MOODY'S
INVESTORS SERVICE

Credit Opinion: SpareBank 1 SR-Bank ASA

Global Credit Research - 29 Apr 2014

Stavanger, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A2/P-1
Bank Financial Strength	C-
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa1
Issuer Rating	A2
Senior Unsecured	A2
Subordinate	Baa3 (hyb)
Jr Subordinate MTN	(P)Baa3

Contacts

Analyst	Phone
Kim Bergoe/London	44.20.7772.5454
Jan Skogberg/London	
Simon Harris/London	

Key Indicators

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

	[2]12-13	[2]12-12	[2]12-11	[2]12-10	[2]12-09	Avg.
Total Assets (NOK billion)	157.0	141.5	131.1	134.8	124.9	[3]5.9
Total Assets (EUR million)	18,778.6	19,291.2	16,927.5	17,284.3	15,070.7	[3]5.7
Total Assets (USD million)	25,875.9	25,433.4	21,974.4	23,187.6	21,622.5	[3]4.6
Tangible Common Equity (NOK billion)	8.8	9.0	9.2	9.0	7.2	[3]5.0
Tangible Common Equity (EUR million)	1,049.7	1,220.5	1,187.6	1,152.7	870.2	[3]4.8
Tangible Common Equity (USD million)	1,446.5	1,609.1	1,541.7	1,546.4	1,248.5	[3]3.7
Net Interest Margin (%)	1.5	1.4	1.4	1.4	1.4	[4]1.4
PPI / Average RWA (%)	1.9	1.5	1.3	1.7	1.8	[5]1.7
Net Income / Average RWA (%)	1.7	1.2	1.0	1.5	1.3	[5]1.4
(Market Funds - Liquid Assets) / Total Assets (%)	29.0	28.3	29.2	35.5	35.8	[4]31.6
Core Deposits / Average Gross Loans (%)	62.4	64.8	61.1	61.7	56.4	[4]61.3
Tier 1 Ratio (%)	12.8	12.2	10.6	10.2	9.6	[5]11.1
Tangible Common Equity / RWA (%)	7.8	8.1	9.0	9.7	8.5	[5]8.6
Cost / Income Ratio (%)	47.8	54.6	59.7	51.2	50.5	[4]52.7
Problem Loans / Gross Loans (%)	1.3	1.1	1.1	1.1	1.2	[4]1.2
Problem Loans / (Equity + Loan Loss Reserves) (%)	10.0	8.9	9.9	11.0	12.7	[4]10.5

Source: Moody's

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

Opinion

SUMMARY RATING RATIONALE

SpareBank 1 SR-Bank's C- standalone bank financial strength rating (BFSR), which is equivalent to a standalone credit assessment of baa2, primarily reflects the bank's good regional market position and strengthened capital buffer, but is constrained by the bank's limited geographic outreach, resulting in high credit risk concentrations, its sizeable exposure to more volatile sectors and its substantial usage of market funds, whose availability and cost largely depends on investor sentiment.

SpareBank 1 SR-Bank's current global local currency (GLC) deposit rating of A2, receives a three-notch uplift from its baa2 standalone credit assessment. This is based on our assessment of a high probability of systemic support for the bank if necessary and its importance to the Norwegian market. Furthermore, we continue to factor in a low probability of support from its membership of the SpareBank 1 Alliance.

Rating Drivers

- The bank benefits from a solid regional market position and brand recognition in south-western Norway.

- The bank's reliance on market funding renders it vulnerable to fluctuations in investor sentiment.

- The bank's asset quality has been solid so far but its substantial exposure to the real estate, construction and shipping sectors pose risks. In addition, single-borrower concentration is high, albeit reducing, largely reflecting limited geographic reach.

- Its earning profile is supported by resilient core banking operations.

- Its membership in the SpareBank 1 Alliance provides the bank with cross selling opportunities, benefits from shared operations and risk management practices as well as a low probability of support from other member banks.

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

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

What Could Change the Rating - Down

The ratings could decline if (1) SpareBank 1 SR-Bank's asset quality deteriorates from current levels, (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. In addition, we believe that downwards pressure could be exerted on the ratings due to external factors, such as less supportive macroeconomic environment and/or substantially adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

FRANCHISE - SOUND POSITION IN SOUTH-WESTERN NORWAY

SpareBank 1 SR-Bank has a sound franchise in the county of Rogaland, south-western Norway with 52 branch offices. Moody's estimates the bank has market shares of above 21% for lending and almost 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%. The franchise value benefits from the bank's membership in the SpareBank 1 Alliance, which consists of 15 savings banks across Norway together representing one of the leading banking groups in Norway. Going forward we expect the bank to be able to maintain a leading position in south-western Norway, but note that the Norwegian banking market is highly competitive and that savings banks generally lack pricing power against the two national market leaders. In addition, the limited geographic diversification is a key constraint in our assessment of the franchise value of the bank.

