

CREDIT OPINION

12 July 2017

Update

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RATINGS

SpareBank 1 Østlandet

Domicile	Hamar, Norway
Long Term Deposit	A1
Type	LT Bank Deposits - Fgn Curr
Outlook	Negative

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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SpareBank 1 Østlandet

Update Following Outlook Change to Negative

Summary Rating Rationale

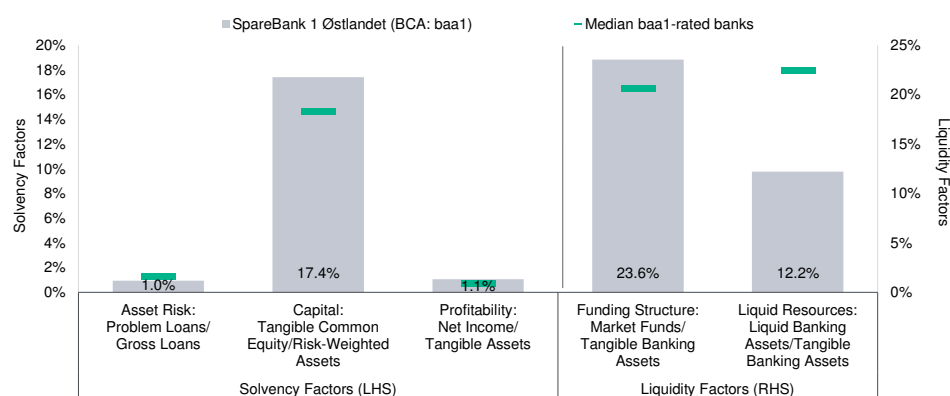
Moody's assigns a baseline credit assessment (BCA) of baa1 to SpareBank 1 Østlandet (known as Sparebanken Hedmark prior to April 2017), a long-term deposit rating of A1, and an issuer rating of A1. We also assign a Counterparty Risk Assessment (CR Assessment) of Aa3(cr) long term and Prime-1(cr) short term.

SpareBank 1 Østlandet BCA of baa1 primarily reflects the bank's strengthened franchise following the acquisition of Bank 1 Oslo Akershus (B1OA) in June 2016 and its legal merger on 1 April 2017, as well as the bank's healthy standalone credit profile. The immediate benefits conferred to the bank include better asset quality (problem loans ratio dropped to 0.6% in March 2017 from 1.1% in March 2016), as well as deeper loans and earnings geographical diversification. 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. The bank's BCA also takes into account its relatively high level of capital markets funding, a common feature among the largest savings bank in Norway.

The bank's A1 deposit and issuer ratings take into account our Loss Given Failure (LGF) analysis, which benefits from its large volume of deposits and substantial layers of subordination resulting in two notches of rating uplift from its BCA. Our current assessment of a moderate probability of government support, which results in one additional notch of rating uplift, is likely to be revised shortly due to the BRRD law in Norway (please see [press release](#) for more details).

Exhibit 1

Rating Scorecard - Key Financial Ratios



Source: Moody's Financial Metrics

Credit Strengths

- » SpareBank 1 Østlandet'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

Credit Challenges

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

Rating Outlook

The negative outlook on the bank's ratings reflects our view that downward pressure is likely to be exerted from the upcoming implementation of BRRD in Norway, which will trigger a reassessment of our government support assumptions for all large savings banks, including SpareBank 1 Østlandet.

Factors that Could Lead to an Upgrade

Upward rating pressure could develop if SpareBank 1 Østlandet 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. However, the current negative outlook contains any upward rating pressure for now.

Factors that Could Lead to a Downgrade

Future downward rating pressure could arise if: (1) SpareBank 1 Østlandet'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 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; (5) the macroeconomic environment deteriorates more than currently anticipated, leading to a lower Macro Profile; and/or (6) passage of the official resolution law in Norway and revision of our government support assumptions for all large Norwegian savings banks, including SpareBank 1 Østlandet.

