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	5
Support Rating Floor	No Floor

SpareBank 1 SMN
Foreign Currency

Long-Term IDR	A-
Short-Term IDR	F2
Viability Rating	a-
Support Rating	5
Support Rating Floor	No Floor

SpareBank 1 Nord-Norge
Foreign Currency

Long-Term IDR	A
Short-Term IDR	F1
Viability Rating	a
Support Rating	5
Support Rating Floor	No Floor

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
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Related Research

Fitch 2018 Outlook: Western European Banks

Sparebank 1 SR-Bank - Ratings Navigator (November 2017)

SpareBank 1 SMN - Ratings Navigator (November 2017)

SpareBank 1 Nord-Norge - Ratings Navigator (November 2017)

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Key Rating Drivers

Strong Franchises, Regional Concentrations: The ratings for SpareBank 1 SR-Bank (SR), SpareBank 1 SMN (SMN) and SpareBank 1 Nord-Norge (SNN), collectively the Sparebanken, reflect their strong regional franchises, healthy profitability, resilient asset quality and sound capital ratios. The ratings also factor in risks arising from continued low oil prices, a sharper than expected property price correction, geographically concentrated lending and liquidity management in the context of the banks' wholesale funding reliance.

SNN's ratings are one notch higher than its Sparebanken peers', reflecting better asset-quality metrics, limited oil exposure and a more retail-oriented business model.

Benefits From Alliance Membership: The Sparebanken are the three largest savings banks in Norway's SpareBank 1 Alliance (the Alliance). They benefit from cost efficiencies and income diversification via the jointly owned SpareBanken 1 Gruppen AS, whose services include life and non-life insurance and fund management products.

Resilient Asset Quality: We expect impaired loans to remain low, supported by a stable operating environment, low-risk business models focused on SME and retail customers, and conservative underwriting standards. Asset quality problems should be contained to offshore service vessel (OSV) portfolios, a material part of which has been restructured in recent years.

A significant property price correction is a key sensitivity for the banks, as reduced consumption would likely negatively impact their SME portfolios.

Healthy Profitability: Pre-impairment profitability is good, with the banks' regional franchises supporting stable revenue generation. Loan impairment charges (LICs) should be largely contained to the OSV segment. Cost-efficiency across the banks is acceptable. Mortgage lending margins rebounded in 2017 following a period of competitive pressure.

Robust Capitalisation, Low Leverage: The Sparebanken's capital adequacy ratios compare well with those of international peers, despite Norwegian floors on the computation of risk weights. Leverage is low in a European context.

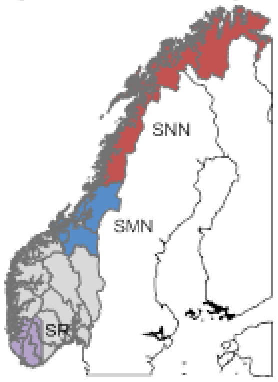
Wholesale Funding Reliance: The Sparebanken rely on wholesale funding to varying degrees and have maintained access to domestic and international funding markets, in particular for covered bonds issuance. Fitch believes the banks will retain large liquidity portfolios to mitigate refinancing risk.

Rating Sensitivities

Asset-Quality Deterioration: The Sparebanken's ratings are mainly sensitive to deteriorating asset quality, particularly if prolonged low oil prices lead to higher unemployment, a deterioration in commercial real estate (CRE) exposure or a significant property price correction, if the banks are unable to absorb higher credit losses via earnings. Any weakening of access to capital markets would also be negative for the ratings.

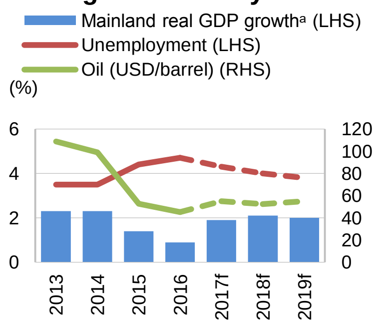
Asset Quality and Capital Improvements: Upward ratings pressure for SR and SMN could arise in the medium term through sustained asset quality improvements combined with continued capital strengthening. For SNN, an upgrade is unlikely given its already high ratings in the context of its size and regional concentrations.

