MOODY'S
INVESTORS SERVICE

Credit Opinion: SpareBank 1 SR-Bank ASA

Global Credit Research - 27 Mar 2015

Stavanger, Norway

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa1
Issuer Rating	**A2
Senior Unsecured	**A2
Subordinate	Baa2 (hyb)
Jr Subordinate MTN	(P)Baa3

* Rating(s) within this class was/were placed on review on March 17, 2015
** Placed under review for possible upgrade on March 17, 2015

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Key Indicators

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

	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (NOK billion)	**174.9**	**157.0**	**141.5**	**131.1**	**134.8**	[4]**6.7**
Total Assets (EUR million)	**19,281.0**	**18,778.6**	**19,291.2**	**16,927.5**	**17,284.3**	[4]**2.8**
Total Assets (USD million)	**23,331.1**	**25,875.9**	**25,433.4**	**21,974.4**	**23,187.6**	[4]**0.2**
Tangible Common Equity (NOK billion)	**15.3**	**13.9**	**12.5**	**8.5**	**8.2**	[4]**16.9**
Tangible Common Equity (EUR million)	**1,689.1**	**1,657.3**	**1,706.7**	**1,102.5**	**1,053.4**	[4]**12.5**
Tangible Common Equity (USD million)	**2,043.9**	**2,283.7**	**2,250.0**	**1,431.2**	**1,413.2**	[4]**9.7**
Problem Loans / Gross Loans (%)	**0.7**	**1.3**	**1.1**	**1.1**	**1.1**	[5]**1.1**
Tangible Common Equity / Risk Weighted Assets (%)	**12.7**	**12.3**	**11.3**	**8.4**	**8.9**	[6]**12.7**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**5.9**	**10.4**	**9.4**	**11.9**	**13.4**	[5]**10.2**
Net Interest Margin (%)	**1.5**	**1.5**	**1.4**	**1.4**	**1.4**	[5]**1.4**
PPI / Average RWA (%)	**1.8**	**1.9**	**1.5**	**1.3**	**1.7**	[6]**1.8**
Net Income / Tangible Assets (%)	**1.1**	**1.2**	**0.9**	**0.7**	**1.0**	[5]**1.0**
Cost / Income Ratio (%)	**48.5**	**47.8**	**54.6**	**59.7**	**51.2**	[5]**52.3**
Market Funds / Tangible Banking Assets (%)	**41.6**	**41.1**	**38.7**	**38.5**	**43.6**	[5]**40.7**
Liquid Banking Assets / Tangible Banking Assets (%)	**11.4**	**11.3**	**9.7**	**9.8**	**8.2**	[5]**10.1**
Gross Loans / Total Deposits (%)	**161.6**	**159.5**	**151.9**	**147.3**	**155.3**	[5]**155.1**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 17 March we placed SpareBank 1 SR Bank's A2 long-term deposit and senior unsecured debt ratings under review for upgrade. The bank's baa2 baseline credit assessment (BCA), all junior debt ratings and short-term ratings remain unchanged.

SpareBank 1 SR-Bank's baa2 BCA primarily reflects the bank's good regional market position and strengthened capital buffer. However, the bank's limited geographic outreach constrains the BCA, resulting in high credit-risk concentrations. It also has sizeable exposure to more volatile sectors and makes substantial use of market funds, whose availability and cost is confidence sensitive.

The review was prompted by the implementation of Loss Given Failure (LGF), which is a component of our new methodology, in combination with the likely removal of one notch of systemic support as well as the bank's strong stand alone credit strength. LGF takes into account the risks faced by the different debt and deposit classes across the liability structure should the bank enter resolution.

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 the country, 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 high level of household indebtedness and domestic banks' reliance on market funding. However, these risks are offset by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared to GDP.

Rating Drivers

- 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 might result in deposit ratings benefiting from a very low loss-given-failure rate, with a likely two-notch uplift from BCA.

- Moderate probability of government support resulting in no uplift for debt and deposits from the BCA

Rating Outlook

The review on SpareBank 1 SR Bank's long term deposit and senior unsecured debt ratings was triggered by the introduction of our new methodology, and specifically our advanced Loss Given Failure analysis, which applies to institutions subject to an operational resolution regime. While not subject to, we expect that Norway as an EEA member will look to introduce legislation or other tools that include mechanisms similar to those in the BRRD; our expectations are based on public comments as well as the governments' track record of mirroring EU banking regulations. Our advanced LGF analysis on SpareBank 1 SR Bank's long term deposits and senior unsecured debt led us to place the ratings on review for upgrade.

The review will focus on the liability structure, in particular the amount of deposits, senior long-term debt outstanding and the amount of debt subordinated to it. Given these developments, we believe the probability of government support for SpareBank 1 SR Bank's long term deposits and senior unsecured debt to be moderate and we expect uplift of one notch from its unsupported level. We expect both the long term deposits and senior unsecured debt ratings to be upgraded by one notch.