Key Indicators

Exhibit 2

SpareBank 1 Ostlandet (Consolidated Financials) [1]

	12-16 ²	12-15 ²	12-14 ²	12-13 ³	12-12 ³	Avg.
Total Assets (NOK billion)	101	56	50	47	44	22.9 ⁴
Total Assets (EUR million)	11,096	5,804	5,485	5,670	6,012	16.6 ⁴
Total Assets (USD million)	11,704	6,305	6,638	7,812	7,926	10.2 ⁴
Tangible Common Equity (NOK billion)	11	8.4	7.3	6.4	5.8	18.0 ⁴
Tangible Common Equity (EUR million)	1,229	871	808	766	784	11.9 ⁴
Tangible Common Equity (USD million)	1,296	946	977	1,055	1,034	5.8 ⁴
Problem Loans / Gross Loans (%)	0.6	1.2	1.4	1.6	2.1	1.4 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	17.9	22.2	20.0	20.7	23.5	20.0 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	4.4	6.3	7.2	9.2	12.1	7.8 ⁵
Net Interest Margin (%)	1.9	2.3	2.3	2.4	2.3	2.2 ⁵

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 for the most updated credit rating action information and rating history.

PPI / Average RWA (%)	2.2	1.9	2.2	2.2	2.3	2.1 ⁶
Net Income / Tangible Assets (%)	1.0	1.4	1.9	1.5	1.0	1.4 ⁵
Cost / Income Ratio (%)	58.2	59.7	54.5	58.6	60.7	58.3 ⁵
Market Funds / Tangible Banking Assets (%)	23.6	22.3	19.7	19.5	20.6	21.1 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	12.2	13.6	11.5	13.9	13.6	12.9 ⁵
Gross loans / Due to customers (%)	131.5	130.8	128.5	123.5	126.0	128.1 ⁵

[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 (%). Any interim period amounts presented are assumed to be fiscal year end amounts for calculation purposes [5] Simple average of periods presented [6] Simple average of Basel III periods presented

Source: Moody's Financial Metrics

Detailed Rating Considerations

SpareBank 1 Østlandet's Ratings are Supported by its Very Strong- Macro Profile

As a domestically oriented bank, SpareBank 1 Østlandet'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.

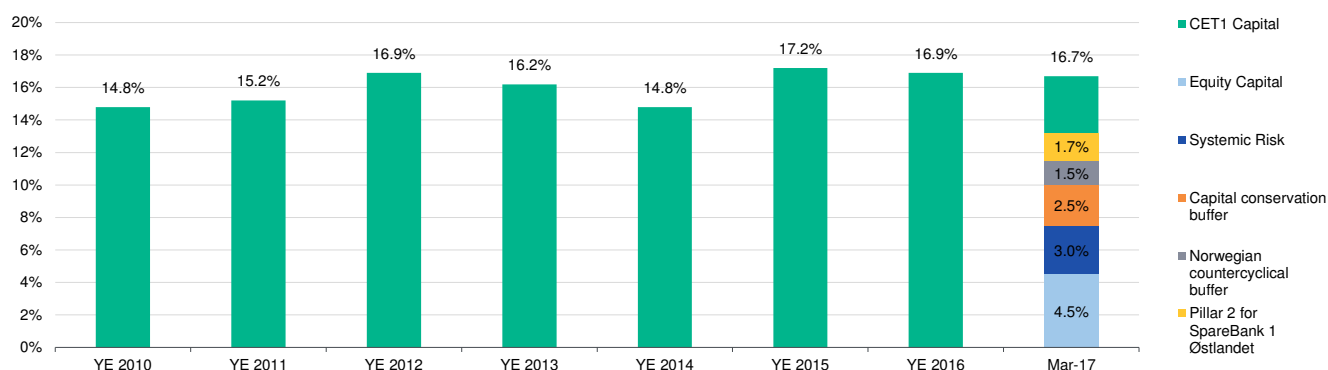
Solid Capital Levels, Which Are the Strongest Among Peers

At end-March 2017 the combined group remains one of the strongest capitalised bank among savings banks in Norway with a Tangible Common Equity (TCE) to risk weighted assets (RWA) ratio at 17.4% and a reported common equity Tier 1 (CET1) ratio of 16.7%, although reduced from 16.9% in December 2016. The bank targets to have at least 16% CET1 ratio on an on-going basis, aiming to be one of Norway's most solid regional savings bank having a leverage ratio of 7.5% at end-March 2017.

