The Major Sparebanken of the SpareBank 1 Alliance

Special Report

Ratings

SpareBank 1 SR-Bank
Foreign Currency

Long-Term IDR	A−
Short-Term IDR	F2
Viability Rating	a−
Support Rating	3
Support Rating Floor	BB+

SpareBank 1 SMN
Foreign Currency

Long-Term IDR	A−
Short-Term IDR	F2
Viability Rating	a−
Support Rating	3
Support Rating Floor	BB+

SpareBank 1 Nord-Norge
Foreign Currency

Long-Term IDR	A
Short-Term IDR	F1
Viability Rating	a
Support Rating	3
Support Rating Floor	BB+

SpareBank 1 Boligkreditt AS
Foreign Currency

Long-Term IDR	A−
Short-Term IDR	F2
Support Rating	1

Sovereign Risk

Long-Term Foreign-Currency IDR	AAA
Long-Term Local-Currency IDR	AAA
Country Ceiling	AAA

Outlooks

SpareBank 1 SR-Bank Long-Term Foreign-Currency IDR	Stable
SpareBank 1 SMN Long-Term Foreign-Currency IDR	Stable
SpareBank 1 Nord-Norge Long-Term Foreign-Currency IDR	Stable
SpareBank 1 Boligkreditt Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Related Research

SpareBank 1 SR-Bank (December 2014)
SpareBank 1 SMN (December 2014)
SpareBank 1 Nord-Norge (December 2014)
SpareBank 1 Boligkreditt AS (December 2013)

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Strong Standalone Strengths: SpareBank 1 SR-Bank's (SR), SpareBank 1 SMN's (SMN) and SpareBank 1 Nord-Norge's (SNN) (collectively the Sparebanken) ratings reflect their strong regional franchises, healthy profitability, sound asset quality and strong capitalisation. They also factor in wholesale funding reliance, high property prices, and geographically concentrated loan books. SNN's ratings are one notch higher than its Sparebanken peers', reflecting stronger capital ratios and a more retail-orientated business and funding model.

Benefits from Alliance Membership: The Sparebanken are the three largest savings banks rated by Fitch Ratings in Norway's SpareBank 1 Alliance (Alliance). They benefit from cost efficiencies and wider income diversification via the jointly owned SpareBank 1 Gruppen AS, offering life and non-life insurance. SpareBank 1 Boligkreditt AS's (S1B) ratings are aligned with those of the largest Alliance members, SR and SMN, and reflect its role as a covered bond funding vehicle for its shareholder banks.

Strong Regional Franchises Support Earnings: The Sparebanken's profitability is strong, underpinning internal capital generation. The banks' regional franchises support stable revenue generation, and operational efficiency is acceptable. Fitch expects continued low loan impairment charges (LICs) in 2015. The banks repriced corporate deposits in 9M14, and Fitch expects this to continue into 2015. Lending margins for retail mortgage loans are under some pressure, as wholesale funding costs are reducing, but should remain satisfactory.

Sound Asset Quality: The Sparebanken's asset quality is strong, driven by a benign operating environment and strong underwriting standards. Fitch expects that banks' management will continue to implement low-risk business models focusing on retail and SME customers, and that concentration risks relating to larger corporates will reduce. A house price correction is a sensitivity for the banks, particularly if reduced consumption negatively affects SME portfolios.

Wholesale Funding Reliance: Similar to most Nordic peers, the Sparebanken rely on wholesale funding to varying degrees. They have maintained access to domestic and international funding markets, in particular for covered bonds through S1B. However, they would be affected by a prolonged dislocation of the debt capital markets, and Fitch believes that the banks will retain significant liquidity portfolios to mitigate this risk. SNN's funding profile is stronger than its Sparebanken peers, driven by a greater retail deposit base.

Good Capitalisation: The Sparebanken's capital adequacy ratios compare well with those of international peers. Leverage is low in a European context. SNN's risk-weighted capitalisation, as well as its leverage, is somewhat stronger than its Sparebanken peers.

