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	5
Support Rating Floor	NF

SpareBank 1 SMN

Foreign Currency	
Long-Term IDR	A-
Short-Term IDR	F2
Viability Rating	a-
Support Rating	5
Support Rating Floor	NF

SpareBank 1 Nord-Norge

Foreign Currency	
Long-Term IDR	A
Short-Term IDR	F1
Viability Rating	a
Support Rating	5
Support Rating Floor	NF

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
Sovereign	
Long-Term Foreign-Currency IDR	Stable
Sovereign	
Long-Term Local-Currency IDR	Stable

Related Research

SpareBank 1 SR-Bank - Ratings Navigator (October 2018)

SpareBank 1 SMN - Ratings Navigator (October 2018)

SpareBank 1 Nord-Norge - Ratings Navigator (October 2018)

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Key Rating Drivers

Strong Franchises, Regional Concentrations: The ratings for SpareBank 1 SR-Bank (SR-Bank), SpareBank 1 SMN (SMN) and SpareBank 1 Nord-Norge (SNN), collectively "the Sparebanken", reflect their stable and low-risk business models, healthy profitability, resilient asset quality and sound capital ratios. The ratings also factor in risks arising from volatility in oil prices, high property prices, geographically concentrated lending and liquidity management in the context of the banks' wholesale funding reliance.

SNN's ratings are one notch higher than its Sparebanken peers', reflecting better asset-quality metrics, limited oil exposure and a more retail-oriented business model.

Benefits from Alliance Membership: The Sparebanken are the three largest savings banks in Norway's SpareBank 1 Alliance (the Alliance). They benefit from cost efficiencies and income diversification via the jointly owned SpareBanken 1 Gruppen AS, whose services include life and non-life insurance and fund management products.

Resilient Asset Quality: We expect impaired loans to remain low, supported by a stable operating environment, low-risk business models focused on SME and retail customers and conservative underwriting standards. Asset-quality problems should be contained to offshore service vessel (OSV) portfolios, a material part of which has been restructured in recent years. A significant property price correction is a key sensitivity for the banks, as reduced consumption would likely have a negative impact on their SME portfolios.

Healthy Profitability: Pre-impairment profitability is good, with the banks' regional franchises supporting stable revenue generation. Loan impairment charges (LICs) should be largely contained to the OSV segment. Cost efficiency across the banks is acceptable. Mortgage lending margin pressures in 2018 are likely to ease in 2019.

Robust Capitalisation, Low Leverage: The Sparebanken's capital adequacy ratios compare well with those of international peers, despite Norwegian floors on the computation of risk weights. Leverage is low in a European context.

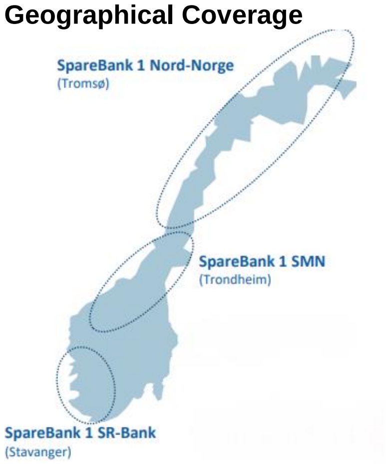
Wholesale Funding Reliance: The Sparebanken rely on wholesale funding to varying degrees and have maintained access to domestic and international funding markets, in particular for covered bonds issuance. Fitch Ratings believes the banks will retain large liquidity portfolios to mitigate refinancing risk.

Rating Sensitivities

Asset-Quality Deterioration: The Sparebanken's ratings are mainly sensitive to deteriorating asset quality, particularly if national or regional economic shocks lead to higher unemployment, deterioration in commercial real-estate exposure or a significant property price correction, if the banks are unable to absorb higher credit losses via earnings. A weakening of access to capital markets would also be negative for the ratings.

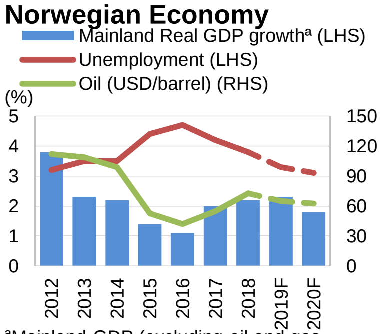
Improvements in Asset Quality, Capital: Upward ratings pressure for SR-Bank and SMN could arise in the medium term through sustained asset-quality improvements combined with continued capital strengthening for SR-Bank. For SNN, an upgrade is unlikely given its already high ratings in the context of its size and regional concentration.

