

Global Credit Research - 24 Jun 2015

Hamar, Norway

## Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa1

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## Key Indicators

### Sparebanken Hedmark (Consolidated Financials)[1]

	[2]3-15	[2]12-14	[3]12-13	[3]12-12	[3]12-11	Avg.
Total Assets (NOK billion)	50.9	49.8	47.4	44.1	43.1	[4]4.2
Total Assets (EUR million)	5,880.4	5,485.3	5,669.7	6,012.3	5,568.8	[4]1.4
Total Assets (USD million)	6,315.6	6,637.5	7,812.5	7,926.5	7,229.1	[4]-3.3
Tangible Common Equity (NOK billion)	7.5	7.3	6.4	5.8	5.3	[4]9.1
Tangible Common Equity (EUR million)	871.4	807.8	765.8	784.0	686.4	[4]6.1
Tangible Common Equity (USD million)	935.8	977.5	1,055.2	1,033.6	891.1	[4]1.2
Problem Loans / Gross Loans (%)	1.3	1.4	1.6	2.1	2.4	[5]1.8
Tangible Common Equity / Risk Weighted Assets (%)	21.0	20.0	20.7	23.5	21.7	[6]20.5
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.7	7.2	9.2	12.1	14.9	[5]10.0
Net Interest Margin (%)	2.3	2.3	2.4	2.3	2.4	[5]2.3
PPI / Average RWA (%)	2.3	2.2	2.2	2.3	1.7	[6]2.3
Net Income / Tangible Assets (%)	1.9	1.9	1.5	1.0	0.7	[5]1.4
Cost / Income Ratio (%)	55.0	54.5	58.6	60.7	64.9	[5]58.8
Market Funds / Tangible Banking Assets (%)	20.9	19.7	19.5	20.6	25.2	[5]21.2
Liquid Banking Assets / Tangible Banking Assets (%)	12.1	11.5	13.9	13.6	14.6	[5]13.1
Gross Loans / Total Deposits (%)	130.4	125.8	121.0	126.0	134.3	[5]127.5

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 affirmed Sparebanken Hedmark's baa2 standalone baseline credit assessment (BCA), baa1 adjusted BCA, the A2 long-term deposit rating and P-1 short-term deposit rating.

The affirmation of Sparebanken Hedmark's baa2 BCA reflects the bank's strong capital and stable retail banking operations, balanced against the challenges posed by a potential acquisition of the remaining stake in Bank 1 Oslo Akershus (not rated), which operates in a more competitive area than Hedmark. While we note that Sparebanken Hedmark's rating currently remains constrained by its limited flexibility to raise capital, owing to its current shareholding structure, we also note its recently announced plan to issue equity certificates equivalent to 60% of its primary capital. This issuance will provide further flexibility and could exert upward pressure on the rating over time if the bank is able to also manage its stake in Bank 1 Oslo Akershus and sustain strong financial performance. The affirmation of the bank's deposit and senior unsecured debt ratings takes into account the Loss Given Failure (LGF) analysis of the bank's own volume of deposits and debt, and the volume of securities subordinated to them, which offset the decrease in government support assumptions.

#### SPAREBANKEN HEDMARK'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

As a pure domestic bank, Sparebanken Hedmark's operating environment is in Norway, and the bank's Macro Profile is thus aligned with that of Norway at Very Strong-. Norwegian banks benefit from operating in an affluent 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 capitalisation and the relatively small size of the banking system compared to GDP.

#### RATING DRIVERS

- Capital levels are the strongest among peers.
- The bank's asset quality metrics are in-line with Norwegian average
- The bank's funding profile is underpinned by a sizeable deposit base but exhibits some reliance on market funding.
- Profitability strong, but an increase in Bank 1 Oslo Akershus stake will put pressure on profitability
- Large volume of deposits and junior debt resulting in deposit ratings benefiting from a very low loss-given-failure rate
- Low probability of government support likely resulting in no additional uplift versus 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 pressure could develop if Sparebanken Hedmark demonstrates (1) good asset quality in its retail and corporate books (2) continued access to capital markets and improved liquidity, and/or (3) stronger earnings generation without an increase in its risk profile. In addition, further upward pressure could emerge following the completion of the transaction relating to the takeover of the remaining part of Bank 1 Oslo Akershus with minimal impact to the bank's capital base, as execution risk currently factored in our ratings will be reduced.