We note that the Norwegian authorities are concerned about the development of financial imbalances in light of strong growth in house prices, especially in the Oslo region. Consequently, the Ministry of Finance recently increased the countercyclical capital buffer from 1.5% to 2%, with effect from 31 December 2017, in line with Norges Bank's advice, in addition to new home mortgage regulations introduced from 1 January 2017. SpareBank 1 Østlandet recently received from Norway's Financial Supervisory Authority (FSA) its Pillar 2 requirement of 1.7% in CET1 capital, which brings the bank's CET1 requirement at 13.2% for 2016 (Exhibit 3) and 13.7% for 2017.

Exhibit 3

SpareBank 1 Østlandet CET1 Capital Ratio Evolution



Source: Company reports and presentation

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. The bank successfully conducted an IPO in June 2017 and the Equity Certificates were listed on the Oslo Stock Exchange. Consequently, this is expected to improve SpareBank 1 Østlandet's capacity to access capital and the action will increase the bank's visibility in international capital markets by tapping a much larger investor base.

Sparebanken Hedmark Sparebankstiftelse (the Foundation) maintains its position as the largest stakeholder of the bank post the IPO and the Foundation is a long-term and financially strong owner with its bylaws stating that it shall maintain its interest through participation in equity certificate issues. Another important innovation, both for the bank and its customers, is that SpareBank 1 Østlandet will become the first bank in Norway to launch customer dividends in 2017, enabling customers to secure a profit via their deposit and loan balances in the bank. The first dividend payment is expected to take place in early 2018.

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. Our assigned Capital score reflects this strength, as well as the bank's adjusted leverage ratio (TCE/Tangible banking assets ratio), which at 7.4% as of year-end 2016 is satisfactory for the Norwegian regulator's requirement and high compared with international standards and similarly-rated global peers.

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

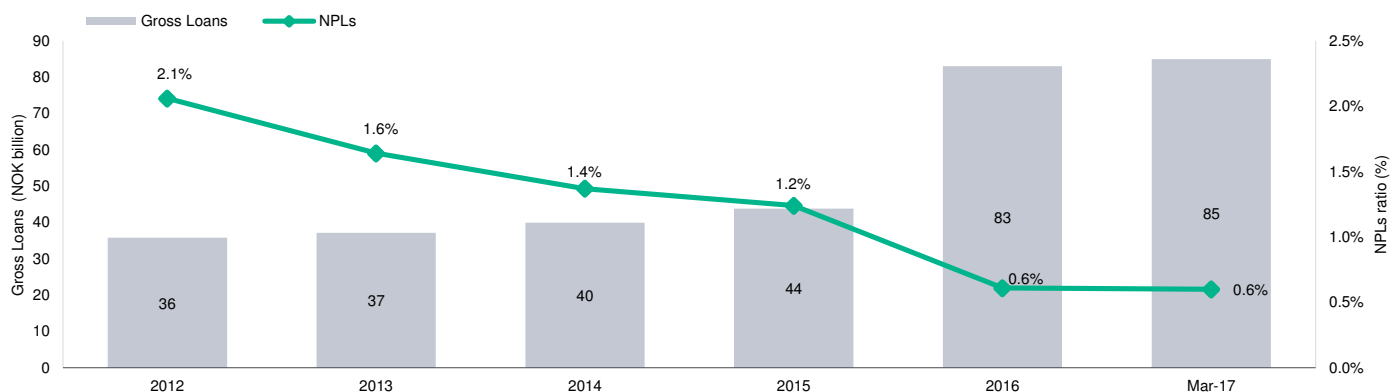
In line with our previous expectation, SpareBank 1 Østlandet's asset quality has improved with overall problem loans for the group reducing to around 0.6% of gross loans (excluding covered bond loans) in March 2017 from 1.1% in March 2016 (see Exhibit 4). This was mainly driven by the strong asset quality 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 74% of gross loans including covered bond loans, with no exposure to the oil sector in March 2017. This supports 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 at 1.1% in December 2016 down from 1.4% in December 2015 for SpareBank 1 Østlandet on a standalone basis.