Geographical Coverage



Source: Fitch

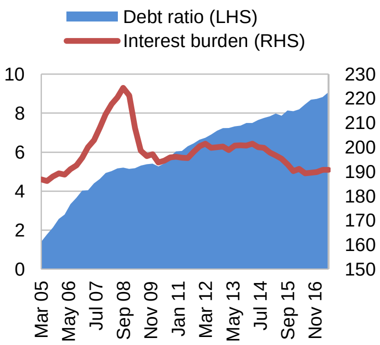
Norwegian Economy



[a] Excluding oil and gas extraction and shipping
Source: Fitch

Household Debt Ratio and Interest Burden

March 2005-June 2017



Source: Statistics Norway and Norges Bank
Debt ratio is loan debt/ disposable income.
Interest burden is interest expenses/(disposable income + interest expenses)

Operating Environment

Strong 'AAA'-Rated Norwegian Sovereign; Housing Market a Risk

As regional banks, the Sparebanken's performance is closely linked to that of the Norwegian economy. Norway has maintained its 'AAA' rating for 20 years and Fitch expects the Norwegian banking sector to continue to benefit from the country's favourable economic environment. Oil prices have recently stabilised and recovered slightly, leading Fitch to forecast mainland GDP growth of 1.9% for 2017 and 2% for 2018 and 2019. Rapid house price inflation has been a recent theme, particularly in the Oslo region, although it has shown recent signs of cooling.

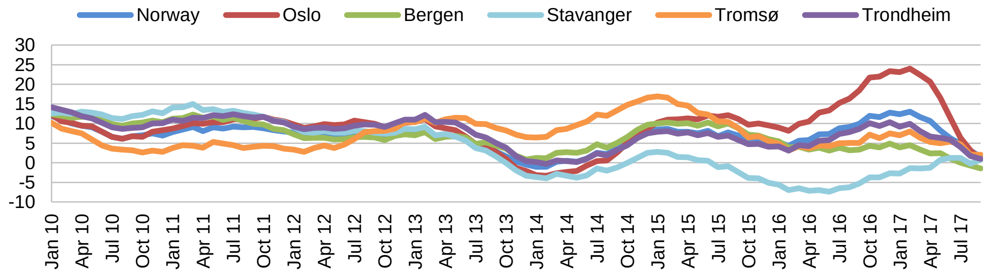
Economic growth has regained some momentum following a couple of years of sluggish growth as a result of the oil price shock. Norway has a high share of industries supplying goods and services to the oil sector and knock-on effects of the downturn included weakening demand in non-oil sectors. This has been mitigated by krona depreciation (23.6% in the three years to September 2017) which boosted non-oil exports.

House prices have risen rapidly over the same period, with year-on-year growth peaking nationally at 13% in February 2017, and 23% in Oslo. There have been signs of a correction recently, as prices fell 1.2% across Norway and 5.2% in Oslo between March and September 2017, in part due to more stringent regulatory measures, as well increased supply from housing construction. Fitch expects house prices to fall by 5% in 2018. A more severe correction, although it is not our base case, combined with a large stock of household debt in Norway (estimated at 236% of disposable income at end-2016), could lead to a fall in domestic demand.

The regional footprint of the Sparebanken means their prospects are also closely linked to the economic development of the regions in which they are active. Fitch believes that central Norway, where SMN operates, has a reasonably diversified economy. Northern Norway, where SNN operates, is supported by a large and stable public sector, and has seen faster economic growth in recent years than the Norwegian average. Rogaland, the centre of Norway's oil industry and SR's main operating market, has faced pressure in the recent downturn, but unemployment remains low by international standards and house prices are recovering having bucked the national trend and fallen in recent years.

