

ISSUER IN-DEPTH

12 March 2018

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RATINGS

SpareBank 1 SR-Bank ASA

LT Senior Unsecured	A1 negative
LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

SpareBank 1 SMN

LT Senior Unsecured	A1 negative
LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

SpareBank 1 Ostlandet

LT Senior Unsecured	A1 negative
LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

SpareBank 1 Nord-Norge

LT Senior Unsecured	A1 negative
LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

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SpareBank 1 SR-Bank, SpareBank 1 SMN, SpareBank 1 Østlandet, SpareBank 1 N-N

SpareBank 1 Alliance Banks' 2017 profit up as economy strengthens

In February 2018, the four biggest lenders in Norway's SpareBank 1 Alliance ([SpareBank 1 SR-Bank](#), [SpareBank 1 SMN](#), [SpareBank 1 Østlandet](#) and [SpareBank 1 Nord-Norge](#)) reported stronger 2017 net profit thanks to a combination of increased lending, lower funding costs, reduced loan losses, and higher earnings contributions from subsidiaries. The improvement came as Norway's economy expanded, helped by fiscal and monetary stimulus, after weak oil prices triggered a slowdown in 2015-16. We expect GDP growth of 2.2% in 2018 and 2.0% in 2019, up from 1.7% in 2017, further supporting the banks' performance. The four banks' high Common Equity Tier 1 (CET1) ratios confirm our view that their loan loss absorption capacity is robust. Although the banks remain reliant on confidence-sensitive market funds, sizeable liquidity buffers help offset this risk.

Oil-exposed banks' asset quality improves. For SpareBank 1 SR-Bank and SpareBank 1 SMN, the increase in profit partly reflected a decline in problem loans to 1.13% and 0.99% of gross loans respectively, from 1.21% and 1.23% in 2016. Both have relatively high exposure to the oil sector, where a cyclical slowdown drove a significant increase in problem loans in 2015 and 2016. High household leverage and elevated property prices remain key risks for all four SpareBank 1 Alliance lenders.

SpareBank 1 Alliance banks' capital is robust. SpareBank 1 Østlandet reported the highest CET1 ratio of 16.8% in December 2017, while the other three banks reported ratios in line with their 14.5%-15% target. The banks' combined regulatory capital requirements will rise by 0.5% in 2018 due to an increase in the countercyclical capital buffer. Nonetheless, we believe all four banks remain well capitalised.

Profit up on increased lending. Increased lending, coupled with lower funding costs as the NIBOR interbank rate fell, boosted all four banks' net interest income and profit in 2017. They also benefited from an increased earnings contribution from subsidiaries, reflected in higher fee and commission income. Operating costs were well-controlled, although SpareBank 1 Østlandet's cost-to-income ratio rose due to one-off factors.

Liquidity buffers mitigate high reliance on market funds. The four banks remain heavily geared towards market funding, particularly covered bonds. However, their sizeable liquidity buffers at end-2017 mitigate the associated risks. All four also reported solid deposit growth during the year. SpareBank 1 SR-Bank's deposit base expanded by 11%, reversing a decline of 3.9% in 2016.

Negative rating outlook driven by the BRRD implementation

This report focuses on the SpareBank 1 Alliance banks' 2017 performance, and how this supports their stand-alone credit profile and corresponding baseline credit assessment (BCAs) of baa1. Concurrently, the negative outlook assigned to all four banks' long-term deposit ratings of A1, is solely driven by the upcoming implementation of the bank recovery and resolution (BRRD) directive, which is about to be enacted into a legislation in Norway.

The intention of the BRRD law is to promote financial stability and ensure that losses are borne by a bank's shareholders and creditors rather than taxpayers. The bail-in tool is a central feature in the BRRD framework, intended to reduce the need for government intervention in failing banks. As a result, government support is less likely for Norwegian banks since bail-in can be used to recapitalise financial institutions and absorb losses. Accordingly, the negative outlook denotes our intention to revise our government support assumptions, which translate into one notch of rating uplift incorporated into these banks' ratings.