What Could Change the Rating - Up

As stated in the Rating Rationale SpareBank 1 SR Bank's ratings are under review in response to the implementation of LGF, which is a component of our new banking methodology

What Could Change the Rating - Down

After the above mentioned review is completed, future downward rating pressure would emerge if (1) our view on SpareBank 1 SR-Bank's asset quality deteriorates from current levels, driven by the less supportive macroeconomic environment and/or substantially adverse developments in the Norwegian real-estate market; (2) financing conditions become more difficult; and/or (3) its risk profile increases, for example as a result of increased exposures to more volatile sectors.

DETAILED RATING CONSIDERATIONS

CAPITAL - STRENGTHENED BUFFER AGAINST FUTURE CREDIT LOSSES

We see SpareBank 1 SR Bank's initiatives to enhance its capital buffer against potential future credit losses as credit-positive and our assigned Capital Score reflects this strength, as well as the bank's TCE / Tangible banking assets ratio of 9%, which is high compared to international standards. SpareBank 1 SR Bank had a Tangible Common Equity Ratio of 12.7% at end-December 2014 (including transitional floor), 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 IRB for its corporate loan book. Additionally, in an effort to rationalise capital use, the bank has taken actions such as reduction of its stake in Bank 1 Oslo Akershus and reorganisation of Sparebank 1 Markets.

EXPOSURES TO VOLATILE SECTORS POSE RISKS TO CURRENTLY SOUND ASSET QUALITY

Sparebank 1 SR-Bank's asset quality is currently sound and showed significant improved in 2014; the bank reported a problem loan ratio (impaired loans as a percentage of total loans) just below 0.7% of on-balance-sheet loans down from 1.3% at end-2013. Those levels, which compare favorably to peers, are underpinned by the bank's relatively well-diversified loan book, which comprised around 55% of loans to retail customers at end-December 2014, 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 (around 20% of on-balance-sheet loans, or just over180% of Tier 1 capital at end-December 2014) and some exposure to oil operations (around 12% of on-balance sheet loans) - although exposure to more vulnerable oil exploration and production is limited. In our view, its exposure to these industries renders the bank vulnerable to deteriorating economic conditions and industry specific risks, which is reflected in our assigned Asset Risk score We expect to see mild asset-quality deterioration from the extremely strong current position as we expect Norway to experience a somewhat tougher bank operating environment compared to recent years due 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.

Whilst the performance in the bank's retail book has been very strong, house prices in Stavanger and Rogaland have grown much more in recent years than in the rest of the country. 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.

PROFITABILITY - LIMITED UPSIDE ON MARGINS AND UNCERTAINTY ON PROVISION LEVELS

We expect the bank's profitability growth to slow in 2015, as we do not expect a continuation of margin increases as a result of lower market interest rates and higher levels of corporate 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 of just under 50%.

In 2014, Sparebank 1 SR-Bank's profitability remains sound. The group reported net profit of NOK2,095 million in 2014 compared to NOK1,860 million in 2013) with higher loan-loss provisions (2014: NOK257 million; 2013: NOK132 million) as the group increased write-downs owing to external market conditions and greater uncertainty driven by lower oil prices. However, profitability was positively affected (NOK0.2billion) by the sale of NETS Holdings AS. Moody's adjusted annualised return on tangible assets was at 1.13% in 2014 for the bank, slightly below 2013 level, but still in line with the three-year average supported by a strong net interest margin, as well as sustained cost levels.

LIQUIDITY - 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 done off-balance-sheet through specialised companies it jointly owns with other members of the SpareBank 1 Alliance (SpareBank 1 Boligkreditt for residential mortgages and SpareBank 1 Næringskreditt for commercial mortgages). At end-December 2014 the bank had transferred NOK32.3billion to Sparebank 1 Boligkreditt and NOK0.6 billion to SpareBank 1 Næringskreditt, i.e. almost 20% of its total loan book. Whilst we positively view the diversification benefit of covered bond funding, we caution that 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 had good access to domestic and international capital markets, we view its reliance on market funding - a common feature at Nordic banks - as 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 (BRRD). We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

For SpareBank 1 SR Bank's long-term deposit rating and senior unsecured debt rating, our review will consider the likely impact on LGF of the combination of their own debt volume and the amount of debt subordinated to them. We expect this will result in a Preliminary Rating Assessment (PRA) of two notches above the BCA, reflecting very low LGF.

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 branch offices. 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 neighboring counties but has a limited national market share at around 3-4%. Therefore we now expect a low probability of government support for debt and deposits, likely resulting in a one-notch of uplift to the PRA.

Foreign Currency Deposit Rating

SpareBank 1 SR-Bank's foreign currency deposit rating of A2 (under review for upgrade) 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 A2 (under review for upgrade) 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	1.0%	aa2	←→	a3	Geographical concentration	Sector concentration
Capital						
TCE / RWA	12.7%	a2	←→	a2	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	1.1%	a2	↓	baa2	Earnings quality	Expected trend
Combined Solvency Score		a1		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	--	--	--	--	A2 RUR Possible Upgrade	A2 RUR Possible Upgrade
Senior unsecured bank debt	--	--	--	--		A2 RUR Possible Upgrade
Dated subordinated bank debt	-1	0	baa2	0		Baa2(hyb)
Junior subordinated bank debt	-1	-1	baa3	0		(P)Baa3

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