% of total loans including loans transferred to covered bond companies).

Whilst we positively view the diversification benefit of covered bond funding, 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 22.3% of the bank's tangible assets at end-June 2016 (31% when adjusting for covered bonds), a share that has been stable over the years.

We assign a score of baa3 compared to baa1 suggested by the scorecard's historical ratio because we use the consolidated market funding reliance to be at 31% of total tangible banking assets adjusted for covered bonds as a proxy for the forecast ratio in the consolidated funding score.

Similarly, the bank's liquidity position also remains modest following the acquisition, with the consolidated liquid assets to total tangible banking assets at around 15.5% as of June 2016 excluding refinancing of the covered bond companies and, according to the bank, cover funding needs for 18 months. 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 are positive in terms of currency risk. In addition, the bank reported a comfortable liquidity coverage ratio (LCR) of approximately 137% at the end-June of 2016.

## Notching Considerations

### Loss Given Failure and Additional Notching

We expect that Norway will seek to introduce legislation to implement the EU Bank Resolution and Recovery Directive (BRRD). In our LGF analysis, 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.

The ratings take into account Moody's LGF analysis of the combined entity's volume of deposits and senior unsecured debt, as well as the volume of securities subordinated to them. This results in an assessment of very low loss given failure and leads to two notches of rating uplift for the issuer ratings, which is the same uplift afforded for the bank's deposit ratings.

### Government Support

Following the acquisition, Sparebanken Hedmark has become the fourth largest savings bank in Norway, from sixth before, while also having presence now in the most important and economically developed region of Oslo-Akershus.

Accordingly, in our opinion the bank is now likely to be considered sufficiently systemically important to assume a moderate probability of government support into its ratings (from low pre-acquisition), which translates into one notch of rating uplift for its deposit and issuer ratings. In particular Moody's considers the bank to be a vital intermediary in financing the SME sector especially in the agricultural and forestry sectors that are central for the Hedmark region. The government support rating uplift overlays the two-notch rating uplift incorporated into the deposit and issuer ratings, based on the loss given failure (LGF) analysis of the bank's liability structure.

The rating agency intends to reassess its government support assumptions for all Norwegian savings banks, including Sparebanken Hedmark, once there is more clarity regarding the timing of the implementation of an official resolution regime through the enactment of a relevant local legislation. This is likely to be aligned with the EU's bank recovery and resolution directive (BRRD), as indicated by the domestic authorities in the past.

### Counterparty Risk Assessment

The bank's long-term Counterparty Risk Assessment (CR Assessment) has been upgraded to Aa3(cr) from A1(cr), while its short-term CR Assessment of P-1(cr) has been affirmed. 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 the likelihood of default and the expected financial loss suffered in the event of default 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 (e.g., swaps), letters of credit, guarantees and liquidity facilities.

### 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 7

### Sparebanken Hedmark

#### Macro Factors

<b>Weighted Macro Profile</b>	<b>Very Strong -</b>	<b>100%</b>
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#### Financial Profile

Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
<b>Solvency</b>						
<b>Asset Risk</b>						
Problem Loans / Gross Loans	1.2%	aa2	↓	a3	Geographical concentration	Sector concentration
<b>Capital</b>						
TCE / RWA	21.6%	aa1	↓↓	aa2	Expected trend	
<b>Profitability</b>						
Net Income / Tangible Assets	0.7%	baa2	← →	baa2	Expected trend	
<b>Combined Solvency Score</b>		aa3		a2		
<b>Liquidity</b>						
<b>Funding Structure</b>						
Market Funds / Tangible Banking Assets	22.3%	baa1	↓↓	baa3	Market funding quality	
<b>Liquid Resources</b>						
Liquid Banking Assets / Tangible Banking Assets	13.6%	baa3	← →	baa3	Stock of liquid assets	
<b>Combined Liquidity Score</b>		baa2		baa3		
<b>Financial Profile</b>				a3		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
<b>Total Qualitative Adjustments</b>				0		
<b>Sovereign or Affiliate constraint:</b>				Aaa		
<b>Scorecard Calculated BCA range</b>				a2-baa1		
<b>Assigned BCA</b>				baa1		
<b>Affiliate Support notching</b>				0		
<b>Adjusted BCA</b>				baa1		

<b>Balance Sheet</b>	<b>in-scope (NOK)</b>	<b>% in-scope</b>	<b>at-failure (NOK)</b>	<b>% at-failure</b>
Other liabilities	10,893	10.9%	17,282	17.3%
Deposits	62,637	62.7%	56,248	56.3%
Preferred deposits	46,351	46.4%	44,034	44.1%
Junior Deposits	16,286	16.3%	12,214	12.2%
Senior unsecured bank debt	22,187	22.2%	22,187	22.2%
Dated subordinated bank debt	1,188	1.2%	1,188	1.2%
Junior subordinated bank debt				
Preference shares (bank)				
Senior unsecured holding company debt				
Dated subordinated holding company debt				
Junior subordinated holding company debt				
Preference shares (holding company)				
Equity	2,997	3.0%	2,997	3.0%
Total Tangible Banking Assets	99,902	100%	99,902	100%



Debt class	De jure waterfall		De facto waterfall		Notching		LGF notching guidance versus 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	38.6%	38.6%	38.6%	38.6%	3	3	3	3	0	a1 (cr)
Deposits	38.6%	4.2%	38.6%	26.4%	2	3	2	2	0	a2

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	2	0	a2	1	A1	A1

Source: Moody's Financial Metrics

## Ratings

Exhibit 8

Category	Moody's Rating
<b>SPAREBANKEN HEDMARK</b>	
Outlook	Stable
Bank Deposits	A1/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	Aa3(cr)/P-1(cr)
Issuer Rating	A1

Source: Moody's Investors Service

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REPORT NUMBER 1043319