Oil-exposed banks' asset quality improves

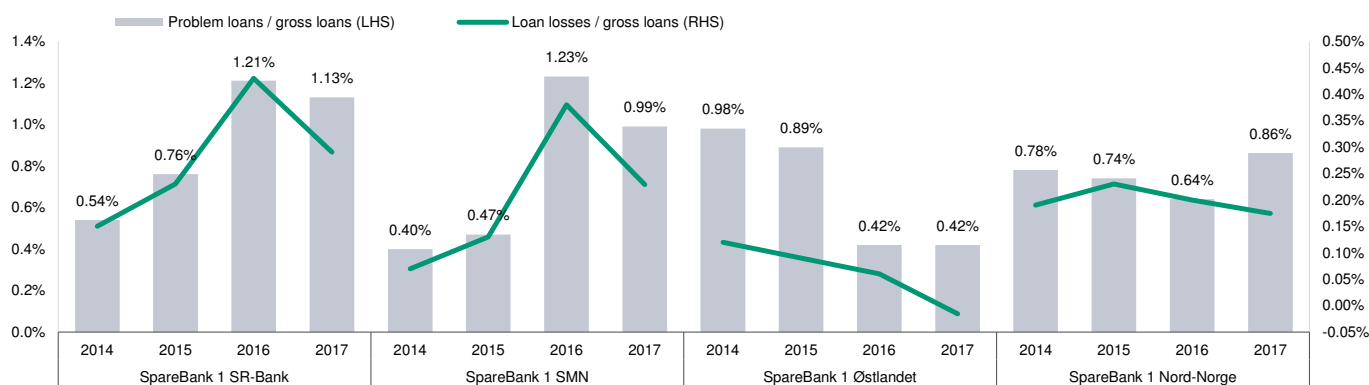
The ratio of problem loans to gross loans at SpareBank 1 SR-Bank and SpareBank 1 SMN declined to 1.13% and 0.99% in December 2017 from 1.21% and 1.23% respectively a year earlier (see Exhibit 1). Both banks have relatively high exposure to the oil sector, where a cyclical slowdown drove a significant increase in problem loans in 2015 and 2016. The two banks also reported a decline in loan losses of about 15 basis points (bps) compared with 2016. There remains a risk of a second round of debt restructurings in the oil and gas sector, leading to a further rise in loan losses, amid continued headwinds in the offshore supply and rigs market.

SpareBank 1 Østlandet, which has no exposure to the oil sector, reported a flat problem loans ratio of 0.42% for 2017, and booked net loan loss reversals of NOK20 million.

SpareBank 1 Nord-Norge's problem loan ratio rose to 0.86% from 0.64% in 2016, reflecting a spike in doubtful loans due to a single commitment, previously included in the bank's general provisions, for which individual loss provisions have now been taken. The bank's ratio of loan losses to gross loans was unchanged at around 20 bps in 2017.

Exhibit 1

Oil-exposed banks benefited from lower problem loans and loan losses



Gross loans include loans transferred to SpareBank 1 Boligkreditt and SpareBank 1 Næringskreditt.

Source: Company reports

High household leverage, combined with elevated property prices, continue to be key risks for the SpareBank 1 Alliance banks, given their high exposure to the household sector. Retail lending accounts for 69% of their gross loans on average, including mortgage loans

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underpinning covered bond issuance (please see "FAQ: [SpareBank 1 banks illustrate Moody's approach to nonconsolidated covered bonds](#)" for more details).

