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 (March 2013)

SpareBank 1 SMN (March 2013)

SpareBank 1 Nord-Norge (March 2013)

SpareBank 1 Boligkreditt (March 2013)

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Alliance Overview: SpareBank 1 SR-Bank (SR), SpareBank 1 SMN (SMN) and SpareBank 1 Nord-Norge (SNN) (collectively the Sparebanken) are the three largest savings banks rated by Fitch Ratings in Norway's SpareBank 1 Alliance (the Alliance). Fitch rates the banks on the basis of their intrinsic strength and has not assigned any group rating.

Benign Operating Environment: The Sparebanken benefit from Norway's favourable economic prospects, as Fitch expects Norway's economy to expand by 3% in 2013 and 2.75% in 2014. Unemployment is forecast to remain at low levels, around 3%.

Sparebanken Benefit from Alliance: Alliance member banks profit from cost efficiencies and wider income diversification through SpareBank 1 Gruppen AS (SG). SG provides insurance, leasing and fund management services through its subsidiaries.

Solid Financial Performance: The Sparebanken benefit from their well-entrenched regional franchises and their good core operating profitability, the latter is supported by low loan impairment charges (LICs). High competition in Norway's banking sector and low interest rate levels, have put pressure on the Sparebanken's margins. Fitch expects margins to improve in 2013, from re-pricing of the loan books to compensate for new regulation, including higher capital requirements.

Sound Asset Quality: Based on Norway's economic outlook, Fitch expects asset quality to remain sound. However, the impact of a potential softening in the housing market represents a downside risk for the banks. In its base case, Fitch does not expect such a scenario to lead to a significant deterioration of the banks' retail portfolios. A possibly more likely scenario is that lower private consumption would affect the asset quality of the banks' corporate exposures.

Wholesale Funding Dependence: The Sparebanken have strong deposit franchises in their respective regions. However, they also rely on wholesale markets for part of their structural funding which exposes them to investor sentiment. A substantial part of wholesale funding is raised by issuing covered bonds through SpareBank 1 Boligkreditt (S1B), a joint funding vehicle of Alliance member banks.

Access to international markets, where in particular covered bonds are issued, remained solid in 2012. Wholesale funding markets have remained largely open for Norwegian banks, benefitting from investors' perception of Norway as a safe haven.

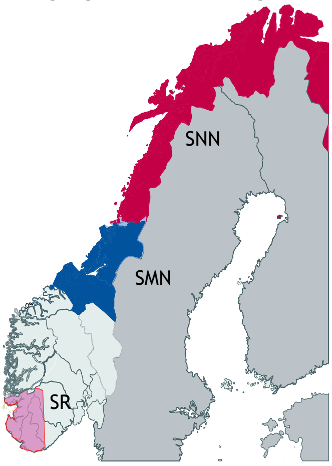
Capitalisation Improving: At end-2012, the Sparebanken's Fitch core capital ratios compared well to European peers, and ranged from 12% at SMN to 14% at SNN, excluding Basel II transitional floors. Capital ratios lag some of the best capitalised Nordic banks; however, the Norwegian risk weights on mortgages and corporate exposures generally exceed those used in for example Sweden. Internal capital generation remained good in 2012.

Rating Sensitivities

Outlook Remains Stable: The Stable Outlook on the Sparebanken's Long-Term IDRs reflects Fitch's expectation of both asset quality and profitability remaining sound, driven by the favourable prospects for the Norwegian economy. Downward pressure on the banks' ratings is most likely to arise from prolonged dislocation in the wholesale funding markets, worse-than-expected developments in the housing market affecting asset quality, or deterioration in the performance of their corporate portfolios.

Figure 1

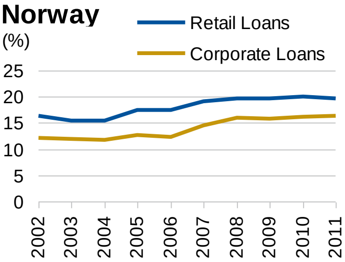
Geographical Coverage



Source: Fitch

Figure 2

Market Shares of the SpareBank 1 Alliance in Norway



Source: SpareBank 1 Alliance

Profile: Regional Banks but Nationwide Brand

In 1996, SR, SMN, SNN 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-2012, Alliance members ran around 350 branches and offices across Norway.