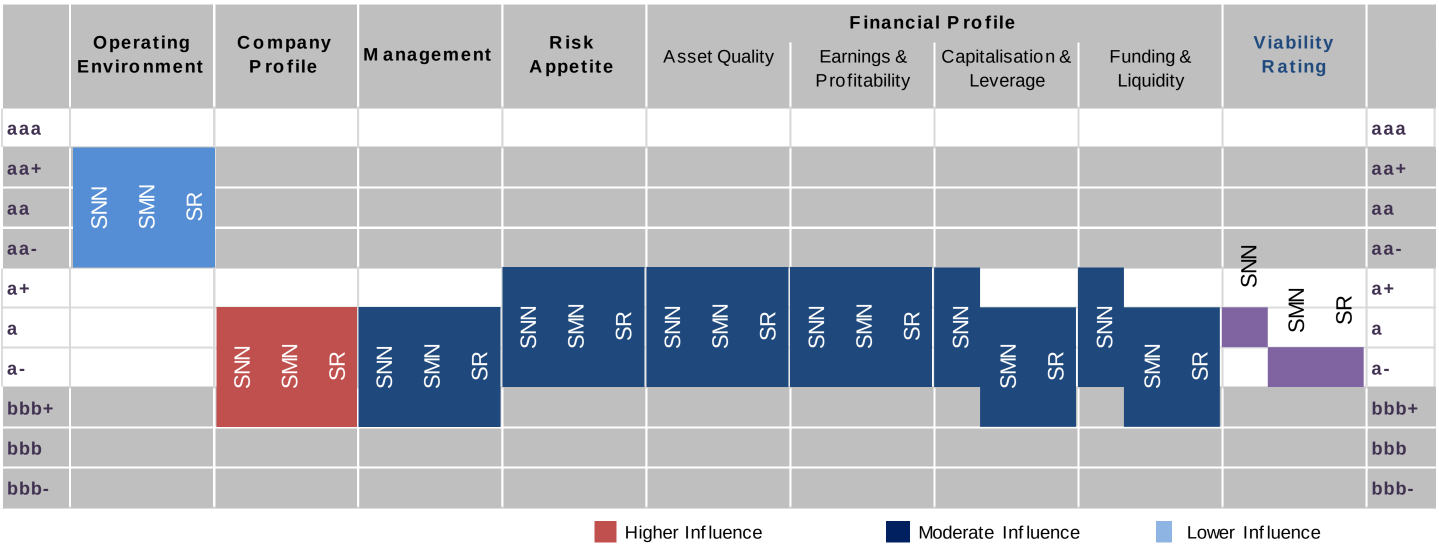
Moderate Probability of Support: The Sparebanken's Support Ratings and Support Rating Floors reflect Fitch's view that there is a moderate probability of support, if required from the Norwegian authorities, given the Alliance banks' strong regional franchises.

Rating Sensitivities

House Prices, Funding Access: The Sparebanken's ratings could be downgraded if credit growth materially weakened capitalisation. The ratings are also sensitive to a significant house price correction and difficulties in obtaining competitively priced wholesale funding.

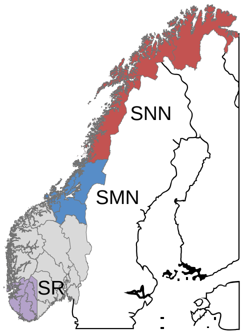
Upgrades Unlikely: An upgrade is unlikely given the already high ratings in the context of their company profiles and geographical concentration. The structural reliance on wholesale funding is also a somewhat limiting factor.

Figure 1
Summary Rating Navigators for the Sparebanken



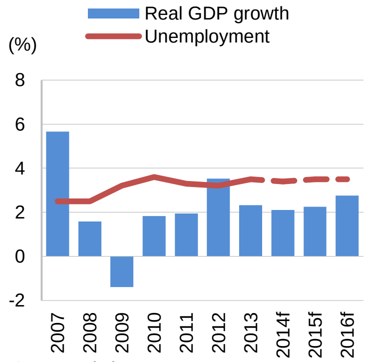
Source: Fitch

Figure 2
Geographical Coverage



Source: Banks

Figure 3
Macro Economy



Source: Fitch

Related Criteria

Global Financial Institutions Rating Criteria (January 2014)

Operating Environment

'AAA' Rated Norwegian Sovereign with Significant Financial Assets

As regional banks, the performance of the Sparebanken is closely linked to that of the Norwegian economy. Norway has maintained its 'AAA' rating for the past 20 years, and Fitch expects the Norwegian banking sector to continue to benefit from the country's favourable economic environment. Despite the minimal growth in the eurozone, Fitch forecasts 2.3% GDP growth for Norway in 2015, and expects unemployment to remain low (around 3.5%). As a small, open economy with large export-driven industries, Norway's economy and consequently the country's banks are sensitive to global growth development, falling commodity prices and an appreciation of the krona. The sovereign balance sheet is supported by well-managed North Sea petroleum revenues, putting the Norwegian authorities in a strong position to respond to adverse shocks. Net government financial assets amounted to around 170% of GDP at end-2013, making Norway a standout among 'AAA' peers.