#### What Could Change the Rating - Down

Future downward rating pressure could arise if (1) Sparebanken Hedmark's financing condition become more difficult, (2) its risk profile increases, for example as a result of increased exposures to more volatile sectors resulting to asset quality deterioration and/or (3) macroeconomic environment deteriorates more than estimated, leading to adverse developments in the Norwegian real-estate market.

#### DETAILED RATING CONSIDERATIONS

## CAPITAL LEVELS ARE THE STRONGEST AMONGST ITS PEERS

Sparebanken Hedmark exhibits the strongest capital levels amongst its Norwegian rated peers. At end-March 2015, the bank's Tangible Common Equity (TCE) to risk weighted assets (RWA) ratio stood at 21%, and its Tier 1 Capital ratio was 15.8%, already in line with updated capital requirements. The capital base consists only of retained earnings and the bank plans to issue equity certificates (60% of its primary capital) at the end of the year, which we view positively as it will improve access to capital markets. Nevertheless, we believe that there is a degree of uncertainty regarding Sparebanken Hedmark's expansion plans, following the increase of its stake in Bank 1 Oslo Akershus (unrated) to 40.5% in 2014 from 12.0% in 2013, which could put pressure in its capital base.

## BANK'S ASSET QUALITY METRICS ARE IN-LINE WITH NORWEGIAN AVERAGE

The bank's asset quality metrics improved somewhat in the 2010-14 period; its problem loan ratio (as measure by impaired loans as a percentage of total loans) decreased to just below 1.3% of on-balance-sheet loans at end-March 2015 from 2.4% at year-end 2010. Nonetheless, this ratio remains relatively high compared to larger rated Norwegian savings banks.

Sparebanken Hedmark's loan portfolio benefits from a substantial proportion of retail loans, mostly in the form of mortgages (close to 60% excluding loans transferred to SpareBank 1 Boligkreditt and almost 70% including them). While the performance of the bank's retail book has been particularly strong in recent years, any more significant slowdown in the economy we expect that would undermine the bank's asset quality.

Our assigned Asset Risk score also reflects the bank's exposure to the property management and construction sectors, which are particularly vulnerable to less favorable economic conditions due to declining oil and gas prices as well as falling investment levels, is sizeable at 20% of on-balance-sheet loans. The rest of the portfolio is mainly focused on SMEs and diversified across industries. The bank also exhibits high borrower concentration, albeit somewhat lower than most of its Nordic rated peers.

## LIQUIDITY - SUBSTANTIAL DEPOSIT BASE, SOME RELIANCE ON MARKET FUNDING BUT LESS THAN MANY PEERS

Sparebanken Hedmark's funding position is underpinned by a substantial deposit base, which accounted for almost 80% of on-balance-sheet funding at end-December 2014, with over 60% of the bank's deposits originate from the retail sector.

We globally reflect the relative stability of covered bonds compared to unsecured market funding through a standard adjustment in our scorecard. Sparebanken Hedmark has increasingly used covered bond funding, which is done off-balance-sheet through specialised companies it jointly owns together with the other members of SpareBank 1 Alliance (SpareBank 1 Boligkreditt for residential mortgages and SpareBank 1 Næringskreditt for commercial mortgages). At end-December 2014, Sparebanken Hedmark had transferred retail mortgages worth NOK15.4 billion to SpareBank 1 Boligkreditt and NOK0.6 billion commercial mortgages to SpareBank 1 Næringskreditt (i.e., equivalent to 28.6% of total loans).

Whilst we positively view the diversification benefit of covered bond funding, its extensive use increases the amount of pledged assets unavailable for unsecured bondholders including depositors in a liquidation. Our assessment of the bank's funding structure reflects our view that Sparebanken Hedmark has some reliance on market funds - a common feature at Nordic banks - but to a lesser degree than peers: market funding accounted for 20% of the bank's tangible assets at end-December 2014 (27% when adjusting for covered bonds) and has been stable over the years

At end-December 2014, liquid assets accounted for 11.4% of tangible assets and, according to the bank, cover funding needs for 18 months (assuming 6% lending growth and 2.6% growth in deposits). The portfolio consists of cash and deposits with the central bank, senior bonds, covered bonds and limited equity investments. The holdings are concentrated on Norwegian securities, which could be a source of vulnerability from a concentration risk point of view, but is positive in terms of currency risk.