Exhibit 4

SpareBank 1 Østlandet's Asset Risk Metrics Post Acquisition



YE2016 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 around 12% of its gross loans, including covered bond loans transferred to SpareBank 1 Næringskreditt, while around 2% of gross loans, including covered bond loans, are towards the building and construction sector as of March 2017. The exposure 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 also believe that the newly acquired residential mortgages loan book in the Oslo area, where house prices have been growing significantly recently, also exposes the bank to downside risks in case of a material house price decline.

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 and in the Oslo-Akershus region where

home prices have been heating up in the last few years. 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

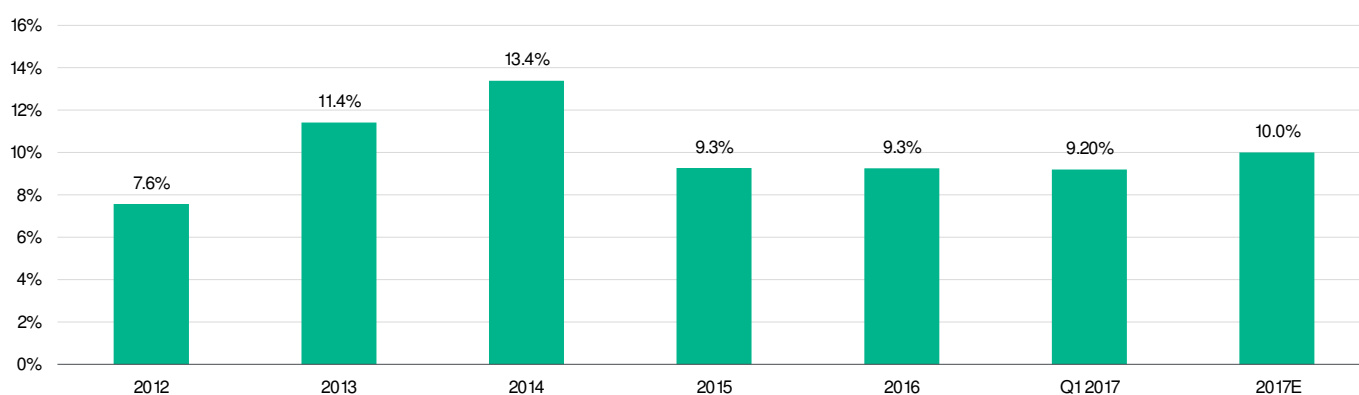
The take-over of B1OA exerted some downward pressure on SpareBank 1 Østlandet's profitability metrics. B1OA's standalone earnings profile is weaker than Sparebanken Hedmark's prior to the acquisition, as the former operates in a more competitive area than Hedmark, resulting in significantly lower margins 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 to 1.07% in March 2017 from 1.36% in December 2015 (excluding assets transferred to covered bond companies). However, we note the higher level of cross-selling at B1OA during 2016, which to some degree counterbalances its lower net interest income through fee income, contributing to profitability levels closer to SpareBank 1 Østlandet prior to the acquisition.