Property Prices in Norway

12 month percentage change, January 2010-September 2017



Note: SMN is based in Trondheim, SNN in Tromsø, and SR in Stavanger
Source: Eiendomsverdi, Finn.no, Norwegian Association of Real Estate Agents (NEF), Real Estate Norway, Statistics Norway and Norges Bank

Related Criteria

Global Bank Rating Criteria (November 2016)

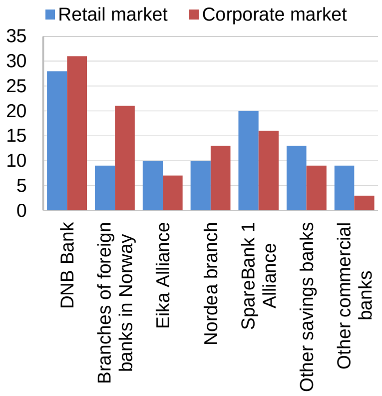
Strong Regulator

The Norwegian regulatory environment is highly developed and transparent, in Fitch's view. The authorities have taken a strict view on risk-weight optimisation and have imposed floors on calculating risk-weights for mortgage loans (effectively 20%-25%). The regulator is proactive and has introduced several measures as a result of rising property prices and household debt. These include increasing the counter-cyclical buffer from 1.5% to 2% at end-2017, introducing a loan-to-income limit of 5x gross income from January 2017, lowering the threshold for the amortisation requirement to 60% loan to value (LTV) and imposing a 60% LTV cap for secondary dwellings in Oslo.

Company Profile

Independent Regional Savings Banks in Nationwide Alliance

Lending Market Shares
End-June 2017; % of total loans in the market



Source: Norges Bank

In 1996, SNN, SMN and SR founded the Alliance along with Sparebanken Vest and Samspar, a group of smaller savings banks. Sparebanken Vest withdrew from the venture in January 2004 to pursue an independent strategy. The Alliance is the second-largest banking group in Norway, behind DNB ASA, with total lending of over NOK700 billion at end-June 2017.

The Sparebanken operate as universal banks for retail and SME customers in their regions, where they hold leading market shares (at least 30%) in deposits and loans. Their business models, although regionally concentrated, have proved stable due to the focus on traditional banking and their relatively simple organisational structures. The Sparebank 1 name is established throughout Norway as one of the country's most recognised financial brands. The Alliance has market shares of approximately 20% in retail banking and 15% in corporate banking.

Jointly Held Subsidiaries Provide Scale Benefits

The Alliance banks benefit from co-operation agreements between the members in areas ranging from marketing and IT to risk-modelling. They own Sparebank 1 Boligkreditt (S1B), which has traditionally been their funding vehicle for mortgage covered bonds, and also a sister company, Sparebank 1 Naeringskreditt AS (S1N), a covered bond funding vehicle primarily backed by commercial property. The Alliance banks also jointly own the holding company SpareBank 1 Gruppen, which provides insurance and fund management services through its subsidiaries. In addition, SpareBank 1 Gruppen is responsible for some product development, which creates scale benefits for its members. Capital-market services are provided by SpareBank 1 Markets, which is owned directly by the Alliance banks (except SR), and not via SpareBank 1 Gruppen.

Management and Strategy

Stable and Competent Management Teams

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

SR is a limited liability savings bank, with just under half of its owners from the local region, around 30% from other parts of Norway and just over 20% of share capital held internationally. SMN and SNN have a distinctive ownership status, whereby the control of the banks resides with local community stakeholders. External investors own equity capital certificates in the banks, entitling them to a proportionate share of the banks' profit, but they will never have a majority vote as per Norwegian savings banks law.

For SMN and SNN, 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 for all three banks are in line with the Norwegian code on corporate governance.

Risk Appetite

Benefits from Alliance Cooperation

Risk systems and expertise are shared across the Alliance and the largest members use the internal ratings-based (IRB) approach to calculate capital requirements for credit risk.

Underwriting standards for mortgage lending are conservative and focus on debt servicing capacity which is stressed for different scenarios. SME and corporate lending involves greater risks, although Fitch believes this is also done in a prudent manner as the banks have good knowledge of their customer base. The Sparebanken have in recent years been actively reducing large exposure concentrations and are focused on retail and SME clients. We expect this trend to continue.

Loan growth for SNN and SMN has been high in 9M17, at around 9% for each (including loans transferred to S1B and S1N; as the Sparebanken own minority stakes in S1B and S1N, the transferred loans are not consolidated on their balance sheets). Fitch understands that the primary driver for such high growth has been the retrenchment of some of the country's larger banks from smaller communities as they seek to optimise their branch networks. Loan growth at SR has been more muted at 1.2% in 9M17, and we expect the bank to remain cautious given the dynamics of its local market, where the oil industry is prevalent. We expect loan growth for SNN and SMN to slow in 2018.