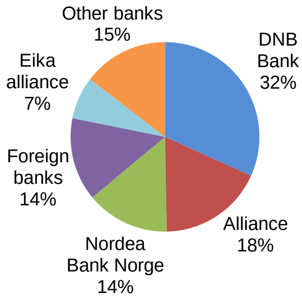
The Norwegian banking sector is reasonably concentrated, with the largest player, DNB Bank ASA, having over a 30% market share and operating throughout the country. Nordea Bank Norge, the Norwegian subsidiary of Nordea Bank AB, is the second largest stand-alone bank. There are a number of savings banks groupings, of which the Alliance is the largest one, while a large number of savings banks also operate independently.

Given their regional footprint, the prospects of the Sparebanken are closely linked to the economic development of the regions in which they are active. While western Norway and the Oslo region have experienced the strongest growth and the largest share of exports, northern Norway's economy is supported by a large and stable public sector and growth is now above the Norwegian average.

The Norwegian regulatory environment is highly developed and transparent, in Fitch's view. The authorities have taken a strict view towards risk-weight optimisation and have, for example, introduced floors in calculating risk-weights for mortgage loans (effectively around 20-25%). In Fitch's view, Norwegian authorities have not taken a leading role in implementing new regulation, instead have looked to implemented rules coming from the EU. In addition, the strong co-operation with other Nordic authorities, particularly in Sweden, has seen them introduce stricter rules applicable in those countries.

Figure 4

Lending Market Shares
End-June 2014



Source: Norges Bank

Company Profile

Independent Regional Savings Banks in Nationwide Alliance

In 1996, SNN, SMN, SR and Sparebanken Vest (SV; A−/Stable) founded the Alliance along with Samspar, a group of smaller savings banks. SV withdrew from the venture in January 2004 to pursue an independent strategy. At end-2013, Alliance members had over 350 branches across Norway. Assets of the Alliance totalled over NOK800bn at end-2013, making the alliance the second largest banking group in Norway behind DNB.

The Sparebanken operate as universal banks for retail and SME customers in their regions, where they hold leading market shares (of at least 30%) in deposits and loans. Their business model, although regionally concentrated, has proven stable given the focus on traditional retail banking and relatively simple organisational structures. On a nationwide level, the Alliance has around a 20% market share in retail lending and around a 18% share in the SME segment. The SpareBank 1 brand has been established as one of Norway's most recognised financial brands.

Benefits from the Alliance Product Subsidiaries

The Alliance banks benefit from co-operation agreements between the members in areas such as marketing and IT. They own S1B, their funding vehicle for covered bonds. The Alliance banks also jointly own the holding company SpareBank 1 Gruppen, which provides insurance and fund management services through its subsidiaries. Alliance member banks benefit from economies of scale, as SpareBank 1 Gruppen is also responsible for some product development. Capital markets services are provided by SpareBank 1 Markets, which is owned directly by the Alliance banks (except SR) and not via SpareBank 1 Gruppen.

Management

The Sparebanken's management teams have a deep local knowledge, and there are strong corporate cultures within the banks. Senior management turnover has been low. The strategic direction in the Alliance has been consistent since its creation, benefiting all its members.

SR converted into a limited liability savings bank in 2011 to make it easier to access capital and funding. SMN and SNN have no plans to follow SR's conversion. SMN's and SNN's owners are the holders of equity capital certificates, although they are without voting rights. Representatives of the owners, together with public appointees, employees and customer representatives, sit on the supervisory board, whose nomination committee appoints the board of directors. Corporate governance principles are in line with the Norwegian code on corporate governance.

Risk Appetite

Sophisticated Risk Management Systems in Context of Company Profiles

The Sparebanken's boards are responsible for assessing and monitoring all risks within the banks, with a delegated authority to the various risk departments for day-to-day responsibility for overall risk assessment.