SpareBank 1 Østlandet's profit after tax increased to NOK274 million in the first quarter of 2017, reflecting 100% ownership in B1OA, compared with NOK169 million in the first quarter of 2016 on a standalone basis prior to the acquisition. SpareBank 1 Østlandet's main source of earnings is net interest income (including fees from loans transferred to the covered bond company), representing around 70% of its operating income in the first quarter of 2017. The bank's cost-to-income ratio (according to Moody's adjusted metrics) was almost 57.3% at end March 2017, slightly higher than the average of the Norwegian rated peers, while loan loss provisions remained low at -0.12% of average loans reflecting recoveries in the first quarter of 2017 (0.08% in the first quarter of 2016). However, we expect that the bank will likely increase its loan losses in 2017-18, mainly driven by the adoption of IFRS 9 with new more conservative principles for write-downs from January 2018 onwards. The methodology in the IFRS 9 standard entails somewhat larger volatility in write-downs, as they will be made at an earlier stage than under current practice.

Nonetheless, 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 minimum NOK75 million per annum. We note that the bank aims to have a long-term target of at least 10% return on equity (RoE) as reported by the bank (9.3% in March 2017), while the current Moody's adjusted RoE (net profit before unusual items over average shareholders' equity) stood at 9.2% as of March 2017 (see Exhibit 5).

Exhibit 5

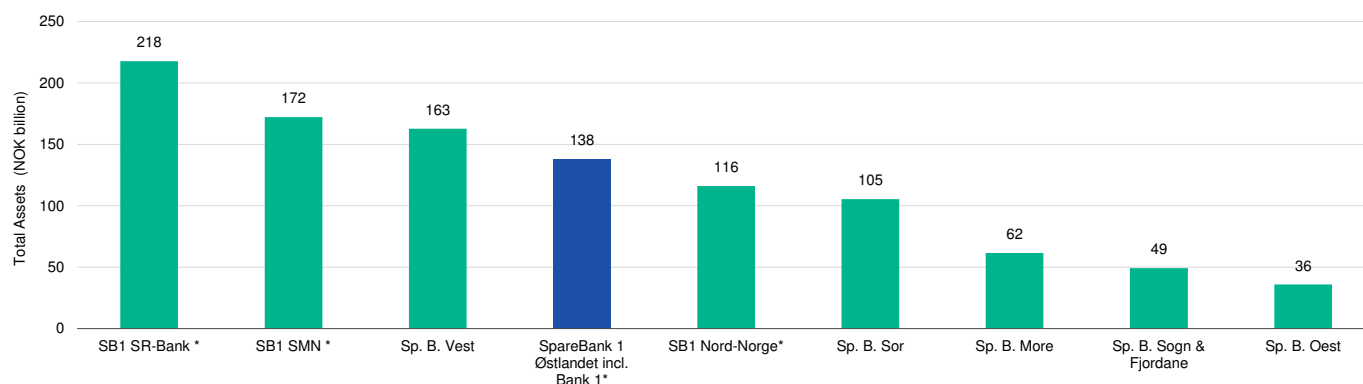
SpareBank 1 Østlandet's Moody's Adjusted Return on Equity (RoE)



YE2016 and Q1 2017 are based on consolidated financials including results from Bank 1 Oslo Akershus
 Source: SpareBank 1 Østlandet reports, Moody's Investors Service

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 6% retail market share and 3% in SMEs in the Oslo-Akershus area. As the fourth largest Norwegian bank now (see Exhibit 6), SpareBank 1 Østlandet 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

Consolidated SpareBank 1 Østlandet (including Bank 1 Oslo Akershus) is Norway's Fourth Largest Savings Bank (31 March 2017)

*SpareBank 1 Alliance banks include assets transferred to Covered Bond companies

Source: Source: Moody's Financial Metrics and Companies' reports

The Bank's Funding Profile is Underpinned By Relatively High Reliance on Market Funding But Also a Sizeable Deposit Base