LIQUIDITY - RELIANCE ON MARKET FUNDING

SpareBank 1 SR-Bank benefits from a good deposit base, which represented over half of on-balance-sheet funding at end-December 2013, but nonetheless substantially relies on market funding. Whilst the bank has had good access to domestic and international capital markets so far, 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.

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 2013 the bank had transferred NOK45.7 billion to Sparebank 1 Boligkreditt and NOK0.6 billion to SpareBank 1 Næringskreditt, i.e. around 28% 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.

A mitigating factor to the bank's reliance on market funds is its improved liquidity buffer, which according to the bank covers funding needs for 19 months (assuming stable lending and deposit volumes). The liquidity buffer (NOK15 billion or around 10% of total assets at end-December 2013) consists mainly of cash, repo eligible covered bonds and other bonds. In addition the bank has NOK 12.1 billion of mortgage loans ready for transfer to Sparebank 1 Boligkredit.

ASSET QUALITY - CURRENTLY SOUND, BUT EXPOSURES TO VOLATILE SECTORS AND HIGH BORROWER CONCENTRATION POSE DOWNSIDE RISKS

With problem loans amounting for 1.3% of on-balance-sheet loans at end-December 2013 (2012: 1.1%), SpareBank 1 SR-Bank asset quality is currently sound. It is underpinned by the bank's relatively well-diversified loan book, which comprised around half of loans to retail customers at end-June 2013 (almost 65% including loans transferred to SpareBank 1 Boligkreditt), mostly in the form of mortgages.

However, the bank has a substantial exposure to the real estate and construction industries (around 25% of on-balance-sheet loans at end-June 2013) and some exposure to shipping (around 5%). In our view, its exposure to such industries, which we view as typically more volatile, renders the bank vulnerable to a deterioration in the currently good economic conditions in Norway and could potentially result in substantial balance-sheet and profitability stress on the bank. In addition, as most of its Nordic peers, SpareBank 1 SR-Bank has a high borrower concentration, which could accelerate the extent and pace of any deterioration in asset quality.

Whilst the performance in the bank's retail book has been very strong so far, we believe that less favourable interest rate and house price levels, combined with highly indebted Norwegian households, could undermine the bank's retail asset quality - especially as the mortgage loans remaining on the bank's balance sheet have higher loan-to-values than those transferred to the Alliance's covered bond companies.

CAPITAL - STRENGTHENED BUFFER AGAINST POTENTIAL FUTURE CREDIT LOSSES

At end-December 2013, the bank's Tier 1 and total capital ratios (including the transitional floor) stood at 12.8% and 14.1%, respectively. We understand that SpareBank 1 SR-Bank will continue to focus on maintaining strong capital levels, in line with the Norwegian authorities' signal that capital requirements for banks should be increased; this will be done primarily through increased margins, improved cost containment and introducing advanced IRB for its corporate loan book. In addition, we note that, in an effort to rationalise capital usage, during H1 2013 the bank has reduced its stake in Bank 1 Oslo Akershus and recently announced it will not be an owner of SpareBank 1 Markets which will be directly owned by the other banks in the Alliance (subjects to Board and regulatory approvals). We see the bank's initiatives to enhance its capital buffer against potential future credit losses as credit-positive.

PROFITABILITY - IMPROVING LENDING MARGINS

Net interest income continues to be SpareBank 1 SR-Bank's main source of earnings, corresponding to around half of the bank's 2013 operating income. Commission income has been a growing source of earnings, contributing almost 40% of income, largely due to 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 31% in 2013, supported by strong loan growth (+5.4% including loans transferred to covered bond companies) and improved lending margins , which more than compensated for the downward pressure on deposit margins. The improved lending margins during 2013 were a result of a sector wide push to increase profitability in response to a higher regulatory capital requirement. Following the increase in 2013, we now see signs that lending margins are stabilising and even falling in some product segments across the Norwegian banking sector. The improvement in pre-tax profit at the bank (2013: NOK1,860 million; 2012: NOK1,361 million) has also been supported by continuing low levels of loan loss provisions (2013: NOK132 million; 2012: NOK 137 million). In 2013 net losses are equal to 11bps as a percentage of gross lending, compared to 13 bps in 2012. In addition, SpareBank 1 SR-Bank's cost efficiency remained good in 2013, as reflected by a cost-to-income ratio of just under 50% down from 53% in 2012.