Market risk arises from the banks' modest trading portfolios, 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 by the banks' ability to change rates on most mortgage loans after a six-week notice period (rates on corporate loans can be adjusted even faster), and is managed using gap and duration analysis. The banks' sensitivity to a 100bp parallel shift in interest rates is small.

Note on Charts

Black-dashed lines in the *Asset Quality* chart and further in the report represent indicative quantitative ranges and corresponding implied scores for Fitch's core financial metrics for banks in the environments that Fitch score in the 'aa' category.

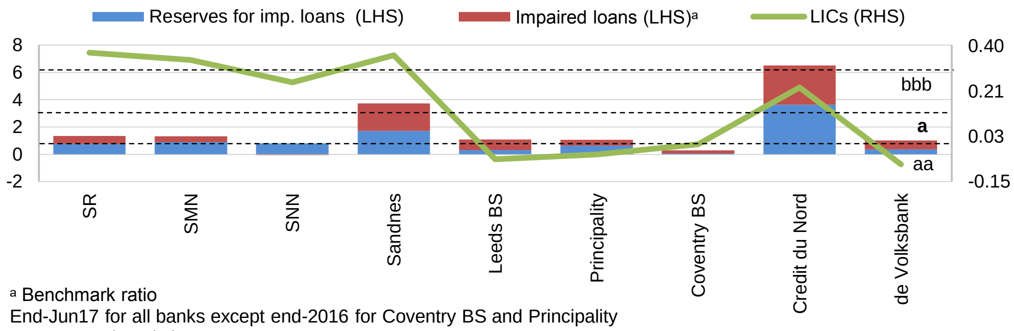
The peers include: Sandnes Sparebank (VR: bbb), Coventry Building Society (a), Leeds Building Society (a-), Principality Building Society (bbb+), Credit du Nord (bbb+)

Financial Profile

Asset Quality

Sound metrics

Key Asset Quality Metrics
(End-Jun 17, % gross loans)

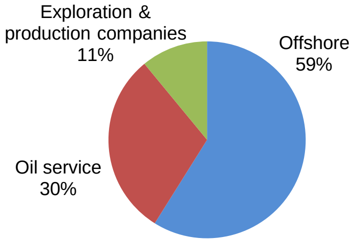


[a] Benchmark ratio
End-Jun17 for all banks except end-2016 for Coventry BS and Principality
Source: Banks, Fitch

The Sparebanken's asset quality is strong and compares well with international peers'. Impaired loans represented a low 65bp-135bp of gross loans at end-September 2017, and LICs less than 35bp of average gross loans in 9M17. Fitch expects the quality of lending to remain resilient, supported by a relatively stable operating environment, with economic growth recovering, and conservative underwriting standards. Sharply lower oil prices since 2014 have translated into asset quality pressures amongst certain portfolios, in particular the OSV segments. We believe the situation has now stabilised and do not expect a more widespread weakness in asset quality, although individual cases may still emerge.

About 65% of the loan books consist of residential mortgage lending, including loans transferred to S1B (around 75% for SNN). The vast majority of mortgage loans have an LTV ratio of less than 75%, in line with legislation for eligible covered bond transfers. House prices in Norway are high, both historically and in an international context, and we expect a modest correction in 2018. This is unlikely to affect the banks' asset quality. In the event of a more adverse correction, although unexpected, we expect households to prioritise mortgage payments but to cut back on consumption, which would probably have a knock-on effect on the banks SME portfolios, in particular in an environment of sharply rising interest rates.

SR's Oil Related Exposure
End-September 2017;
NOK 14.9bn (EAD)

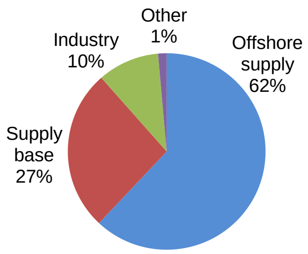


Source: SR, Adjusted by Fitch

Property and Offshore Are Key Risk Areas

The Sparebanken's exposures to oil and gas-related activities vary significantly as a result of their respective geographical concentrations, but we believe these are manageable for all three banks. The banks have good knowledge of their customers and work proactively with them to identify potential problems at an early stage. Exposures will nonetheless remain under scrutiny through 2018, and all banks have reduced the proportion of lending to this segment in recent years.