Leading Franchises in their Operating Regions

The Sparebanken operate as universal banks for retail and SME customers in their respective regions, where they hold leading market shares in deposits and loans. The banks' strategy centres on strengthening their local franchises and increasing cross-selling in the retail and corporate segments. The Alliance encompasses co-operation agreements between the member banks in areas such as marketing, IT and risk management. The banks also own S1B, a funding vehicle for covered bonds.

The jointly owned SG provides insurance, leasing and fund management services through its subsidiaries. Alliance member banks benefit from some economies of scale, as SG is also responsible for product development. Thanks to concerted marketing efforts, the SpareBank 1 brand has been established as one of the most recognised financial brands in Norway.

Given their regional footprint, the prospects of the Sparebanken are highly linked to the economic development of the regions in which they are active. While Western Norway and the Oslo region are experiencing the strongest growth and the largest share of exports, northern Norway's economy is supported by a large and stable public sector.

Economic Environment Expected to Remain Favourable despite Slow Eurozone Growth

The Sparebanken continue to benefit from Norway's favourable economic environment. Despite the minimal growth in the Eurozone, Fitch forecasts healthy real GDP growth in 2013 and 2014, and expects unemployment to remain low. However, Norway's economy is not immune from global economic uncertainty. As a small, open economy with large export-driven industries, Norway's economy and consequently the country's banks are vulnerable to slowing global growth and falling commodity prices and an appreciation of the NOK.

Figure 3

Economic Data

(%)	Avg 2006-10	2011	2012	2013	2014
Real GDP growth	2.3	2.6	3.4	3.0	2.8
Unemployment	3.0	3.3	3.1	3.2	3.2
Inflation	2.3	1.3	0.5	1.8	2.0

Source: Fitch

Corporate Governance

SR concluded its conversion to a limited liability savings bank in 2011, and the new shares were registered on the stock exchange on 2 January 2012. As SR faces strong economic growth in its core operating region, the bank expects the new equity instrument to make it easier to raise capital to support the region's economic growth. SMN and SNN do not currently have any issued ordinary share capital, and Fitch understands that they have no plans to follow SR's conversion.

SMN's and SNN's owners are the holders of equity capital certificates. 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.

Related Criteria

Global Financial Institutions Rating Criteria (August 2012)

Moderate Probability of Support from Authorities; Support between Alliance Members Possible

Fitch believes that there is a moderate probability of support from the Norwegian government, if needed, given the three institutions' strong regional franchises. The Norwegian authorities have been supportive of the banking system, including introducing a swap scheme in 2008 allowing banks to exchange covered bonds for government securities. Given the strength of the public finances, Fitch expects the ability to support the banks to be strong.

While there is the possibility of implicit support among the member banks, Fitch understands that no legal obligation to financially support troubled member banks arises from membership of the Alliance. The Alliance banks are members of the national depositor protection scheme. Separate support mechanisms relate to S1B.

Given the largest Alliance members' reliance on wholesale funding for part of their structural funding, Fitch considers the likelihood of shareholder support for S1B as extremely high. Alliance banks are committed to maintaining S1B's Tier 1 capital ratio at 9%.

Performance: Competition to Remain Intense; Lending Margin Increases offsetting Deposit Margin Pressures

The Sparebanken face strong competition in their operating regions. DnB Bank represents the banks' main competition in cities (such as Stavanger, Trondheim and Tromso) and the corporate segment, whereas small, local savings banks are strong in rural areas. Competition has led to an erosion of lending margins, although the pressure eased in 2012. Fitch expects the new regulation, including higher capital requirements, to lead to banks increasing lending margins in 2013. The low interest rates have affected net interest income from lower deposit margins, and Fitch expects this to remain in 2013. Improving cross-selling through a full-service offering and gaining a greater share of wallet are important aspects for the Sparebanken in order to maintain their competitiveness.