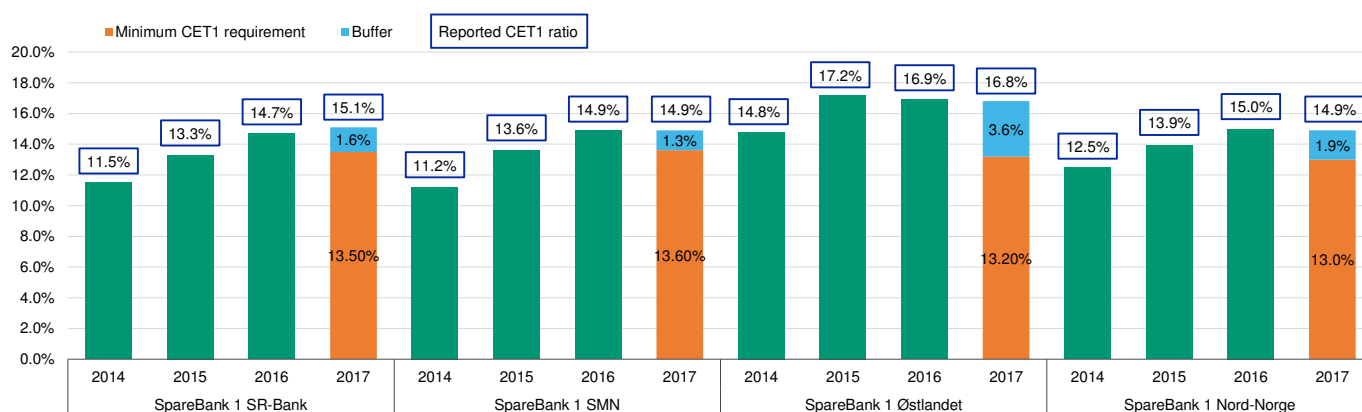
However, Norwegian house prices have fallen back from their 2017 peak, partly because of stricter mortgage lending criteria introduced during the year by the Ministry of Finance. The four SpareBank 1 Alliance banks' limited exposure to the real estate market in Oslo, where house price inflation has been strongest, also helps limit risks related to a potential property market correction.

SpareBank 1 Alliance banks' capital is robust

The capital position of the four large rated SpareBank 1 Alliance banks remained robust in 2017, given their risk profile and regulatory capital requirements. SpareBank 1 Østlandet reported a CET1 ratio of 16.8% in December 2017, the highest of the group. The other three achieved CET1 ratios in line with their 14.5%-15% target (see Exhibit 2).

Exhibit 2

The SpareBank 1 Alliance banks' capital remained robust in 2017 Common Equity Tier 1 (CET1) ratio (%)



Minimum CET1 requirement does not include the 0.5% increase in the countercyclical capital buffer (2.0% from 1.5%), effective as of 31 December 2017.

Source: Company reports

Despite challenging credit conditions and increased loan losses in 2015 and 2016, SpareBank 1 SR Bank built up its CET1 ratio to 15.1% as of December 2017 from 14.7% a year earlier and 13.3% in December 2015. The bank operates in Western Norway, the region that suffered most from a sharp drop in global oil prices in 2014/2015.

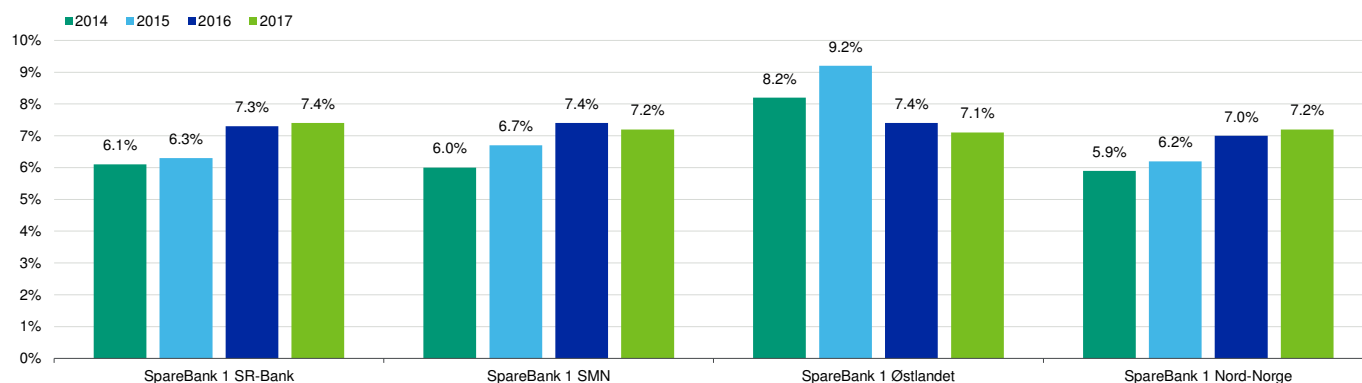
As of 31 December 2017, the Ministry of Finance increased the countercyclical capital buffer requirement for banks to 2% from 1.5%. As a result, the banks' combined regulatory capital requirements for 2018 (including individual Pillar 2 requirements) increased by 0.5%, reducing their capital headroom. At the same time, we expect the introduction of the IFRS 9 accounting standard on 1 January 2018 to result in a minor reduction in the banks' CET1 capital. This is because loan loss provisions are expected to increase under IFRS 9, reducing retained earnings and subsequently loss absorbing common equity. The four banks estimate that their CET1 capital ratios will fall by around 8 basis points on average due to an anticipated increase in provisions in 2018.