NOTE ON DATA

Unless noted otherwise, all figures shown in this report are sourced from the bank's latest annual and interim financial reports and our Banking Financial Metrics. These metrics are based on our own chart of account, and are adjusted for analytical purposes. Please refer to the documents entitled " Financial Statement Adjustments in the Analysis of Financial Institutions " published on 19 December 2013.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A2 to SpareBank 1 SR-Bank. Under Moody's Joint Default Analysis, the rating receives a three-notch uplift its baa2 standalone credit assessment. As a result of SpareBank 1 SR-Bank's importance to the region and the region's importance to the national economy of Norway (local currency deposit ceiling of Aaa), Moody's assesses a very high probability of systemic support for the bank from Norway in the event of a stress situation. We are however likely to gradually reduce such unusual support uplift as such support mechanisms are phased out, as banks' stand-alone profiles improve, and as regulators globally consider implementing bank resolution regimes. Furthermore, SpareBank 1 SR-Bank also benefits from a low probability of support from SpareBank 1 Alliance.

Notching Considerations

SpareBank 1 SR-Bank's subordinated (dated) and junior subordinated (undated) debt instruments are rated Baa3(hyb), i.e. two notches below SpareBank 1 SR-Bank's baa1 adjusted standalone credit assessment (which includes one notch of support from the SpareBank 1 Alliance). There is no coupon deferral option for subordinated debt while the issuer remains a going concern but junior subordinated debt features a coupon skip mechanism, which requires coupon suspension on a cumulative basis if a minimum regulatory capital trigger is breached. The wider notching compared to similar instruments issued by banks in other Nordic countries primarily reflects the ability of rated Norwegian issuers such as SpareBank 1 SR-Bank to permanently write-down principal in a going concern scenario if net assets are less than 25% of share capital and after the bank's share capital has been fully written down.

SpareBank 1 SR-Bank's Tier 1 securities are rated Ba1(hyb), i.e. three notches below its adjusted standalone credit assessment. They are deeply subordinated, as they are senior only to equity. The loss absorption for Tier 1 securities stems from the non-cumulative coupon skip mechanism while the issuer remains a going concern. Coupon skip is mandatory upon the breach of minimum regulatory capital requirements or if the issuer does not have sufficient available distributable funds (balance-sheet trigger). The securities also feature a permanent principal write-down if the share capital has been reduced to zero and a temporary principal write-down if capital falls below the regulatory minimum.

The ratings do not include systemic support uplifts, reflecting Moody's view that systemic support for subordinated debt may no longer be sufficiently predictable or reliable to be a sound basis for incorporating uplift into Moody's ratings.

Foreign Currency Deposit Rating

SpareBank 1 SR-Bank's foreign currency deposit rating of A2 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 is unconstrained given that Norway has a country ceiling of Aaa.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C-	
Factor: Franchise Value						D+	Neutral
Market share and sustainability			x				
Geographical diversification					x		
Earnings stability			x				
Earnings Diversification [2]							
Factor: Risk Positioning						D+	Neutral
Corporate Governance [2]	--	--	--	--	--		
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management		x					
- Risk Management			x				
- Controls	x						
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
Credit Risk Concentration	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management				x			
Market Risk Appetite		x					
Factor: Operating Environment						A-	Neutral
Economic Stability		x					
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						C	
Factor: Profitability						C	Neutral
PPI % Average RWA (Basel II)			1.58%				
Net Income % Average RWA (Basel II)			1.31%				
Factor: Liquidity						D-	Neutral
(Market Funds - Liquid Assets) % Total Assets					28.83%		
Liquidity Management				x			
Factor: Capital Adequacy						A	Weakening
Tier 1 Ratio (%) (Basel II)	11.87%						
Tangible Common Equity % RWA (Basel II)	8.28%						
Factor: Efficiency						B	Neutral
Cost / Income Ratio		54.02%					
Factor: Asset Quality						B+	Weakening
Problem Loans % Gross Loans		1.17%					
Problem Loans % (Equity + LLR)	9.58%						
Lowest Combined Financial Factor Score (15%)						D-	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						C	

Aggregate BCA Score		a3	
Assigned BFSR		C-	
Assigned BCA		baa2	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.