MOODY'S
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Credit Opinion: SpareBank 1 Nord-Norge

Global Credit Research - 24 Jun 2015

Tromso, Norway

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	A1/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Senior Unsecured	A1
Subordinate MTN	(P)Baa2
Jr Subordinate MTN	(P)Baa3
Pref. Stock Non-cumulative	Ba1

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Key Indicators

SpareBank 1 Nord-Norge (Consolidated Financials)[1]

	[2]**3-15**	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	**Avg.**
Total Assets (NOK billion)	**82.1**	**83.2**	**77.5**	**75.3**	**71.0**	[4]**3.7**
Total Assets (EUR million)	**9,488.6**	**9,169.3**	**9,273.0**	**10,266.8**	**9,169.6**	[4]**0.9**
Total Assets (USD million)	**10,190.7**	**11,095.4**	**12,777.6**	**13,535.6**	**11,903.4**	[4]**-3.8**
Tangible Common Equity (NOK billion)	**9.2**	**9.3**	**8.4**	**6.8**	**6.3**	[4]**9.7**
Tangible Common Equity (EUR million)	**1,061.5**	**1,024.8**	**1,004.8**	**928.0**	**818.8**	[4]**6.7**
Tangible Common Equity (USD million)	**1,140.1**	**1,240.0**	**1,384.6**	**1,223.5**	**1,062.9**	[4]**1.8**
Problem Loans / Gross Loans (%)	**0.9**	**1.1**	**1.7**	**2.0**	**1.9**	[5]**1.5**
Tangible Common Equity / Risk Weighted Assets (%)	**15.4**	**15.0**	**14.5**	**12.4**	**12.3**	[6]**15.2**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**5.7**	**6.9**	**10.9**	**15.2**	**14.2**	[5]**10.6**
Net Interest Margin (%)	**1.9**	**1.9**	**1.8**	**1.7**	**1.7**	[5]**1.8**
PPI / Average RWA (%)	**1.8**	**1.7**	**1.8**	**1.4**	**1.2**	[6]**1.8**
Net Income / Tangible Assets (%)	**1.4**	**1.1**	**1.2**	**0.8**	**0.8**	[5]**1.1**
Cost / Income Ratio (%)	**55.0**	**55.4**	**53.7**	**60.0**	**63.4**	[5]**57.5**
Market Funds / Tangible Banking Assets (%)	**28.8**	**30.5**	**27.6**	**28.6**	**28.6**	[5]**28.8**
Liquid Banking Assets / Tangible Banking Assets (%)	**16.6**	**17.4**	**14.9**	**16.1**	**15.6**	[5]**16.1**
Gross Loans / Total Deposits (%)	**132.5**	**126.2**	**116.4**	**113.9**	**107.1**	[5]**119.2**

Source: Moody's

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

Opinion

SUMMARY RATING RATIONALE

On 11 May we upgraded SpareBank 1 Nord-Norge's long-term deposit and senior unsecured debt ratings to A1 from A2. We affirmed the baa1 baseline credit assessment (BCA) and adjusted BCA, the Baa2 subordinated rating, Baa3 junior subordinated rating, Ba1(hyb) preference stock rating and Prime-1 short term obligation rating.

The affirmation of SpareBank 1 Nord-Norge's baa1 BCA reflects the bank's strong regional position, retail focus and sizeable deposit base, as well as improvements in the bank's capital base and asset quality. These positive drivers are counterbalanced by our view that in the current operating environment real estate exposures in the loan book may lead to a modest rise in problem loans from their low current levels.

The upgrade of the bank's deposit and senior unsecured debt ratings to A1 from A2 takes into account the Loss Given Failure (LGF) analysis of the bank's own volume of deposits and senior unsecured debt, and the volume of securities subordinated to them, which partially offsets the decrease in government support assumptions. SpareBank 1 Nord-Norge benefits from a large volume of deposits and substantial layers of subordination, resulting in very low loss given failure.

SPAREBANK NORD-NORGE'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

As a pure domestic bank, SpareBank 1 Nord-Norge's operating environment is heavily influenced by Norway and its Macro Profile is thus aligned with that of Norway at Very Strong-. Norwegian banks benefit from operating in a wealthy and developed country with very high economic, institutional and government financial strength, as well as low susceptibility to event risk. The main risks to the system stem from a high level of household indebtedness and domestic banks' reliance on market funding. However, these risks are offset by the strength of households' ability to service debt, banks' adequate capitalization and the relatively small size of the banking system compared with GDP.

Rating Drivers

- Capital ratios are improving

- Strong asset quality reflects retail-focus but limited by sector and borrower concentrations

- Funding profile is underpinned by a sizeable deposit base but exhibits some reliance on market funding

- Large volume of deposits and junior debt resulting in deposit ratings benefiting from a very low loss-given-failure rate.

- Moderate probability of government support resulting in one notch uplift from BCA for debt and deposits

Rating Outlook

The stable outlooks on the bank's long-term senior debt and deposit ratings reflect our view that the bank's financials will remain broadly resilient in the face of a modest slowdown in Norway's still strong economic performance.