All four banks were able to meet the minimum leverage ratio requirement of 5% with a comfortable margin. SpareBank 1 SR-Bank reported a 2017 leverage ratio of 7.4%, the highest of the group. SpareBank 1 SMN and SpareBank 1 Nord Norge both reported a ratio of 7.2%, compared with 7.1% for SpareBank 1 Østlandet (see Exhibit 3).

This ranking, which reverses the classification of the four banks by CET1 ratio, indicates that SpareBank 1 SR-Bank has a proportionally higher volume of risk-weighted assets because of its bigger corporate loan book. SpareBank 1 Østlandet's asset pool, in contrast, has greater exposure to retail mortgages, and has correspondingly lower risk weights.

Exhibit 3

The SpareBank 1 Alliance banks' leverage ratios are well above the minimum requirement



Source: Company reports

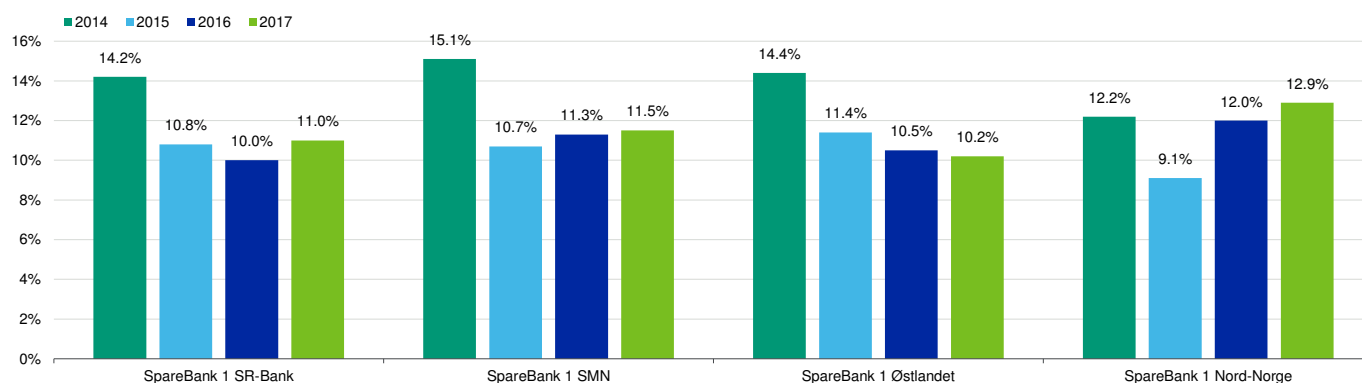
Profit up on increased lending

SpareBank 1 SR-Bank reported a 19% increase in its 2017 net profit, the biggest of the top four SpareBank 1 Alliance lenders. SpareBank 1 Østlandet and SpareBank 1 Nord-Norge's net profit rose by a more moderate 15%, while SpareBank 1 SMN's climbed by 9%.

As measured by return on equity (ROE), the top performer among the four SpareBank 1 Alliance banks in 2017 was SpareBank 1 Nord-Norge, with reported rate of 12.9% for 2017. This was also the highest ROE among all Norwegian commercial banks (see Exhibit 4).