In 2007, the banks gained approval from the Norwegian authorities to adopt the internal ratings-based approach to measure credit risk in their retail and SME portfolios. While initially that led to low risk-weights of around 10%, various floors and Basel II transitional rules have meant effectively the capital impact has been more limited. Nonetheless, the Sparebanken use this for risk management purposes. Systems and expertise are shared across the Alliance, and the banks have been preparing to move to the advanced IRB approach for corporate exposures.

Underwriting standards for the Sparebanken's mortgage lending are conservative, and risk appetite is somewhat constrained by the covered bond legislation as well as S1B's criteria for eligible mortgage loans. SME and corporate lending involves greater risks, although Fitch believes this also has been done in a prudent manner. Concentration risk has reduced since the financial crisis as the exposures to mid-sized corporates have reduced and the focus has been tightened to retail customers and SMEs.

Risk and reporting tools are robust, and the use of a credit bureau is widespread in Norway. The loan portfolios are relatively granular, and the Sparebanken continuously monitor risk limits and tests their product range. Credit risk represents the most significant capital charge for these banks at 85%-90% of total capital requirements at end-September 2014, excluding transitional rules.

Credit growth over the past few years has been broadly in line with economic developments, with growth in corporate lending being relatively modest in 9M14; excluding loans transferred to S1B, SNN's, SMN's and SR's loan books grew by 4%-8%. Fitch expects loan growth to reduce further in 2015 as the banks adjust to higher capital requirements, and lower credit demand.

Moderate Exposure to Market Risk

Market risk arises from the financial instruments held by the banks, as well as indirectly through the jointly owned holding company SpareBank 1 Gruppen, in particular in its insurance investment portfolio. Interest rate risk is mitigated to some extent, as rates on most mortgage loans can be varied following a six-week notice period; Fitch understands that interest rates on corporate loans can be adjusted even faster. Interest rate risk is managed using gap and duration analysis within relatively small limits for sensitivity to a 100bp parallel shift in interest rates. Fitch considers the banks' volume of equity investments to be relatively small. There are strict limits on equity investments made by the Sparebanken.

Financial Profile

Asset Quality: Solid Loan Books Supported by Benign Environment

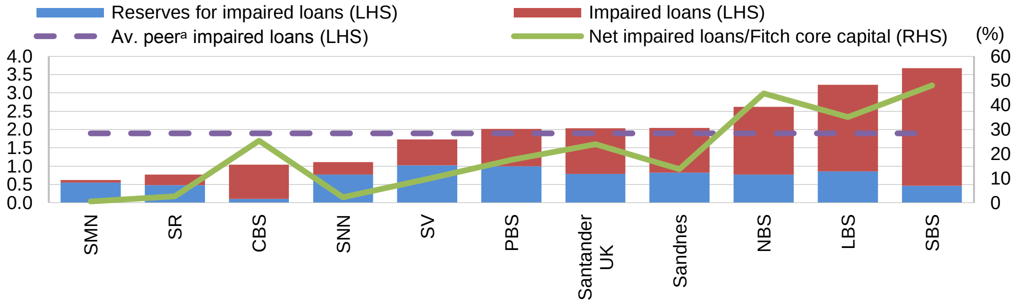
The Sparebanken's asset quality is strong and compares well to peers. Impaired loans represents a low 60bp-110bp of gross loans, and net impaired loans (after deducting reserves) represent less than 3% of Fitch Core Capital for the three banks, all at end-September 2014. The quality of the lending is supported by the benign Norwegian operating environment, which has kept unemployment low combined with resilient consumption and investments, in turn supporting both residential mortgage lending as well as SMEs.

- Interim reporting for Sparebanken's peers is in many instances less detailed than year-end reporting. For consistency, end-2013 (2013 for profitability) ratios have been used for the peers but end-September 2014 (9M14) for the Sparebanken.