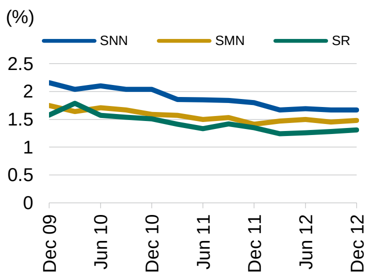
Net Interest Revenue: Margin Pressures Stabilising

Interest income is the main source of revenue for the Sparebanken, although fees and commission income remains important. The banks' net interest margins (NIMs) were broadly maintained in 2012, reflecting higher lending margins filtering through to interest income, offsetting the low deposit margins. The bulk of banks' loan exposure can be repriced with a short notice period. However, fierce competition, in particular in the mortgage market, might not allow banks to pass on higher deposit costs completely. Fitch believes that increases in the policy rate are unlikely, which will continue to put pressure on earnings of the banks' low-yielding liquid assets.

Of the three banks, SNN continues to have the widest NIM, reflecting lower competition in its region and lower levels of wholesale funding compared to SR and SMN. SMN's and SR's management teams expect competition to continue to be intense in their respective operating regions of southwest and mid-Norway. Volume growth (including loans transferred to S1B) remained brisk in 2012, although Fitch expects credit growth to slow in 2013

Figure 4

Net Interest Margins



Source: Fitch

Other Income Driven by Fees and Commissions

Fee income largely comprises money transfer fees and commissions on brokerage, insurance and savings products. This source of earnings grew strongly in 2012, following around 10% growth in 2011, reflecting the Alliance banks' focus to deepen the share of wallet.

Income from equity-accounted associates remained broadly stable in 2012. Given the still significant economic uncertainties, in particular in the Eurozone, Fitch expects market volatility to continue to be challenging in 2013. Activities through the subsidiaries of the Sparebanken also supplemented earnings. Real estate agencies contributed positively to the banks' financial performance, driven by a continued high volume of real estate transactions.

Fitch has made some reclassifications to the banks' reported financial data. These include commission income received from S1B (reclassified as gross interest income) and levies paid to the banks' guarantee fund (reclassified as fee expense instead of interest expense). Various gains on the banks' shareholding in the enlarged payment service providers have been reclassified as non-recurring income, as has the income from a reduction in pension liabilities.

Acceptable Cost Efficiency Broadly Unchanged

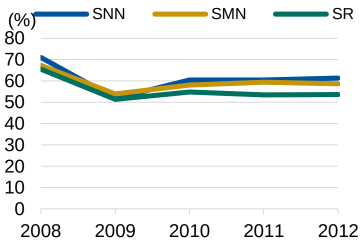
Cost containment initiatives and the streamlining of processes should help dampen cost growth. Cost efficiency ratios were broadly stable in 2012, and Fitch expects revenue growth outpacing costs to be the key driver in improving cost/income ratios.

Earnings Comfortably Absorb Loan Losses; Risks from Larger Exposures

LICs remained low in 2012, supported by a strong domestic economy. Fitch expects LICs to remain low in 2013. SNN reported higher LICs in Q312 as a result of a small number of larger exposures, which highlights a degree of concentration risk in the books; however, given the low starting point, the relative increase is large, although the absolute amount remains small. Fitch expects the banks' loan loss absorption capacity to remain resilient as revenue generation remains good, supported by well-entrenched regional franchises, and a focus on retail and SME sectors.

Figure 5

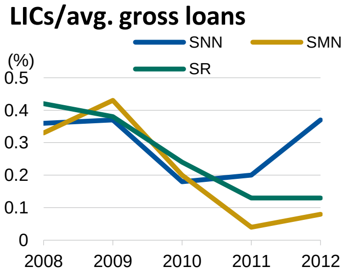
Cost/Income Ratios



Source: Fitch

Figure 6

LICs/avg. gross loans



Source: Fitch

Risk Management

Asset quality could come under pressure from rising interest rates and a sharp house price correction. Most loans on the Sparebanken's books are floating rate, making households sensitive to significant increases in interest rates. This is amplified by a relatively significant household indebtedness. In the short- to medium-term, Fitch does not expect interest rates to increase substantially driven by a slow global economic outlook, as well as the strengthening of the NOK possibly affecting exporters.

