MOODY'S
INVESTORS SERVICE

Credit Opinion: SpareBank 1 SR-Bank ASA

Global Credit Research - 06 Nov 2015

Stavanger, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A1/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	Aa3(cr)/P-1(cr)
Issuer Rating	A1
Senior Unsecured	A1
Subordinate	Baa2
Jr Subordinate MTN	(P)Baa3

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Key Indicators

SpareBank 1 SR-Bank ASA (Consolidated Financials)[1]

	[2]**6-15**	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	**Avg.**
Total Assets (NOK billion)	**181.9**	**174.9**	**157.0**	**141.5**	**131.1**	[4]**8.5**
Total Assets (EUR million)	**20,749.3**	**19,281.0**	**18,778.6**	**19,291.2**	**16,927.5**	[4]**5.2**
Total Assets (USD million)	**23,119.0**	**23,331.1**	**25,875.9**	**25,433.4**	**21,974.4**	[4]**1.3**
Tangible Common Equity (NOK billion)	**15.9**	**15.3**	**13.9**	**12.5**	**8.5**	[4]**16.8**
Tangible Common Equity (EUR million)	**1,812.6**	**1,689.1**	**1,657.3**	**1,706.7**	**1,102.5**	[4]**13.2**
Tangible Common Equity (USD million)	**2,019.6**	**2,043.9**	**2,283.7**	**2,250.0**	**1,431.2**	[4]**9.0**
Problem Loans / Gross Loans (%)	**0.7**	**0.7**	**1.1**	**1.1**	**1.1**	[5]**0.9**
Tangible Common Equity / Risk Weighted Assets (%)	**13.2**	**12.7**	**12.3**	**11.3**	**8.4**	[6]**13.0**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**6.7**	**5.9**	**8.7**	**9.4**	**11.9**	[5]**8.5**
Net Interest Margin (%)	**1.5**	**1.5**	**1.5**	**1.3**	**1.4**	[5]**1.4**
PPI / Average RWA (%)	**1.8**	**1.9**	**1.9**	**1.5**	**1.2**	[6]**1.8**
Net Income / Tangible Assets (%)	**1.0**	**1.1**	**1.2**	**0.9**	**0.7**	[5]**1.0**
Cost / Income Ratio (%)	**49.7**	**48.4**	**48.3**	**55.4**	**60.7**	[5]**52.5**
Market Funds / Tangible Banking Assets (%)	**38.3**	**41.6**	**41.1**	**38.7**	**38.5**	[5]**39.6**
Liquid Banking Assets / Tangible Banking Assets (%)	**11.9**	**11.4**	**11.3**	**9.7**	**9.8**	[5]**10.8**
Gross loans / Due to customers (%)	**165.5**	**173.8**	**167.8**	**162.0**	**158.3**	[5]**165.5**

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

Moody's assigns SpareBank 1 SR-Bank a baseline credit assessment (BCA) of baa1, a long-term deposit rating of A1, a senior unsecured debt rating of A1, a senior subordinated rating of Baa2(hyb), a junior subordinated rating of Baa3, and a short term rating of Prime-1. We also assign a Counterparty Risk Assessment (CRA) of Aa3(cr) long term and Prime-1(cr) short term.

SpareBank 1 SR-Bank's BCA of baa2 primarily reflects the bank's solid regional position and strengthened capital buffers, as well as the bank's limited geographic reach, which results in high credit-risk concentrations in specific industries. The BCA also incorporates our expectation that a decline in oil-related investments will lead to a more challenging operating environment for SR-Bank than for its peers, given that the bank has a greater exposure to borrowers which are dependent on oil-related revenue sources.

The upgrade of the bank's deposit and senior unsecured debt ratings in June 2015 takes into account our Loss Given Failure (LGF) analysis of the bank's own volume of deposits and debt, and the volume of securities subordinated to them, which partially offsets the decrease in our government support assumptions.

Rating Drivers

- Sparebank 1 SR-Bank's BCA is supported by its Very Strong- Macro Profile

- A strengthened capital buffer for future credit losses

- Exposures to volatile sectors pose risks to currently sound asset quality

- Limited upside for profit margins and uncertainty over provision levels

- Reliance on market funding renders the bank vulnerable to fluctuations in investor sentiment

- Large volume of deposits and junior debt result in deposit ratings benefiting from a very low loss-given-failure rate, with a two-notch uplift from the BCA

- Moderate probability of government support resulting in one additional notch of uplift for debt and deposits from the BCA

Rating Outlook

The stable outlooks on the bank's long-term senior debt and deposit ratings reflect our view that the bank's financial metrics will remain broadly resilient in the face of a modest slowdown in Norway's still strong economic performance.

What Could Change the Rating - Up

Upward momentum could develop if SpareBank 1 SR-bank demonstrates (1) sustained good asset quality in its retail and corporate loan books, including the more volatile segments; (2) continued good access to capital markets and improved liquidity; and/or (3) strong earnings generation without an increase in its risk profile.