Geographical Coverage



Source: Sparebank 1, adjusted by Fitch Ratings

Norwegian Economy



[a]Mainland GDP (excluding oil and gas extraction and shipping)
Source: Fitch Ratings

Related Criteria

Bank Rating Criteria (October 2018)

Operating Environment

Strong 'AAA' Rated Norwegian Sovereign

As regional banks, the Sparebanken's performance is closely linked to that of the Norwegian economy. Norway has maintained its 'AAA' rating for the past 20 years and Fitch expects the Norwegian banking sector to continue to benefit from the country's favourable economic environment. Norway has had a strong cyclical recovery from the sluggish growth in 2015-2016 following the sharp fall in oil prices in 2014. Mainland GDP growth rebounded to 2.0% in 2017 (2016: 1.1%), and then accelerated slightly to 2.2% in 2018. Mainland GDP growth should then slow down to 1.8% by 2020, as growth converges on Norway's medium-term potential growth estimate of 1.5%.

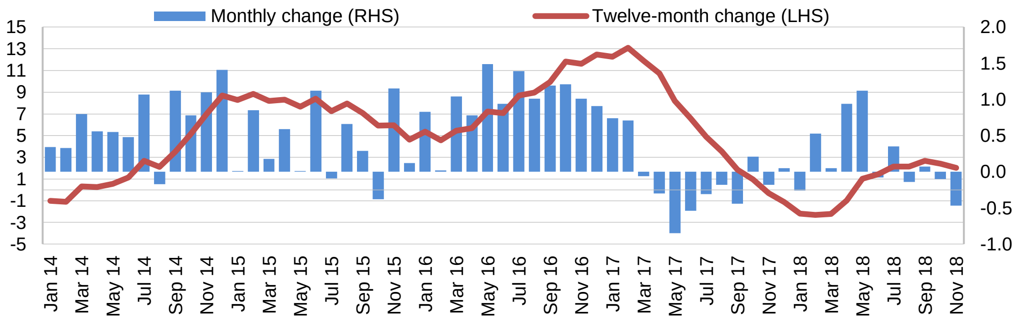
The regional footprint of the Sparebanken means their prospects are also closely linked to the economic development of the regions in which they are active. Fitch believes that central Norway, where SMN operates, has a reasonably diversified economy. Northern Norway, where SNN operates, is supported by a large and stable public sector, and has had faster economic growth in recent years than the Norwegian average. Rogaland, the centre of Norway's oil industry and SR-Bank's main operating market, has faced pressure in the most recent downturn but macroeconomic conditions have improved significantly over the past two years. The unemployment rate fell to 2.5% in December 2018 and is now just slightly above the national rate of 2.4%, while real-estate prices have been broadly stable since 2H16.

House Prices Expected to Grow Modestly

House prices have risen rapidly for a prolonged period of time, with year-on-year growth peaking nationally at 13% in February 2017 and 23% in Oslo. However, housing price inflation has been more or less in line with disposable income since early 2017, with notably negative growth towards end-2017 and the beginning of 2018, in part due to more stringent regulatory measures, as well as increased supply from housing construction. Fitch expects house prices to grow by 1% in both 2019 and 2020 as higher incomes are likely to be offset by lower population growth and higher mortgage lending rates.

House Prices Development

Twelve-month change and seasonally adjusted monthly change



Source: Fitch Ratings, Norges Bank; Eiendomsverdi, Finn.no and Real Estate Norway

Strong Regulator

The Norwegian regulatory environment is highly developed and transparent. The authorities have introduced a range of measures to tackle rising property prices and household debt. These include subjecting the banks to risk-weight floors (20%-25%) for mortgage loans. In addition, the following rules were introduced in 2015 and renewed on 1 July 2018 (until 31 December 2019): an 85% loan-to-value (LTV) cap on residential mortgage lending, a 60% cap on equity credit lines, a 60% cap on secondary homes in Oslo (banks are allowed to deviate from the requirements for 10% of approved loans (8% in Oslo)); a debt-to-income cap of 5x; amortisation requirement for loans with a LTV of above 60%; and a requirement to stress borrowers' repayment ability to a 5% interest-rate increase.

In December 2018, the Ministry of Finance decided to increase the countercyclical capital buffer requirement for banks to 2.5% from 2% (applicable from 31 December 2019).

Company Profile

Independent Regional Savings Banks in Nationwide Alliance

In 1996, SNN, SMN and SR-Bank founded the Alliance along with Sparebanken Vest and Samspar, a group of smaller savings banks. Sparebanken Vest withdrew from the venture in January 2004 to pursue an independent strategy. The Alliance is the second-largest banking group in Norway, behind DNB ASA, with total lending of approximately NOK750 billion at end-June 2018.