Exhibit 4

SpareBank 1 Nord-Norge reported the highest return on equity in 2017



Source: Company reports

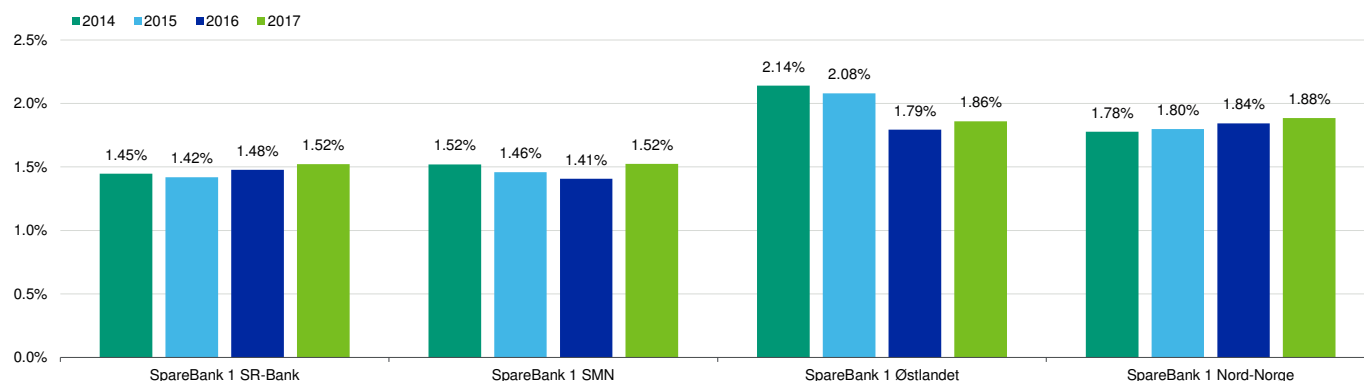
All four banks benefited in 2017 from higher interest income thanks to a rise in lending volumes, just as a fall in the three month NIBOR interbank lending rate reduced their funding costs. SpareBank Nord-Norge led the group with a ratio of net interest income to average assets of 1.88%, closely followed by SpareBank 1 Østlandet with 1.86%.

SpareBank 1 SR-Bank and SpareBank 1 SMN both achieved a more moderate interest income to assets ratio of 1.52% in 2017, albeit up from 1.48% and 1.41% respectively in 2016. This is because less profitable corporate lending make up a higher proportion of both banks' loan books (see Exhibit 5).

Exhibit 5

Net interest income rose due to increased lending and lower funding costs

Net interest income to average assets



Average assets do not take into account loans transferred to covered bond companies

Source: Company reports

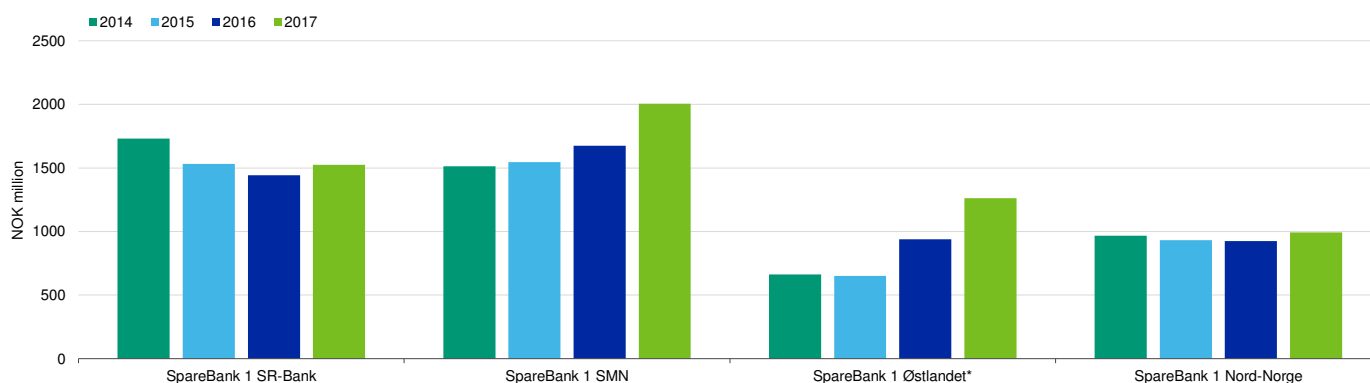
The four banks booked higher net fee and commission income in 2017, reflecting an increased contribution from their respective subsidiaries, and from companies jointly owned by the wider SpareBank 1 Alliance. These companies provide real estate, accounting, leasing and investment services, allowing the SpareBank 1 Alliance members to offer customers a broader range of products.