SpareBank 1 Østlandet's funding profile has not changed in any significant way compared to prior the acquisition in December 2015, with market funding reliance (assuming 50% of covered bonds as market funding) to be around 31% of total tangible banking assets in March 2017, mainly driven by the issuance of covered bonds. We also note that since June 2016 the bank participates in the SpareBank 1 Alliance's EUR10 billion EMTN program, and was able to issue EUR50 million of senior bonds in November 2016 and another EUR30 million in May 2017. The bank's funding position is also underpinned by a substantial deposit base, which accounted for around 70% of on-balance-sheet funding at end-March 2017, with nearly 58% 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. SpareBank 1 Østlandet has increasingly used covered bond funding, which is done off-balance-sheet through specialized 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-March 2017, SpareBank 1 Østlandet had transferred retail mortgages worth NOK35.5 billion to SpareBank 1 Boligkreditt and NOK1.3 billion commercial mortgages to SpareBank 1 Næringskreditt (i.e., equivalent to 30.2% of total gross 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 SpareBank 1 Østlandet has some reliance on market funds - a common feature at Nordic banks - but to a lesser degree than peers. On balance sheet market funding accounted for 24.1% of the bank's tangible assets at end-March 2017 (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 since the consolidated market funding reliance is at around 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 consolidated liquid assets to total tangible banking assets at around 10.6% as of end-March 2017 excluding refinancing of the covered bond companies and, according to the bank, cover funding needs for 17 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 liquidity coverage ratio (LCR) of approximately 93% at end-March 2017 (117% at end-December 2016). The decreased LCR is due to the bank's decision to adjust the ratio downwards to be more closely in line with the 80% statutory requirement.

Notching Considerations

Loss Given Failure and Additional Notching

We expect that Norway will shortly pass legislation to implement the EU Bank Recovery and Resolution Directive (BRRD), which confirms our current assumptions regarding LGF analysis. 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, SpareBank 1 Østlandet 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 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 notches rating uplift incorporated into the deposit and issuer ratings, based on the loss given failure (LGF) analysis of the bank's liability structure. However, the expected implementation of the official resolution regime in Norway in the coming months, will likely cause us to reconsider/lower our government support assumptions for all rated savings banks in Norway, including SpareBank 1 Østlandet, as reflected by the current negative rating outlook.

Counterparty Risk Assessment

We assign a Aa3(cr) long term and P-1(cr) short term CR Assessment to SpareBank 1 Østlandet.

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

SpareBank 1 Østlandet

Macro Factors

Weighted Macro Profile	Very Strong -	100%
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Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.1%	aa2	↓↓	a3	Geographical concentration	Sector concentration
Capital						
TCE / RWA	17.9%	aa2	← →	aa2	Expected trend	
Profitability						
Net Income / Tangible Assets	1.0%	baa1	← →	baa1	Expected trend	
Combined Solvency Score		aa3		a2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	23.6%	baa1	↓↓	baa3	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	12.2%	baa3	← →	baa3	Stock of liquid assets	
Combined Liquidity Score		baa2		baa3		
Financial Profile				a3		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				Aaa		
Scorecard Calculated BCA range				a2-baa1		
Assigned BCA				baa1		
Affiliate Support notching				0		
Adjusted BCA				baa1		

Balance Sheet	in-scope (NOK million)	% in-scope	at-failure (NOK million)	% at-failure
Other liabilities	11,153	11.1%	17,586	17.5%
Deposits	63,070	62.8%	56,637	56.4%
Preferred deposits	46,672	46.5%	44,338	44.2%
Junior Deposits	16,398	16.3%	12,299	12.3%
Senior senior unsecured bank debt	21,937	21.9%	21,937	21.9%
Dated subordinated bank debt	1,203	1.2%	1,203	1.2%
Equity	3,011	3.0%	3,011	3.0%
Total Tangible Banking Assets	100,374	100%	100,374	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	38.3%	38.3%	38.3%	38.3%	3	3	3	3	0	a1 (cr)
Deposits	16.5%	4.2%	38.3%	4.2%	2	2	2	1	0	a2

Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Deposits	1	0	a2	1	A1	A1

Source: Moody's Financial Metrics

Ratings

Exhibit 8

Category	Moody's Rating
SPAREBANK 1 OSTLANDET	
Outlook	Negative
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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