## PROFITABILITY STRONG BUT POTENTIAL INCREASE IN BANK 1 OSLO AKERSHUS STAKE WILL PUT PRESSURE IN PROFITABILITY

In our view, the increased stake in Bank 1 Oslo Akershus will put additional pressure in Sparebanken Hedmark's revenue profile. The bank's earnings profile is weaker than Sparebanken Hedmark's as the bank operates in a more competitive area than Hedmark resulting to significantly lower margins while its operations lack efficiency.

Sparebanken Hedmark's main source of earnings is net interest income, representing around 56% of its 2014 operating income (when including fees from loans transferred to the covered bond company). The bank's cost-to-income ratio (according to Moody's adjusted metrics) was almost 55% in 2014, slightly higher than the average of the Norwegian rated peers; while loan loss provisions remained low at NOK66million in 2014, in line with NOK72 million in 2013. Sparebanken Hedmark reported a net profit of NOK1.04 billion over 2014. Moody's adjusted annualised return on tangible assets was at 1.86%, higher than both the 2013 level and the three-year average due to increased contribution from equity stakes.

Our assigned Profitability score reflects our expectations that the growth of Sparebanken Hedmark's will slow over the coming year as we do not expect a continuation of margin increases. Further more we expect a reduction in profitability of the Group once the acquisition of the remaining stake in Bank 1 Oslo Akershus is completed. All else being equal, we would not anticipate the bank's corporate loan losses to remain at their current level as we expect Norway to experience a slightly tougher bank operating environment in 2015-2016 compared to recent years.

## **Notching Considerations**

### **LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING**

We expect that Norway will seek to introduce legislation to implement the EU Bank Resolution and Recovery Directive (BRRD). In our LGF analysis 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 metrics are in line with our standard assumptions.

For Sparebanken Hedmark's long-term deposit ratings, our affirmation has considered the likely impact on loss-given-failure of the combination of their own volume and the amount of debt subordinated to them. This has resulted in a 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.

With regional loan and deposit market shares of around 23% and 45% (lending market share is estimated at 33% by the bank when including mortgages transferred to covered bond company), respectively, Sparebanken Hedmark has a sound local market position in the county of Hedmark in eastern Norway. The national market share is however notably smaller at roughly 0.9% in terms of loans and 1.6% in terms of deposits (based on total on-balance sheet lending in the bank's counties of operation and in the whole country according to Statistics Norway). Therefore we now expect a low probability of government support for debt and deposits, resulting in zero notches of uplift.

### **COUNTERPARTY RISK ASSESSMENT**

We also assigned a long-term and short-term CR assessment of A1(cr) and P-1 (cr) respectively.

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.

### **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

Sparebanken Hedmark

<b>Macro Factors</b>	
<b>Weighted Macro Profile</b>	Very Strong -

<b>Financial Profile</b>						
<b>Factor</b>	<b>Historic Ratio</b>	<b>Macro Adjusted Score</b>	<b>Credit Trend</b>	<b>Assigned Score</b>	<b>Key driver #1</b>	<b>Key driver #2</b>
<b>Solvency</b> <b>Asset Risk</b> <i>Problem Loans / Gross Loans</i>	1.6%	aa3	← →	a3	Geographical concentration	Sector concentration
<b>Capital</b> <i>TCE / RWA</i>	21.0%	aa1	← →	aa3	Expected trend	
<b>Profitability</b> <i>Net Income / Tangible Assets</i>	1.6%	aa3	↓↓	baa3	Earnings quality	Expected trend
<b>Combined Solvency Score</b>		aa2		a3		
<b>Liquidity</b> <b>Funding Structure</b> <i>Market Funds / Tangible Banking Assets</i>	19.7%	a2	← →	baa3	Market funding quality	
<b>Liquid Resources</b> <i>Liquid Banking Assets / Tangible Banking Assets</i>	11.5%	baa3	← →	baa3	Stock of liquid assets	
<b>Combined Liquidity Score</b>		baa1		baa3		

<b>Financial Profile</b>	<b>baa1</b>
<b>Qualitative Adjustments</b>	<b>Adjustment</b>
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
<b>Total Qualitative Adjustments</b>	<b>0</b>
Sovereign or Affiliate constraint	Aaa
Scorecard Calculated BCA range	a3 - baa2
<b>Assigned BCA</b>	<b>baa2</b>
Affiliate Support notching	1

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	0	A2	A2

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