SNN's Oil Related Exposure
End-September 2017;
NOK1.3bn

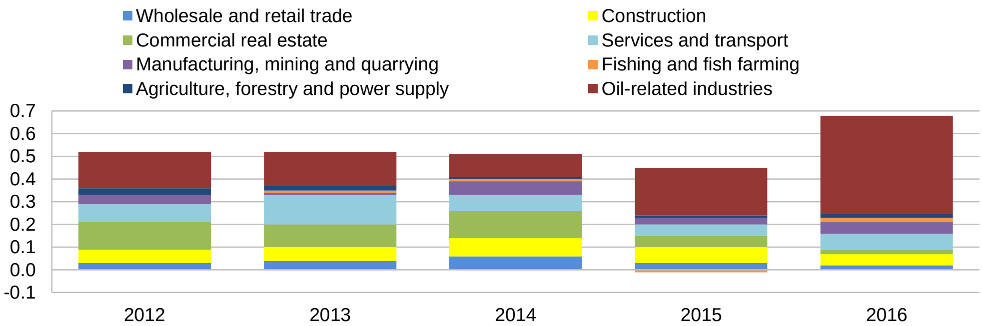


Source: SNN, Adjusted by Fitch

SR has the most substantial oil and gas exposure, given its regional presence in the centre of Norway's petroleum industry, Rogaland, at 7.3% of total exposure at default (EAD) at end-September 2017. The corresponding figures for SMN and SNN are 3.5% (almost exclusively OSV lending) and 1.3%, respectively. OSV companies have been under pressure due largely to high fixed costs and reduced demand for vessels, particularly older ones, and these have contributed to the bulk of LICs over 2016 and 2017. We expect LICs to decline into 2018 as SR and SMN have restructured a material part of their OSV portfolios. For SR total restructured OSV exposures were NOK5.5 billion (2.7% of gross EAD) at end-September 2017.

Other sections of the oil and gas portfolios have fared better in recent years owing to lower fixed costs and hence greater adaptability. However, they could still be susceptible to further downturns in the industry. SR, in particular, would be sensitive to more widespread contagion given its concentration in south-west Norway.

Annual Loan Losses by Sector, 2012-2016
As % of total corporate lending for Norwegian banking sector



Source: Norges Bank

The Sparebanken's corporate lending is predominantly to local SME customers. The regional nature of their franchises means there is some single-name concentration in their loan books, although they have been reducing large exposures in recent years. Corporate lending is around a third of loan exposure for SR and SMN, and around a quarter for SNN (including for all banks loans transferred to S1B and S1N).

CRE lending accounted for between 10% (SMN) and 15% (SR) of loans at end-September 2017. The quality of these portfolios benefits from relatively modest vacancy rates and, when disclosed, the share of impaired loans in these portfolios is roughly in line with the overall impaired loans ratios of the banks. An economic slowdown could harm the quality of these exposures through weakening cash flows and falling collateral values. The combination of high real-estate prices, relatively higher vacancy rates and declining rental prices in areas exposed to the petroleum industry is a risk for the banks.

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, is moderate at 5%-10% loans for the three banks.

Earnings and Profitability

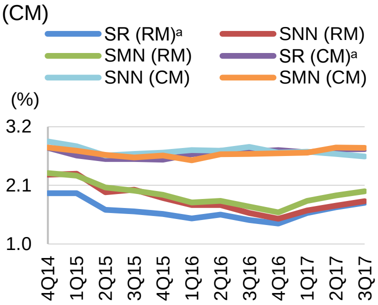
Stable Performance

The Sparebanken exhibit good pre-impairment profitability, which we expect will continue in 2018. The banks benefit from resilient revenue generation, reflecting stable banking models weighted towards traditional commercial banking, and supported by their strong regional franchises. Net interest income represents between 40% and 60% of total income.