The Sparebanken operate as universal banks for retail and SME customers in their regions, where they hold leading market shares (at least 30%) in deposits and loans. Their business models, although regionally concentrated, have proved stable due to the focus on traditional banking and their relatively simple organisational structures. The Sparebank 1 name is established throughout Norway as one of the country's most recognised financial brands. The Alliance has market shares of approximately 20% in retail banking and 15% in corporate banking.

Jointly Held Subsidiaries Provide Scale Benefits

The Alliance banks benefit from co-operation agreements between the members in areas ranging from marketing and IT to risk modelling. They own Sparebank 1 Boligkreditt (S1B), which has traditionally been their funding vehicle for mortgage covered bonds, and also a sister company, Sparebank 1 Naeringskreditt AS (S1N), a covered bond funding vehicle primarily backed by commercial property. The Alliance banks also jointly own the holding company SpareBank 1 Gruppen, which provides insurance and fund management services through its subsidiaries. In addition, SpareBank 1 Gruppen is responsible for some product development, which creates scale benefits for its members. Capital-market services are provided by SpareBank 1 Markets, which is owned directly by the Alliance banks (except SR-Bank), and not via SpareBank 1 Gruppen.

Management and Strategy

Stable and Competent Management Teams

The Sparebanken's management teams have deep local knowledge, and there are strong corporate cultures within the banks. Senior management turnover is low and the strategic direction in the Alliance has been consistent since its creation.

SR-Bank is a limited liability savings bank, with just under half of its owners from the local region, about 30% from other parts of Norway and just over 20% of share capital held internationally. SMN and SNN have a distinctive ownership status, whereby the control of the banks resides with local community stakeholders. External investors own equity capital certificates in the banks, entitling them to a proportionate share of the banks' profit, but they will never have a majority vote as per Norwegian savings banks law.

For SMN and SNN, 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 for all three banks are in line with the Norwegian code on corporate governance.

Risk Appetite

Benefits from Alliance Cooperation

Risk systems and expertise are shared across the Alliance and the largest members use the internal ratings-based approach to calculate capital requirements for credit risk.

Underwriting standards for mortgage lending are conservative and focus on debt servicing capacity, which is stressed for different scenarios. SME and corporate lending involves greater risks, although Fitch believes this is also done in a prudent manner as the banks have good knowledge of their customer base. The Sparebanken have in recent years been actively reducing large exposure concentrations and are focused on retail and SME clients. We expect this trend to continue.

Loan growth for SNN and SMN has been high in 2017 and 2018, at 8% and 8%, respectively for SNN, and 10% and 8%, for SMN (loan growth for both includes loans transferred to S1B and S1N; as the Sparebanken own minority stakes in S1B and S1N, the transferred loans are not consolidated on their balance sheets). The primary driver for such high growth has been the retrenchment of some of the country's larger banks from smaller communities as they seek to optimise their branch networks. Loan growth at SR-Bank was more muted at 3% in 2017 but increased to 8% in 2018. We expect a good yet prudent growth rate as economic conditions in its local markets, where the oil industry is prevalent, are now positive following a subdued period in 2016-2017. We expect loan growth for SNN and SMN to slow slightly in 2019 as market share gains are likely to slow down.

Market risk arises from the banks' modest trading portfolios, as well as indirectly through the jointly owned holding company SpareBank 1 Gruppen, in particular in its insurance investment portfolio. Interest-rate risk is mitigated by the banks' ability to change rates on most mortgage loans after a six-week notice period (rates on corporate loans can be adjusted even faster), and is managed using gap and duration analysis. The banks' sensitivity to a 100bp parallel shift in interest rates is small.

Note on Charts

Peers include: Coventry Building Society (a), Leeds Building Society (a-), Principality Building Society (bbb+), Credit du Nord (CdN, bbb+) and De Volksbank (DeVolks, a-).

Peer charts use 1H18/end-June 2018 data because FY18/end-2018 data are not available at the time of publication.