What Could Change the Rating - Up

Upward rating momentum could develop if SpareBank 1 Nord-Norge 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, and/or (3) stronger earnings generation without an increase in its risk profile.

What Could Change the Rating - Down

Future downward rating pressure would emerge if (1) SpareBank 1 Nord-Norge's asset quality deteriorates more than we anticipate; (2) financing conditions become more difficult; and/or (3) its risk profile increases, for example as a result of increased exposure to more volatile sectors and/or (4) macroeconomic environment deteriorates more than estimated, leading to adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

CAPITAL RATIOS ARE IMPROVING

SpareBank 1 Nord-Norge benefits from a strong capital base which has been improving over the years and is a relative strength for the bank. At end March 2015, the bank's Tangible Common Equity (TCE) ratio was 15.4% (including transitional floors), a significant improvement when compared with 2012 (12.4%) and already in excess of the 11% minimum regulatory requirement that will come into force in July 2015. During the first quarter of 2015, the bank received permission to apply the Advanced IRB approach to calculate regulatory charges against credit risk on corporate clients compensating for the increase in the risk weight of home mortgages as a result of Norwegian's FSA tightening (consolidated level increase to 23%). SpareBank 1 Nord-Norge is aiming to have an internal capital buffer of at least 1% above the statutory minimum requirement and its long-term goal for Core Tier 1 capital ratio is currently 14.5%. In connection to achieving the new capital requirements the Board had previously communicated a reduced dividend payout ratio in the lead up to 2016 but given the bank's financial strength, this ratio is expected to normalise earlier.

Our assigned Capital Score reflects this strength, as well as the bank's TCE/Tangible banking assets ratio of over 11%, which is well within international standards.

STRONG ASSET QUALITY REFLECTS RETAIL-FOCUS BUT LIMITED BY SECTOR AND BORROWER CONCENTRATIONS

SpareBank 1 Nord-Norge's loan book benefits from a substantial proportion of retail loans, mostly in the form of mortgages (almost 70% when including loans transferred to covered bond companies). The bank's asset quality is strong with a problem loan ratio (impaired loans as a percentage of total loans) of 0.9% of on-balance-sheet loans at end-March 2015, down from 1.7% at end-2013. This level benefits from the beneficial lending environment in Norway, including high unemployment benefits which support borrowers' ability to repay debt and a creditor-friendly legal framework. Additionally, the current low levels of problem loans benefit from the supportive macroeconomic conditions Norway has experienced over recent years.

Our assigned asset risk score indicates that overall, asset risk remains a relative strength for SpareBank 1 Nord-Norge. We expect that the current low problem loan levels will be very hard to maintain in the longer term. We expect to see mild asset quality deterioration from the extremely strong current position, as we expect that Norway will experience a somewhat tougher bank operating environment compared with recent years owing to declining oil and gas prices, as well as falling investment levels, which will likely reduce general economic growth. Many mainland companies in Norway support the hydrocarbon industry and their performance is closely linked to the performance of the sector. SpareBank 1 Nord-Norge's loan book exhibits some concentration towards the real estate and construction sectors, which represented 14% of the on-balance-sheet loan portfolio. We also note risks related to individual borrower concentration, which could accelerate the extent and pace of any deterioration in asset quality, and is common to many Nordic banks.

PROFITABILITY - LIMITED UPSIDE ON MARGINS

SpareBank 1 Nord-Norge's earnings base benefits from resilient retail banking operations, which contributed to just over 40% of its 2014 pre-provision profit. Net interest income continued to constitute the largest proportion of income at almost 50% (compared with net fee and commission income of 32% and income from financial instruments of 20%). However, the importance of net interest income was significantly reduced from 2012 when it constituted 62% of total income, as a result of a material improvement in fee and commission income related to a 90% increase in commission income from loans transferred to the two Alliance covered bond companies. Income from the covered bond companies booked as commission income mainly originates from interest income from the bank's mortgage loans transferred to Sparebanken 1 Boligkreditt.

The bank's cost-income ratio (54% at end-2014) remains strong and improved from almost 59% at end-2012 as the bank's income outgrew costs. Still, costs increased by 7% as a result of higher employers' National Insurance contributions, higher provisions for bonuses and future restructuring costs, as well as write downs on acquired assets.

The bank's 2014 loan losses of NOK321 million were significantly higher than in 2013 (NOK172 million). The majority of the losses were made to cover the group's exposure in Russia following the economic crisis in the country that caused deposit outflows and resulted in liquidity pressures, reducing the exposure to 0.4% of total assets.

SpareBank 1 Nord-Norge reported net income at NOK1.1billion over 2014 compared with NOK966 million in 2013. Net income as a share of tangible banking assets has averaged 1.0% over the past three years, in line with most

Norwegian savings banks. We expect that the bank's profitability growth will slow over the coming year owing to a renewed margin pressure as a result of lower interest rates. All else being equal, we would not anticipate the bank's corporate loan losses to remain at their currently low levels as we expect that Norway will experience a slightly tougher bank operating environment than in recent years, which is reflected in our Profitability score.