Margins rebounded slightly in 2017 following a period of pressure driven by competition and prolonged low interest rates. This increase was aided by repricing, particularly in the retail segment. Fitch does not expect a return to pre-crisis practises of market share-driven lending and believes that retail and corporate lending margins will remain broadly stable in 2018.

Lending Margin

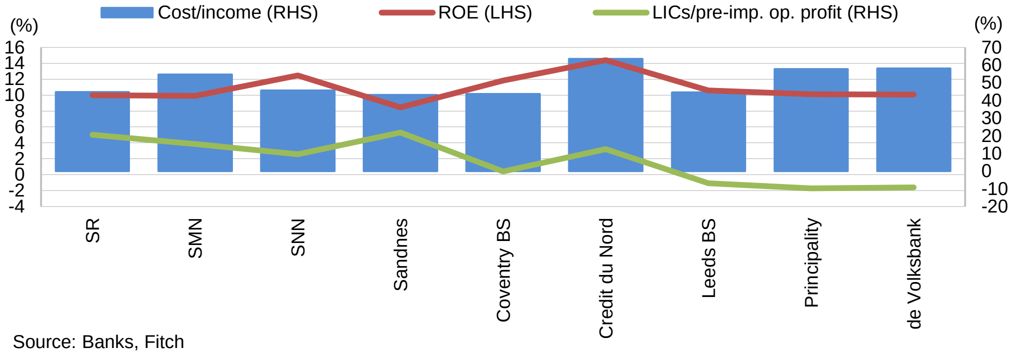
Retail Market (RM), Corporate Market (CM)



[a] Margin incl. cov. bond companies
Avg. customer interest rate measured against 3m moving avg. or avg. NIBOR
Source: Banks

Key Performance Metrics

(1H17)



Source: Banks, Fitch

Commission income has been steadily increasing as a proportion of total revenues for the Sparebanken and is a reflection of the Alliance banks' focus on the cross-selling of ancillary products, such as insurance, wealth management and real-estate brokerage, and the support from the jointly owned SpareBank 1 Gruppen.

Good Cost Efficiency

Cost efficiency compares favourably to international peers and remains a strong focus for the management teams. LICs are generally low, averaging below 20% of pre-impairment profit from 2013-2016, but have been high in 9M17 for SR and SMN due to oil-related exposures.

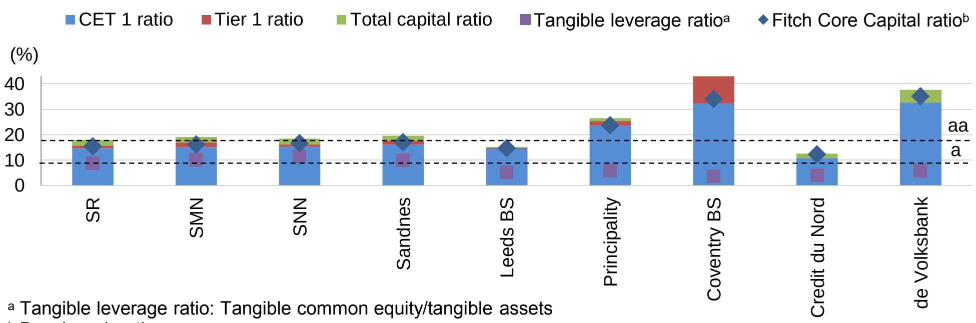
Capitalisation and Leverage

Solid Metrics

The Sparebanken's capital ratios compare well with those of international peers', despite Norwegian floors on the computation of risk weights. Utilisation of IRB models is marginal, as highlighted by strong leverage ratios in a European context. Reported leverage ratios ranged from 7.2% (SR) to 7.7% (SNN) at end-September 2017, compared to a minimum regulatory requirement of 5% (for non-domestic systemically important banks in Norway). SNN has a stronger capital position than its Sparebanken peers', primarily thanks to lower leverage. Unreserved impaired loans represented less than 5% of Fitch Core Capital for all three banks at end-September 2017, a low level in Fitch's view.