What Could Change the Rating - Down

Future downward rating pressure would emerge if (1) Sparebank 1 SR-Bank's problem loan ratio increases significantly above our system-wide expectation of approximately 2%; (2) financing conditions become more difficult; (3) the bank's risk profile increases, for example as a result of increased exposures to more volatile sectors or if the quality of the oil-related portfolio deteriorates on the back of lower oil prices; and/or (4) the macroeconomic environment deteriorates more than currently anticipated, leading to a lower Macro Profile and net profitability falling below 0.5% of total assets, including mortgages transferred to SpareBank 1 Boligkreditt.

DETAILED RATING CONSIDERATIONS

SPAREBANK 1 SR-BANK'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

SpareBank 1 SR-Bank's operating environment is purely domestic and its Macro Profile is thus aligned with that of Norway, at Very Strong-. Norwegian banks benefit from operating in a wealthy 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 the 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 small size of the banking system compared to GDP.

A STRENGTHENED CAPITAL BUFFER FOR FUTURE CREDIT LOSSES

SR-Bank's initiatives to enhance its capital buffer against potential future credit losses is credit-positive, which we reflect in its assigned Capital score. The bank's tangible common equity (TCE) / tangible banking assets ratio of 9%, which is high compared to international standards, is also reflected in the Capital score. SpareBank 1 SR-Bank had a Tier 1 Capital ratio of 13.1% at end-September 2015, as the bank continues to focus on maintaining strong capital levels, in line with the Norwegian authorities' capital requirements.

The bank aims to improve further capital ratios through cost containment and the introduction of the advanced Internal Ratings-Based (IRB) approach for its corporate loan book. Additionally, in an effort to rationalise capital use, the bank has taken actions such as a reduction of its stake in Bank 1 Oslo Akershus (not rated), a reorganisation of Sparebank 1 Markets as well as the run-off of BN Bank's (not rated) corporate portfolio that is co-owned by the rest of the SpareBank 1 Alliance banks.

EXPOSURES TO VOLATILE SECTORS POSE RISKS TO CURRENTLY SOUND ASSET QUALITY

We expect to see mild asset-quality deterioration from the very strong current position as we expect Norway to experience a somewhat tougher bank operating environment compared to recent years owing to declining oil and gas prices, as well as falling investment levels. Many mainland companies in Norway support the hydrocarbon industry and their performance is still closely linked to the performance of the sector, especially in the areas of operation of SpareBank 1 SR-Bank.

Sparebank 1 SR-Bank's asset quality showed significant improvement in 2014, while it remained largely unchanged in the third quarter of 2015; the bank reported a problem loan ratio (impaired loans as a percentage of total loans) of 0.7% of on-balance-sheet loans down from 1.3% at end-2013. These levels, which compare favourably to peers, are underpinned by the bank's relatively well-diversified loan book, which comprised around 62.4% (including covered bond company) of loans to retail customers at 30 June 2015, mostly in the form of mortgages, and strong macroeconomic development in recent years.

However, the bank has a substantial exposure to the real-estate and construction industries (over 19% of on-balance-sheet loans, or just over 200% of Tier 1 capital) and some exposure to oil operations (over 12% of on-balance sheet loans), although exposure to more vulnerable oil exploration and production is limited. The bank's exposure to these industries renders it vulnerable to deteriorating economic conditions and industry-specific risks, which is reflected in our assigned Asset Risk score.

While the performance in the bank's retail book has been very strong, house prices in Stavanger have grown at a higher rate than in the rest of the country in recent years. Although turnover volume is still high, a significant slowdown in the local economy, combined with the increased vulnerability of households which have increased indebtedness, could undermine the bank's asset quality. This includes the retail sector, especially as 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.

LIMITED UPSIDE FOR PROFIT MARGINS AND UNCERTAINTY OVER PROVISION LEVELS

Sparebank 1 SR-Bank's profitability is strong but growth has slowed down in 2015 in line with our expectations, as a result of lower market interest rates and higher loan losses. Our Profitability score reflects our expectations that Norway will likely experience a slightly tougher bank operating environment than in recent years.

Net interest income continues to be SpareBank 1 SR-Bank's main source of earnings, corresponding to more than half of the bank's 2014 operating income. Commission income has been a growing source of earnings, contributing around 30% of income, supported by the fact that interest income related to loans transferred to covered bond companies is reported as commission income rather than interest income. Combined growth in net interest income and commissions from covered bond companies was around 6.5% in 2014, a significant slowdown from +31% in 2013, as the bank bought back loans from the covered bond companies. In addition, SpareBank 1 SR-Bank's cost efficiency remained good in 2014, as reflected by a cost-to-income ratio at 52%.

