MOODY'S
INVESTORS SERVICE

Credit Opinion: SpareBank 1 Nord-Norge

Global Credit Research - 27 Mar 2015

Tromso, Norway

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*A2/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Senior Unsecured	**A2
Subordinate MTN	(P)Baa2
Jr Subordinate MTN	(P)Baa3
Pref. Stock Non-cumulative	Ba1 (hyb)

* Rating(s) within this class was/were placed on review on March 17, 2015
** Placed under review for possible upgrade on March 17, 2015

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Key Indicators

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

	[2]12-14	[3]12-13	[3]12-12	[3]12-11	[3]12-10	Avg.
Total Assets (NOK billion)	83.2	77.5	75.3	71.0	68.8	[4]4.9
Total Assets (EUR million)	9,169.3	9,273.0	10,266.8	9,169.6	8,820.5	[4]1.0
Total Assets (USD million)	11,095.4	12,777.6	13,535.6	11,903.4	11,833.1	[4]-1.6
Tangible Common Equity (NOK billion)	7.7	7.1	5.5	5.2	4.5	[4]14.2
Tangible Common Equity (EUR million)	847.2	846.1	754.5	670.6	578.7	[4]10.0
Tangible Common Equity (USD million)	1,025.1	1,165.8	994.7	870.6	776.4	[4]7.2
Problem Loans / Gross Loans (%)	0.9	1.7	2.0	1.9	2.0	[5]1.7
Tangible Common Equity / Risk Weighted Assets (%)	12.4	12.2	10.0	10.0	9.2	[6]12.4
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.8	12.8	18.4	17.1	19.8	[5]15.0
Net Interest Margin (%)	1.9	1.8	1.7	1.7	1.8	[5]1.8
PPI / Average RWA (%)	1.8	1.9	1.4	1.2	1.8	[6]1.8
Net Income / Tangible Assets (%)	1.2	1.3	0.8	0.8	1.2	[5]1.1
Cost / Income Ratio (%)	53.8	52.4	58.4	62.9	53.3	[5]56.2
Market Funds / Tangible Banking Assets (%)	30.5	27.6	28.6	28.6	30.7	[5]29.2
Liquid Banking Assets / Tangible Banking Assets (%)	17.4	14.9	16.1	15.6	15.5	[5]15.9
Gross Loans / Total Deposits (%)	133.8	116.4	113.9	107.1	107.8	[5]115.8

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 17 March we placed SpareBank 1 Nord-Norge's A2 long term deposit and senior unsecured debt ratings under review for upgrade. The bank's baa1 standalone credit assessment (BCA), all junior debt ratings, short term and preference stock ratings remain unchanged.

SpareBank 1 Nord-Norge standalone baseline credit assessment (BCA) primarily benefits from the bank's strong regional market position, retail-focus and sizeable deposit base, but is mainly constrained by the high borrower concentration and substantial exposure to the real estate sector in its loan book.

The review was prompted by the implementation of Loss Given Failure, which is a component of our new methodology, in combination with downward pressure on current government support assumptions. LGF takes into account the risks faced by the different debt and deposit classes across the liability structure should the bank enter into resolution.

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 review on SpareBank 1 Nord-Norge's long term deposit and senior unsecured debt ratings was triggered by the introduction of our new methodology, and specifically our advance Loss Given Failure analysis, which applies to institutions subject to an operational resolution regime. While not subject to EU's Bank Recovery and Resolution Directive (BRRD), we expect that Norway as an EEA member will look to introduce legislation or other tools that include mechanisms similar to those in the BRRD. Our expectations are based on public comments as well as the government's track record of mirroring EU banking regulations. Our advanced LGF analysis on SpareBank 1 Nord-Norge's long term deposits and senior unsecured debt led us to place the ratings on review for upgrade.

The review will focus on the liability structure, in particular the amount of deposits, senior long-term debt outstanding and the amount of debt subordinated to it. We believe the probability of government support for SpareBank 1 Nord-Norges's long term deposits and senior unsecured debt to be moderate and we expect uplift of one notch from its unsupported level. We expect both the long term deposits and senior unsecured debt ratings to be upgraded by one notch.

What Could Change the Rating - Up

As stated in the Rating Rationale SpareBank 1 Norrd-Norge's ratings are under review in response to the implementation of LGF, which is a component of our new banking methodology.

What Could Change the Rating - Down

After the above mentioned review is completed, 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. In addition, we believe that downward pressure could be exerted on the ratings from external factors, such as a less supportive macroeconomic environment and/or substantially adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

CAPITAL RATIOS ARE IMPROVING

SpareBank 1 Nord-Norge had a Tangible Common Equity (TCE) ratio of 12.4% at end-December 2014 (including the transitional floor), a significant improvement when compared with 10% in 2012 and already in excess of the 11% minimum regulatory requirement that will come into force in July 2015. 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 almost 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-December 2014, down from 1.5% 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 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 1.1% over the past three years, in line with most 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.

As reflected in our methodology, 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 look to introduce legislation or other tools that include mechanisms similar to those in the EU's Bank Resolution and Recovery Directive (BRRD). 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 review will consider the likely impact on loss-given-failure of the combination of their own volume and the amount of debt subordinated to them. We expect this will result in Preliminary Rating Assessment (PRA) of two notches above the BCA, reflecting very low loss-given-failure.

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 now expect a moderate probability of government support for debt and deposits, resulting in one notch of uplift to the PRA.

Foreign Currency Deposit Rating

SpareBank 1 Nord-Norge's foreign currency deposit rating of A2 (under review for upgrade) 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 A2 (under review for upgrade) 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.

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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	1.5%	aa3	←→	baa1	Single name concentration	Geographical concentration
Capital						
TCE / RWA	12.4%	a2	←→	a2	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	1.1%	a2	↓	a2	Expected trend	
Combined Solvency Score		a1		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	30.5%	baa3	←→	ba1	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking	17.4%	baa2	←→	baa2	Stock of liquid assets	

Assets						
Combined Liquidity Score		baa3		baa3		

Financial Profile	**baa1**

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	**a3 - baa2**
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	--	--	--	--	A2 RUR Possible Upgrade	A2 RUR Possible Upgrade
Senior unsecured bank debt	--	--	--	--		A2 RUR Possible Upgrade
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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