Capital & Tangible Leverage

End-Jun 17



[a] Tangible leverage ratio: Tangible common equity/tangible assets
[b] Benchmark ratio
End-Jun17 for all banks except end-2016 for Coventry BS and Principality
Source: Banks, Fitch

The Sparebanken have been building buffers over their minimum regulatory requirements, and Fitch expects these to be maintained, even taking into account the recently announced increase in the counter-cyclical buffer requirement from 1.5% to 2%. The three banks target a common equity Tier 1 (CET1) ratio of at least 14.5% (SNN), including a management buffer, rising to 15.0% (SR, SMN) depending on their respective Pillar 2 requirements. The total regulatory CET1 requirements amounted to 13.5% (SNN), 14.1% (SMN) and 14.0% (SR), including pillar 2 requirements of 1.5%, 2.1% and 2.0% respectively. SNN had already reached its target at end-September 2017, reporting a CET1 ratio of 15.4%. SMN and SR are well under way to reaching their targets primarily through earnings generation.

Funding and Liquidity

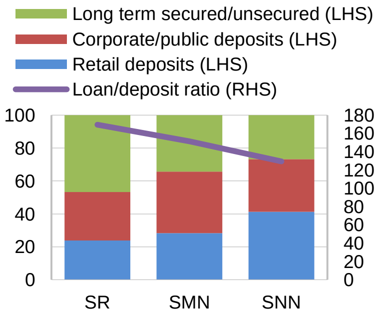
Funding Profile Sensitive to Investor Confidence

The Sparebanken rely on wholesale funding to varying degrees, with SNN's funding mix being somewhat more deposit-based. All of the Sparebanken use covered bonds funding through S1B and S1N, although due to the ownership structure of these issuing entities, their balance sheets are not fully consolidated, meaning that full indirect use of wholesale funding is not included in the Sparebanken's financial reporting. At end-September 2017, the Sparebanken had transferred 10% (SR) to 27% (SNN) of total lending to S1B and S1N.

The funding profiles for the Sparebanken benefit from stable regional deposit franchises, with loan/deposit ratios ranging from around 130% (SNN) to 170% (SR). For SR and SMN, retail deposits account for about half of their deposit bases, with the remainder made up of corporate and public-sector deposits. SNN has a higher weighting of retail deposits.

Non-Equity Funding Mix

End-September 2017 (%)



Source: Banks, Fitch

In 2015, SR established its own 100%-owned covered bond vehicle, SR-Boligkreditt (SRB), and this has now become the primary issuer of covered bonds for SR, having bought NOK40.8 billion loans from SR at end-September 2017, compared to a total NOK20 billion by S1B and S1N. Fitch does not expect this to fundamentally alter the shape of SR, with transferred loans still within Norwegian covered bonds legislation. SMN and SNN have continued to exclusively use S1B for mortgage covered bond funding.

Fitch expects the Sparebanken to continue to retain access to the capital markets, particularly for covered bond issuance. However, the relatively small size of Norway's domestic funding market means that covered bonds are predominantly issued abroad. SR, as the largest senior unsecured issuer among the Sparebanken, has also had to diversify internationally. Whilst international funding creates a larger investor base, this could prove less reliable in times of stress. Fitch believes the Sparebanken will retain significant liquidity portfolios to mitigate the risk.

The banks' liquidity portfolios predominantly consist of highly rated ('AA' or higher) Nordic covered bonds and other central bank-eligible assets. Contingent liquidity sources include loan sales to respective covered bond companies, and central bank repo facilities. The Sparebanken conduct internal stress tests and maintain sufficient liquidity to be able to continue to operate without access to the wholesale markets for 12 months, based on their assumptions. The banks' Liquidity Coverage Ratios were 120%, 124% and 212% for SNN, SMN and SR, respectively at end-September 2017.

Support

Resolution Legislation to be implemented

In June 2017 the Norwegian Ministry of Finance proposed to fully implement legislation in line with the EU's Bank Recovery and Resolution Directive. We expect this legislation to come into force in 2018. As a result, it is or view that senior creditors will no longer be able to rely on receiving full extraordinary support from the sovereign in the event that any of these banks becomes non-viable. In line with our approach for EU banks, we hence apply a Support Rating of '5' and a Support Rating Floor of 'No Floor' to the Sparebanken.

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