Figure 5

Asset Quality (as % of Gross Loans)

End-September 2014 (end-2013 for peers)



[a] Peers: Coventry Building Society (CBS; VR of 'a'),Sparebanken Vest (SV; 'a-'), Principality Building Society (PBS; 'bbb+'), Santander UK('a'), Sandnes Sparebank (Sandnes; 'bbb'), Nationwide Building Society (NBS; 'a'), Leeds Building Society (LBS; 'a-') and Skipton Building Society (SBS; 'bbb')
Source: Banks, Fitch

Residential Lending Largely Mortgage Loans

Residential mortgage lending represents around half of the Sparebanken's loan books, somewhat more for SNN. The vast majority of mortgage loans have a loan to value (LTV) ratio of less than 75%, in line with S1B's criteria for loan transfers. These portfolios have performed well, supported by the low interest rates and unemployment, and Fitch expects the quality of the lending will remain solid in 2015.

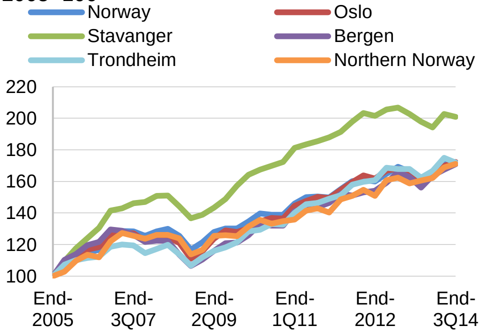
Various tax incentives to borrow (tax deductibility of interest expenses and limited or no capital gains tax on main residence) have increased Norwegian households' indebtedness to around 200% of disposable income. More leveraged households and strong wage growth have fuelled increases in property prices. While Fitch expects households' ability to service their debt to remain strong, high debt levels have made them more sensitive to interest rate increases, most likely manifesting itself in lower consumption. The quality of mortgage lending should therefore be able to sustain a moderate fall in house prices before impaired mortgage loans markedly increase. However, lower consumption could affect Norwegian businesses and the Sparebanken's SME lending.

Property prices have increased significantly in Norway in recent years, and a large fall could affect the Sparebanken. Stavanger and South-Western Norway have seen the strongest growth rates in recent years - SR's operating market - although most large cities have experienced escalating house prices. Fundamental factors, such as rising incomes, under supply of housing, and population growth, have likely been the main drivers. Fitch expects that house prices are likely to stabilise or moderately fall in 2015, driven by more strict credit supply as well as households' more negative house price expectations.

Figure 6

Regional House Price Development

2005=100

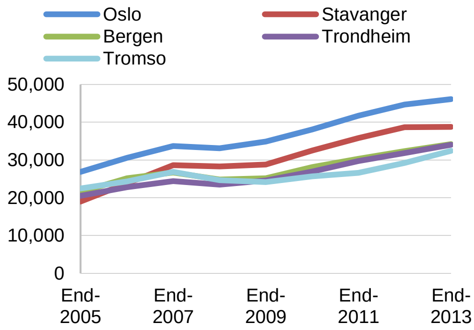


Source: Fitch, Statistics Norway

Figure 7

Regional House Prices Per m²

NOKk/m²



Source: Fitch, Statistics Norway

SME Lending of Good Quality, Concentrations Reducing

The Sparebanken's corporate lending is predominately local SME customers. Due to the regional nature of their franchises, there is some single name concentration in their loan books, although the banks have focussed on reducing borrower concentrations in recent years. Corporate lending represents around half of SMN's and SR's total lending, and around 40% for SNN.

Commercial real estate (CRE) portfolios account for around 15% of SNN's and SMN's lending, with a somewhat higher 20% for SR. The quality of these portfolios benefits from relatively modest vacancy rates and impaired CRE loans are not markedly different to the portfolio averages (somewhat higher for SNN however). An economic slowdown could harm the quality of these exposures through weakening cash flows and falling collateral values. Exposures to commercial property mostly relate to buy-to-let investments and are typically in long-term contracts with high quality tenants. A modest proportion is to development projects, and then largely to residential housing projects with a high degree of pre-sales.

Exposure to other cyclical industries, such as fish farming and shipping, is moderate at 5%-10% for the three banks, particularly given that the majority of the shipping exposures is in practice in offshore businesses. Overall the Norwegian industry is highly exposed to oil price developments.