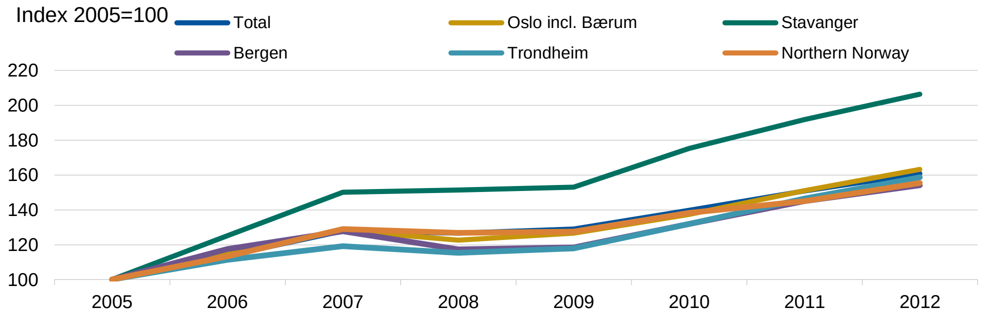
House prices have increased significantly in Norway over the past 20 years, see figure 7, and a significant correction in house prices could affect the Sparebanken. Historical losses on mortgage loans (eg, after the bursting of the property bubble in the early 1990s) has been minimal, supported by strong serviceability of Norwegian households and generous social benefits, although households are more indebted than in the past. Fitch expects that the main risk to the banks' asset quality is via secondary effects, such as falling consumer confidence or banks tightening their lending standards, leading to corporate asset quality deterioration.

Fitch considers risk management to be relatively sophisticated, given the size of the Sparebanken. The Sparebanken are mainly exposed to credit risk in their loan books, while market risk remains moderate. Operational risk management is sound.

Figure 7

Regional House Price Development

Index 2005=100



Source: Fitch, Statistics Norway

Relatively Sophisticated Credit Risk Systems; Some Single-Name Concentration

The Sparebanken use identical risk models, but apply their own limits for credit authorisations and exposures. The banks use the Basel II internal ratings-based (IRB) approach to measure retail credit risk. They are working towards approval for the advanced IRB approach for corporate exposures (currently on the foundation IRB).

The level of non-performing loans at the Sparebanken remained moderate at end-2012. SR and SMN operate in regions where property prices have increased faster than the national average for some property types; loan loss reserves may therefore be more sensitive to adjustments in collateral values.

Loan Portfolio

	SNN		SMN		SR	
	(NOKm)	(%)	(NOKm)	(%)	(NOKm)	(%)
Agriculture/forestry/ fishing	1,619	3	8,576	11	4,141	4
Transportation/Shipping	2,671	5	5,739	8	6,451	6
Construction	1,037	2	3,504	5	3,804	3
CRE	7,081	13	11,710	16	24,306	22
Other Corp	11,503	21	12,175	16	18,242	17
Retail	30,640	56	33,239	44	52,569	48
Total	**54,551**	**100**	**74,943**	**100**	**109,513**	**100**

Source: Fitch

At SMN and SR, corporates represent around half of total lending, while the corporate segment at SNN only accounts for around 40% of the loan book. Commercial real estate portfolios account for between 15% and 20% of loan books. The asset quality of these portfolios benefits from relatively modest vacancy rates and increasing rents. An economic slowdown could harm the asset quality of these exposures through weakening cash flows and falling collateral values. Exposures to commercial property mostly relate to property investments and are relatively well diversified by tenants. The proportion of exposures to the riskier development, construction and building sectors is modest at an average 4% of gross loans.