FUNDING PROFILE IS UNDERPINNED BY A SIZEABLE DEPOSIT BASE BUT EXHIBITS SOME RELIANCE ON MARKET FUNDING

SpareBank 1 Nord-Norge's on-balance sheet funding consisted for almost 70% of deposits at end-December 2014, which has proven resilient over many years. As of end-2014, the bank's deposits were up by almost 2% year-on-year, driven mainly by retail deposit growth despite a contraction in government deposits. Market funding accounted for just over 30% of the bank's tangible banking assets at end - December 2014 and has been stable over the years.

We globally reflect the relative stability of covered bonds compared with unsecured market funding through a standard adjustment in our scorecard. SpareBank 1 Nord-Norge has increasingly used covered bond funding, which is done off-balance-sheet through specialized companies it jointly owns together with other members of the SpareBank 1 Alliance (SpareBank 1 Boligkreditt for residential mortgages and SpareBank 1 Næringskreditt for commercial mortgages). At end-December 2014 the bank had transferred retail mortgages worth NOK24 billion to these vehicles, i.e., almost 30% of its gross loan book. Whilst we view positively the diversification benefit of covered bond funding, we caution that extensive use of covered bond funding increases the amount of pledged assets unavailable for unsecured bondholders, including depositors in liquidation.

Our funding structure score reflects our view that SpareBank 1 Nord-Norge's usage of market funding is of sufficient scale to represent a source of risk because, in times of market stress, market funding can become more expensive or/and restricted.

Additionally, SpareBank 1 Nord-Norge's liquid assets accounted for just over 17% of total assets at end-December 2014. The liquidity reserve primarily consists of Norwegian T-bills, sovereigns, rated covered bonds as well as bonds issued by domestic or international financial institutions and domestic corporate bonds.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We expect that Norway will introduce legislation to implement the EU's Bank Resolution and Recovery Directive (BRRD). In our LGF analysis we assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

For SpareBank 1 Nord-Norge's long term deposit rating and senior unsecured debt rating, our rating upgrade has considered the likely impact on loss-given-failure of the combination of their own volume and the amount of debt subordinated to them. Therefore, this has result in Preliminary Rating Assessment (PRA) of two notches above the BCA, reflecting very low loss-given-failure.

For junior securities issued by SpareBank 1 Nord-Norge, our LGF analysis confirms a high level loss-given-failure, given the small volume of debt and limited protection from more subordinated instruments and residual equity. We also incorporate additional notching for junior subordinated and preference share instruments reflecting the coupon features.

GOVERNMENT SUPPORT

The expected implementation of resolution legislation has caused us to reconsider the probability that government support would benefit certain creditors.

SpareBank 1 Nord-Norge has a solid, defensible footprint in northern Norway with 66 branches across the region. Moody's estimates that the bank commands market shares of around 32% in deposits and 16% in terms of loans in the three most northerly counties of Norway, although its national market share is limited, at around 2.4% in terms of deposits and 1.4% in terms of loans (based on total lending in the bank's counties of operation and in the whole country according to Statistics Norway). Therefore we conclude a moderate probability of government support for debt and deposits, resulting in one notch of uplift.

For other junior securities, we continue to believe that potential government support is low and these ratings do not include any related uplift. Junior securities also include additional downward notching from the BCA reflecting coupon suspension risk ahead of a potential failure.

COUNTERPARTY RISK ASSESSMENT

We assign a Aa3(cr) long-term and P-1(cr) short-term CR assessment to SpareBank 1 Nord-Norge.

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

Foreign Currency Deposit Rating

SpareBank 1 Nord-Norge's foreign currency deposit rating of A1 is unconstrained given that Norway has a country ceiling of Aaa.

Foreign Currency Debt Rating

SpareBank 1 Nord-Norge's senior unsecured foreign currency debt rating of A1 is unconstrained given that Norway has a country ceiling of Aaa.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

SpareBank 1 Nord-Norge

Macro Factors	
Weighted Macro Profile	**Very Strong -**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.4%	aa2	←→	a3	Single name concentration	Geographical concentration
Capital						
TCE / RWA	15.4%	aa2	←→	aa2	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	1.1%	a2	↓	a2	Expected trend	
Combined Solvency Score		aa3		a1		
Liquidity						

Funding Structure						
Market Funds / Tangible Banking Assets	30.5%	baa3	←→	ba1	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	17.4%	baa2	←→	baa2	Stock of liquid assets	
Combined Liquidity Score		baa3		baa3		

Financial Profile	**a3**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	Aaa
Scorecard Calculated BCA range	**a2 - baa1**
Assigned BCA	**baa1**
Affiliate Support notching	**0**
Adjusted BCA	**baa1**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	2	0	a2	1	A1	A1
Senior unsecured bank debt	2	0	a2	1		A1
Dated subordinated bank debt	-1	0	baa2	0		(P)Baa2
Junior subordinated bank debt	-1	-1	baa3	0		(P)Baa3
Non-cumulative bank preference shares	-1	-2	ba1	0		Ba1(hyb)

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