Earnings and Profitability

Stable Performance; Margin Focus from Increasing Regulatory Requirements

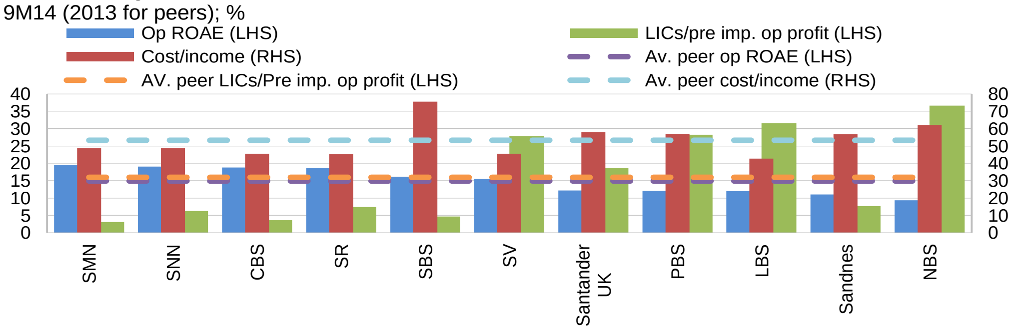
Fitch expects the Sparebanken to maintain their profitability in 2015 compared to 2014. Their earnings reflect a traditional banking model, relying largely on net interest income and commission income, and are supported by their strong regional franchises. The continued low interest rate environment will continue to affect deposit margins, and there are signs of increasing competition for retail mortgage lending. Nonetheless, Fitch does not expect a return to pre-crisis levels with predominately volume and market share targets, and believes retail margins will stabilise in 2015 and corporate lending margins will remain steady. Commission income is increasing as a proportion of total revenues for the Sparebanken, and is a reflection of the Alliance banks' focus on cross selling and the support from the jointly owned SpareBank 1 Gruppen.

Cost efficiency is adequate at the Sparebanken, and this remains a strong focus for management. The three banks successfully improved their cost/income ratios in 9M14, and Fitch expects further improvements to materialise over 2015 and 2016. Fitch expects continued low LICs in 2015.

Figure 8

Profitability

9M14 (2013 for peers); %



Source: Banks, Fitch

Capitalisation and Leverage

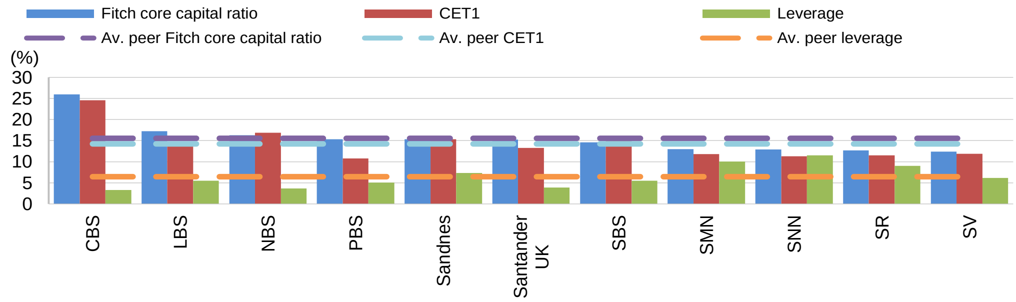
The Sparebanken's capital adequacy ratios are in line with similarly rated European peers, despite Norwegian floors on the computation of risk-weights. Compared to many peers, they only benefit marginally from the use of Internal Ratings Based (IRB) models, which is highlighted in strong leverage for all three banks. SNN's capitalisation is somewhat stronger than its Sparebanken peers.

Fitch expects the Sparebanken to build capital in order to meet 13% common equity Tier 1 (CET1) target for domestic systemically important financial institutions (D-SIFI) in 2016, even though the banks have not at this stage been classified as D-SIFIs. The D-SIFI CET1 requirement includes a 1% countercyclical buffer from 2Q15.

Figure 9

Capitalisation and Leverage[1]

End-September 2014 (End-2013 for peers)



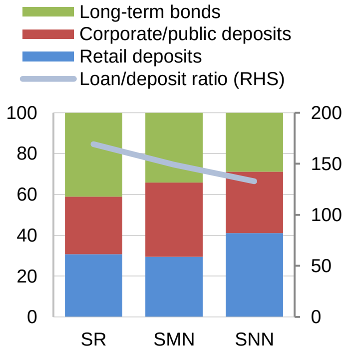
[1] Tangible common equity/tangible assets excluding insurance assets and netting derivatives

Source: Banks, Fitch

Figure 10

Non-Equity Funding Mix

End-September 2014 (%)



Source: Banks, Fitch

Funding and Liquidity

Market Funding Dependence Makes Sparebanken Sensitive to Investor Confidence

The Sparebanken rely on wholesale funding to various degrees, with SNN's funding mix somewhat more deposit based. All the Sparebanken also use covered bonds funding through S1B, although given the ownership structure the balance sheet is not fully consolidated meaning the full indirect use of wholesale funding is not included in the Sparebanken's financial reporting. At end-September 2014, the Sparebanken had transferred between 20%-35% of total lending to S1B.