In 2015, Sparebank 1 SR-Bank reported net profits of NOK1.30 billion compared to NOK1.65 billion at end September 2014. Higher spreads in the wholesale market during the third quarter of 2015 lead to losses on the investment sequirities held in the bank's liquidity portfolio amounting NOK137 million (capital gains of NOK222 million at end September 2014). In addition higher loan-loss provisions represented 0.16% of average loans (0.12% at end September 2014) as the group increased write-downs owing to external market conditions and greater uncertainty driven by lower oil prices. The Moody's-adjusted annualised return on tangible assets stood at 0.9% at end September 2015, below the 1.1% reported in 2014 and the bank's three-year average.

RELIANCE ON MARKET FUNDING RENDERS IT VULNERABLE TO FLUCTUATIONS IN INVESTOR SENTIMENT

SpareBank 1 SR-Bank benefits from a good deposit base, which represented over half of on-balance-sheet funding at end-December 2014; nonetheless it relies substantially on market funding at over 40% of tangible assets.

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. Covered bonds have become an increasingly important source of funding for the bank; such funding is completed off-balance-sheet through specialised companies it owns jointly with other members of the SpareBank 1 Alliance (SpareBank 1 Boligkreditt for residential mortgages and SpareBank 1 Næringskreditt for commercial mortgages).

At end June 2015, the bank had transferred NOK30.6 billion to Sparebank 1 Boligkreditt and NOK0.6 billion to SpareBank 1 Næringskreditt, i.e. almost 20% of its total loan book. In addition, in Q2 2015 the bank set up SR-Boligkreditt AS, a wholly owned covered bond company, to diversify and optimise its funding. While we view positively the diversification benefit of covered bond funding, extensive use of covered bond funding increases the amount of pledged assets unavailable for unsecured bondholders, including depositors in liquidation.

Our Funding Structure score reflects our view that although SpareBank 1 SR-Bank has benefitted from good access to domestic and international capital markets, its reliance on market funding - a common feature at Nordic banks - is a material source of risk because, in times of market stress, market funding can become more expensive or/and restricted.

A mitigating factor to the bank's reliance on market funds is its improved liquidity buffer. The liquidity buffer (NOK18.2 billion or around 11% of tangible assets at end-December 2014) consists mainly of cash, repo eligible covered bonds and other bonds. In addition to the liquidity buffer, the bank has NOK27.4 billion in home mortgages ready to be transferred to a covered bonds company.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We expect that Norway will look to introduce legislation or other tools that include mechanisms similar to those in the EU's Bank Resolution and Recovery Directive. 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 are in line with our standard assumptions.

For SpareBank 1 SR-Bank's long-term deposit rating and senior unsecured debt rating, our June 2015 rating upgrade considered the likely loss-given-failure impact of the combination of their own debt volume and the amount of debt subordinated to them. This has resulted in a Preliminary Rating Assessment (PRA) of two notches above the BCA, reflecting very low loss-given-failure.

For junior securities issued by SpareBank 1 SR-Bank, our LGF analysis confirms a high level loss-given-failure, given the small volume of debt and limited protection from more subordinated instruments and residual equity. We also incorporate additional notching for junior subordinated reflecting the coupon features.

GOVERNMENT SUPPORT

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

SpareBank 1 SR-Bank has a sound franchise in the county of Rogaland, south-west Norway, with 48 branches. We estimate that the bank has market shares of around 20% for lending and over 35% for deposits in Rogaland (based on total lending in the county according to Statistics Norway). The bank has also expanded into the neighbouring counties but has a limited national market share at around 3-4%. Therefore, we expect a moderate probability of government support for debt and deposits, resulting in one additional notch of rating uplift.

For junior securities, we continue to believe that potential government support is low and these ratings do not include any related uplift. Junior securities also include additional downward notching from the BCA reflecting coupon suspension risk ahead of a potential failure.

COUNTERPARTY RISK ASSESSMENT

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

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.

Foreign Currency Deposit Rating

SpareBank 1 SR-Bank's foreign-currency deposit rating of A1 is unconstrained, given that Norway has a country ceiling of Aaa.

Foreign Currency Debt Rating

SpareBank 1 SR-Bank's foreign-currency debt rating of A1 is unconstrained given that Norway has a country ceiling of Aaa.

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 Factors

SpareBank 1 SR-Bank ASA

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	0.9%	aa2	←→	a3	Geographical concentration	Sector concentration
Capital						
TCE / RWA	13.2%	a1	←→	a1	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	1.0%	a2	↓	baa2	Earnings quality	Expected trend

Combined Solvency Score		aa3		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	41.6%	b1	←→	b1	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	11.4%	baa3	←→	baa3	Quality of liquid assets	
Combined Liquidity Score		ba2		ba2		

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	2	0	a2	1	A1	A1
Senior unsecured bank debt	2	0	a2	1		A1
Dated subordinated bank debt	-1	0	baa2	0		Baa2(hyb)
Junior subordinated bank debt	-1	-1	baa3	0		(P)Baa3

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