Net fee and commission income, including contributions from these companies, is a vital earnings stream for the four leading SpareBank 1 Alliance banks, accounting for around 40% of SpareBank 1 SMN's total revenues in 2017 and 36% of SpareBank 1 Østlandet's. SpareBank 1 Nord-Norge and SpareBank 1 SR-Bank relied on subsidiaries and associated companies for 30% and 29% of total 2017 income respectively.

SpareBank 1 SMN reported 20% growth in net fee and commission income in 2017, the biggest increase of the four banks (see Exhibit 6). The improvement largely reflected expansion at the bank's accounting services subsidiary, SpareBank 1 Regnskapshuset SMN.

At the other end of the spectrum, SpareBank 1 SR-Bank achieved year on year growth in net fee and commission income of just 6%. This reflected a reduction in the bank's stake in the SpareBank 1 Alliance's jointly owned covered bond companies (see below). As a result, those companies' contribution to SpareBank 1 SR-Bank's earnings was flat.

Exhibit 6

Net fee and commission income increased in 2017

*2017 not comparable with previous years following merger with Bank 1 Oslo Akershus in June 2016. Fee and commission income includes commission income received from jointly owned covered bond companies.

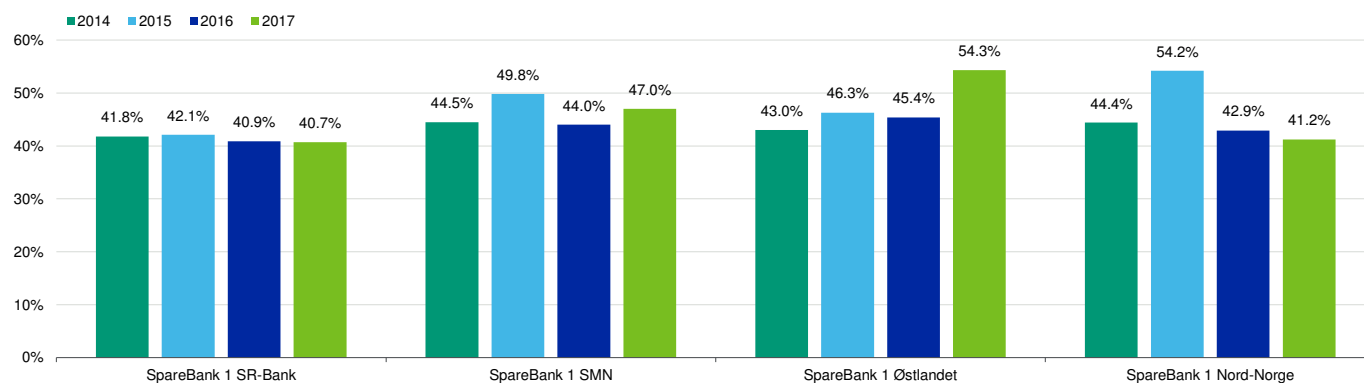
Source: Company reports

Operating costs were generally well-controlled across all four SpareBank 1 Alliance banks. However, SpareBank 1 Østlandet's 2017 cost-to-income ratio spiked to 54.3% from 45.4% in 2016, reflecting a first full-year cost contribution from Bank 1 Oslo Akershus, which it acquired in June 2016. SpareBank 1 Østlandet's 2017 costs were also inflated by a one-off item of NOK30 million related to the bank's initial public offering (IPO), which was completed in June 2017.

SpareBank 1 SR-Bank's reported a cost-to-income ratio of 40.7% in 2017, the lowest of the group, while SpareBank 1 Nord-Norge and SpareBank 1 SMN also reported sub-50% cost-income ratios (see Exhibit 7).

Exhibit 7

SpareBank 1 Østlandet's cost to income ratio rose following merger and IPO



Source: Company reports

In 2017, SpareBank 1 Østlandet had a ratio of operating expenses to average assets of 1.80%, the highest of the four leading Alliance banks, while SpareBank 1 SR-Bank had the lowest at 1.04%. However, the average on-balance sheet assets of SpareBank 1 Østlandet are not comparable with those of SpareBank 1 SR-Bank, as the former transfers a higher volume of mortgage loans off balance sheet to support covered bonds issuance.