Funding profiles benefit from stable regional deposit franchises, with loans/deposits ratios ranging from around 130% (SNN) to 170% (SR). Retail deposits account for around half of the banks' deposit bases, with the remainder relating to the corporate and public sectors; SNN has a somewhat larger retail deposit base.

Fitch expects the funding markets to remain open for the Sparebanken, particularly for issuance of covered bonds. The relatively small size of Norway's domestic funding market means, however, that covered bonds are predominately issued abroad. SR as the largest senior unsecured issuer among the Sparebanken has had to diversify internationally. While international diversification creates a larger investor base, it could also lead to greater difficulties in times of stress, as international investors could be less sticky. Fitch believes the Sparebanken will retain significant liquidity portfolios to mitigate this risk.

The Sparebanken have announced that they have applied to establish individual covered bonds companies to supplement S1B. The primary driver, as far as Fitch understands, is to avoid breaching large exposure restrictions, particularly in a stress when additional covered bonds issuance could be used as liquidity contingency for repos with the central bank or in the market. Fitch does not expect this will fundamentally alter the shape of the Sparebanken, nor for S1B, although some domestic issuance will likely be made through these new vehicles to test the market. The new vehicles also open up for additional loan transfers outside S1B's criteria (but still within Norwegian coverd bonds legislation), such as LTVs between 60%-75%, and fixed rate mortgages loans.

Liquidity is expected to be maintained at high levels to mitigate wholesale funding risks. The Sparebanken conduct internal stress tests and maintain sufficient liquidity to be able to continue to operate without access to wholesale markets for a period of 12 months, based on the banks' assumptions. Contingent liquidity sources include loan sales to S1B and central bank repo facilities, and will be supplemented by the individual covered bonds companies. The banks' liquidity portfolios predominantly consist of highly rated ('AA' or higher) Nordic covered bonds and other central bank eligible assets. Basel III liquidity ratios will be sensitive to the treatment of covered bonds and public-sector deposits.

Support

Moderate Probability of Sovereign Support

The Sparebanken's Support Ratings of '3' and Support Rating Floors of 'BB+' reflect Fitch's view that there is a moderate probability of support from the Norwegian authorities if required. This is driven by their strong regional franchises, but also reflecting their limited size on a national level. Fitch also believes that the Norwegian authorities' ability to provide support remains high.

The Support Ratings and Support Rating Floors are potentially sensitive to any change in Fitch's assumptions about the ability (as reflected in its ratings) or willingness of the Norwegian state to provide timely support to the banks if required. They are also sensitive to a change in Fitch's assumptions around the availability of sovereign support for banks more generally. In Fitch's view, there is a clear intention ultimately to reduce implicit state support for financial institutions in Europe. Progress in implementing resolution legislation and mechanisms may change Fitch's current view on the perceived propensity of sovereigns to provide support.

A bank resolution framework has not yet taken centre stage in Norway, although Fitch expects drafting and implementation to progress over 2015. As part of the European Economic Area (EEA), Norway is bound to implement some European directives, although Fitch expects that it will aim to do so in the most flexible format possible. It is also likely that Norwegian banking authorities will take into consideration what is implemented in other Nordic countries, particularly in Sweden, but again providing the most flexibility possible to decide on a process of resolution.

Fitch believes support for Norwegian banks will likely reduce over time, although that ultimately support will still be highly probable for the country's largest banks. This is partly driven by Norway's strong ability to support its banks, but also the largely domestic focus of the banking sector. Fitch believes that while the Support Rating Floor will likely reduce for the largest banks, the justification for maintaining the wide notching to the larger regional banks has reduced. For a small number of regional Norwegian banks, including the largest rated Alliance banks, existing Support Ratings and Support Rating Floors are unlikely to be affected unless Norway adopts a much less flexible approach to resolution than Fitch currently expects.