Exposure to other cyclical sectors, such as the shipping and fishing industries, is moderate reflecting the local economies. Fitch believes that there is some single-name concentration in the Sparebanken's loan books, although that the levels were acceptable at end-2012.

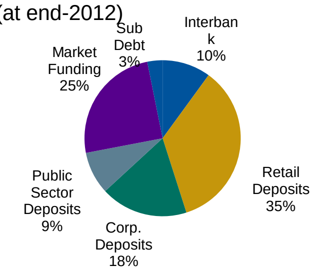
Some Concerns Regarding Rapid Increase in Residential Property Prices

Retail exposure mainly relates to mortgage lending. Reflecting low unemployment and interest rates, this exposure continues to perform well. The vast majority of mortgage loans have a loan/value ratio of less than 75%, in line with S1B's criteria for loan sales.

The Sparebanken have significant exposure to retail mortgages. Residential real estate prices in Norway have increased strongly and the sustainability of further significant increases is doubtful. If prices are deflated by income growth, the increase is less dramatic but still material. Fundamental factors appear to be the key drivers behind the price growth, such as low supply of new housing, high home ownership, population growth and low interest rates; although the agency expects that growth will level off. A moderate fall cannot be ruled out, although the agency does not, in its base case, expect this to lead to significantly higher LICs in the Sparebanken's residential mortgage portfolios.

Figure 9

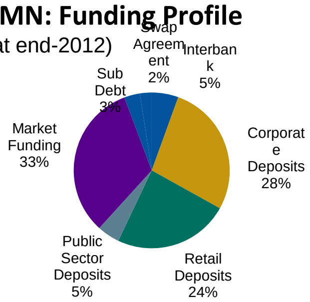
SNN: Funding Profile
(at end-2012)



Source: SNN

Figure 10

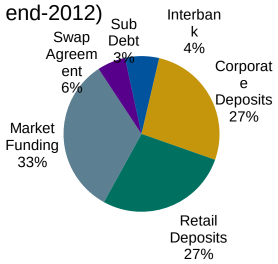
SMN: Funding Profile
(at end-2012)



Source: SMN

Figure 11

SR: Funding Profile
(at end-2012)



Source: SR

Moderate Exposure to Market Risk

Exposure to market risk is moderate. It arises from the financial instruments held by the banks, as well as indirectly through SG, 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 analyses 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.

Reduced Operational Risk from Acquisitions as Integration Progresses

The banks' operational risk is closely monitored using a framework set up by the Alliance. All members use the standardised approach to calculate their capital charge for operational risk. The Sparebanken aim to convert to the advanced measurement approach.

Funding and Capital

Dependence on Market Funding Makes the Sparebanken Sensitive to Prolonged Market Dislocation

The Sparebanken are reliant on wholesale funding, similar to many Nordic banks. Wholesale funding markets have remained largely open for the Alliance banks, and Fitch expects this will continue, in particular for the issuance of covered bonds via S1B. Spreads benefit from investors' perception of the high quality of Norwegian assets. Given the relatively small size of Norway's domestic covered bond market, the Alliance has diversified its investor base to international markets. While international issuance provides a diversification of the investor base, international investors may prove to be less sticky in times of stress.

Funding profiles benefit from the banks' stable regional deposit franchises. The Sparebanken's loan/deposit ratio range from around 130% (SNN) to 160% (SR), excluding issuance done by S1B. 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.