SpareBank 1 SMN's 2017 ratio of operating expenses to average assets was at 1.62%, while SpareBank 1 Nord-Norge's was at 1.45%.

For SpareBank 1 SR-Bank and SpareBank 1 SMN, the net profit improvement in 2017 also reflected lower loan losses during the year as their asset quality improved, while SpareBank 1 Østlandet benefited from net loan loss reversals (see above).

Liquidity buffers mitigate high reliance on market funds

The four biggest Sparebank 1 Alliance banks remain heavily geared towards market funding, particularly mortgage covered bonds. Wholesale funding (including covered bonds) accounted for around 50% of the banks' total non-equity funding at the end of 2017. However, the banks' sizeable liquidity buffers mitigate the risks associated with this high reliance on market funding, which can be sensitive to shifts in investor sentiment.

We view positively the diversification benefit of covered bond funding, although extensive use of covered bonds increases the amount of pledged assets unavailable for unsecured bondholders and depositors in liquidation.

All four banks reported 2017 liquidity coverage ratios (LCRs) well above the 80% requirement under Basel III, which rose to 90% as of 1 January 2018. SpareBank 1 SR Bank reported an LCR of 168% as of December 2017, closely followed by SpareBank 1 SMN with 164%. SpareBank 1 Nord-Norge had a 2017 LCR of 126%, while Sparebank 1 Østlandet's stood at 114%.

During 2017, all four banks also reported solid deposit growth. SpareBank 1 SMN achieved the biggest increase with 13.9%, followed by SpareBank 1 SR-Bank, whose deposit base expanded by 11%, reversing a decline of 3.9% in 2016. The increase at both banks was driven by a sizeable inflow of public sector deposits. SpareBank 1 Østlandet and SpareBank 1 Nord-Norge reported more moderate deposit growth of 4.6% and 7.4% respectively in 2017.

The four banks issue covered bonds through the SpareBank 1 Alliance's jointly owned covered bond companies SpareBank 1 Boligkreditt (residential mortgages) and SpareBank 1 Naeringskreditt (commercial real estate mortgages).

In December 2017, SpareBank 1 SR-Bank cut its ownership stake in SpareBank 1 Boligkreditt to 8% from 13.9% at the beginning of the year. The bank set up its own covered bond company, SpareBank 1 SR-Boligkreditt, in 2015. By December 2017 the nominal volume of covered bonds issued by this company was NOK 39.6 billion, or 21.2% of the bank's total gross loans (26.9 billion, or 14.8% of total gross loans as of December 2016).

As of 31 December 2017, SpareBank 1 Østlandet was the largest owner of the SpareBank 1 Boligkreditt vehicle, with a stake of 21.1%. This compared with 19.9% for SpareBank 1 SMN and 16.9% for SpareBank 1 Nord-Norge.

Moody's related publications

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- » [Norway - Bank resolution regime makes support less likely, drives negative outlook](#), 3 August 2017

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- » [Norway Macro Profile: Very Strong -](#), 15 December 2017

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- » [Credit Opinion: Government of Norway – Aaa stable](#), 8 October 2017
- » [Credit Opinion: SpareBank 1 SR-Bank ASA - Regular update](#), 11 December 2017
- » [Credit Opinion: SpareBank 1 SMN - Regular update](#), 15 December 2017
- » [Credit Opinion: SpareBank 1 Østlandet - Regular update](#), 15 December 2017
- » [Credit Opinion: SpareBank 1 Nord-Norge - Regular update](#), 15 December 2017

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- » [Analysis: Government of Norway – Aaa stable](#), 30 June 2017

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- » [FAQ: SpareBank 1 banks illustrate Moody's approach to nonconsolidated covered bonds](#), 15 January 2018

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- » [Swedish Banks Could Weather A Significant House Price Drop](#), 10 May 2017
- » [Possible house price drop poses some risk for Canadian, Swedish, Australian banks](#), 20 November 2017
- » [High house prices pose persistent risk where slow to adjust to homeownership costs](#), 14 December 2017
- » [Tighter underwriting rules cool housing market but high household debt is a risk](#), 4 March 2018

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- » [Moody's Bank Rating Methodology](#)

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