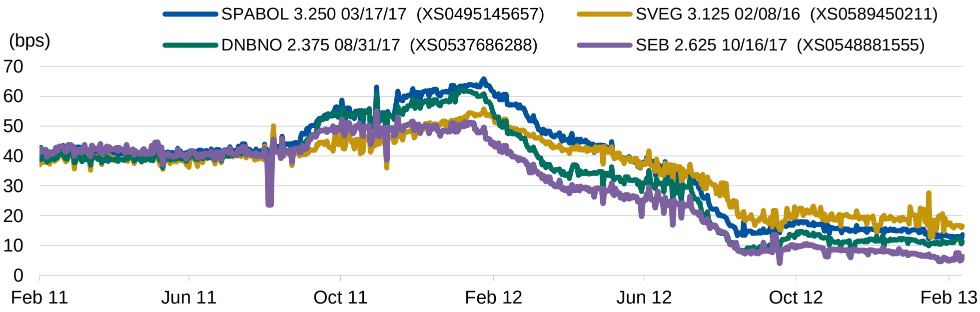
Loan growth has generally exceeded deposit growth for many years, resulting in the Sparebanken's dependence on market funding. A substantial part of wholesale funding is raised through the issuance of covered bonds. S1B retained relatively uninterrupted access throughout the crisis. At end-2012, the Sparebanken had transferred around a quarter of their total lending to S1B.

As of end-2012, issuance in EUR and NOK accounted for just over 40% each. Issuance in USD, which accounts for the remainder, commenced in late 2010 and has successfully broadened the investor base. S1B completed its most recent 5.5-year covered bond issue of EUR1bn in August 2012 (which was priced at 17bp over mid-swap) and seven-year covered bond issue of USD1.25bn in November 2012 (70bp over mid-swap).

The cost of covered bond funding has gradually increased since issuance started in 2007. Fitch regards covered bonds as a relatively stable form of market funding for the Sparebanken, despite the small but growing size of the domestic covered bond market. As a result of the limited volume of domestic government bonds outstanding, Fitch expects the domestic market to continue to grow. Nevertheless, the Alliance does rely partly on international investors for its structural funding.

Figure 12

Asset Swap Rates for CVBs of Nordic Issuers



Source: Bloomberg

Liquidity Managed to Sustain 12 Months Without Funding Market Access

Liquidity is expected to be maintained at high levels, especially given the uncertainty surrounding regulatory changes. 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 facilities.

The banks' liquidity portfolios consist largely of highly rated government, Nordic covered and bank bonds. The bulk remained unpledged and eligible for central bank facilities. Basel III liquidity ratios will be sensitive to the treatment of covered bonds and public-sector deposits.

Capitalisation Improving

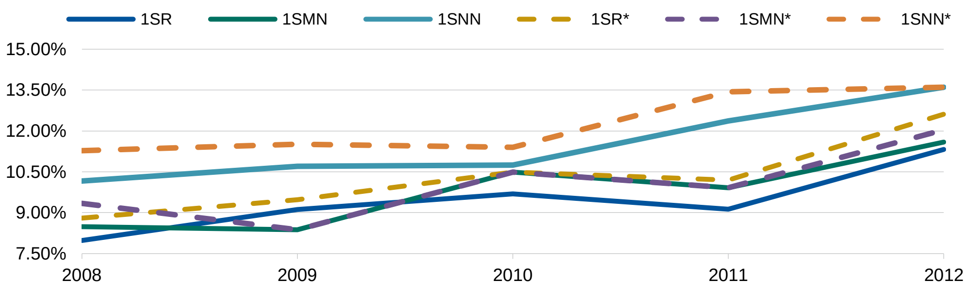
Internal capital generation remained good in 2012 at around 10% for the three banks. To boost capital levels in light of regulatory changes and investor demands, SR and SMN completed rights issues of NOK1.5bn and NOK0.9bn respectively in 2012. The Sparebanken's Fitch core capital ratios compared well to peers at around 12% to 14% at end-2012.

Leverage (tangible common equity/ tangible assets) continues to be relatively moderate. At around 9% for the Sparebanken, they remain less levered than most of their larger Nordic peers. While the capital ratios lag some of the best capitalised banks in the Nordics, this is partly explained by the higher risk-weights used in Norway compared to, for example, Sweden.

To improve its access to capital and broaden its investor base, SR converted to a limited liability savings bank; this was approved by the Norwegian Ministry of Finance in Q211. Its new shares were registered on the stock market at the beginning of January 2012.

Figure 13

Fitch Core Captial Ratio Development



Source: Fitch *Without transitional arrangement