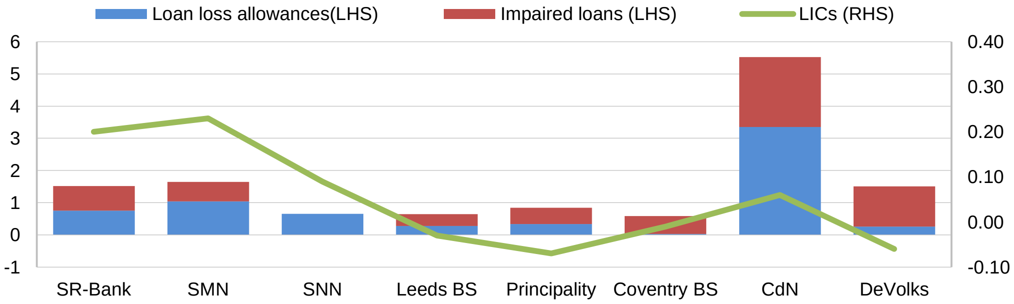
Financial Profile

Asset Quality

Sound Metrics

Key Asset-Quality Metrics

End-June 2018, % gross loans



Source: Fitch Ratings, Banks

The Sparebanken's asset quality is strong and compares well with international peers'. Impaired loans were a low 60bp-140bp of gross loans at end-2018, and LICs a low 3bp-23bp of average gross loans at end-2018. Fitch expects the quality of lending to remain resilient, supported by a relatively stable operating environment and conservative underwriting standards. Sharply falling oil prices in 2014-2016 translated into asset-quality pressures among certain portfolios in 2016, in particular the OSV segment. The situation improved in 2017-2018 and we do not expect oil-related weakness in asset quality over the foreseeable future, although individual cases may still emerge.

About 60%-65% of the loan books consist of residential mortgage lending, including loans transferred to S1B (about 70% for SNN). The vast majority of mortgage loans have an LTV ratio of less than 75%, in line with legislation for eligible covered bond transfers. High property prices are unlikely to directly affect the quality of the banks' mortgage lending. In the event of an adverse correction, although unexpected, we expect households to prioritise mortgage loan payments but to cut back on consumption, which would probably have a knock-on effect on the banks' SME portfolios, in particular in an environment of sharply rising interest rates.

Property and Offshore Are Key Risk Areas

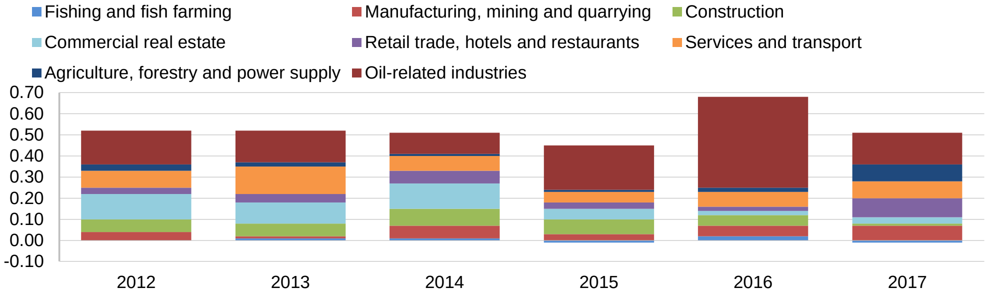
The Sparebanken's exposures to oil and gas-related activities vary significantly as a result of their respective geographical concentrations, but we believe they are manageable for the three banks. The banks have good knowledge of their customers and work proactively with them to identify potential problems at an early stage. Exposures will, nonetheless, remain under scrutiny through 2019, and all banks have reduced the proportion of lending to this segment in recent years.

SR-Bank has the largest oil and gas exposure, given its regional presence in the centre of Norway's petroleum industry, Rogaland, at 5.7% of total loan volume at end-2018 (5.3% at end-2017). The corresponding figure for 2018 for SMN is 2.9%, almost exclusively OSV lending, and for SNN is 1.0%. OSV companies have been under pressure largely due to high fixed costs and reduced demand for vessels, particularly older ones, and these have contributed to the bulk of LICs over 2016 and 2017. LICs have declined in 2018 as SR-Bank and SMN have restructured a material part of their OSV portfolios.

Other sections of the oil and gas portfolios have fared better in recent years owing to lower fixed costs and therefore greater adaptability. However, they could still be susceptible to further downturn in the industry. SR-Bank, in particular, would be sensitive to more widespread contagion given its concentration in southwest Norway.

Annual Loan Losses By Sector, 2012-2017

As % of total corporate lending for Norwegian banking sector



Source: Fitch Ratings, Norges Bank

The Sparebanken's corporate lending is predominantly to local SME customers. The regional nature of their franchises means there is some single-name concentration in their loan books, although they have been reducing large exposures in recent years. Corporate lending is about 40% of loan exposure for SR-Bank and about 30% for SMN and SNN (including for all bank loans transferred to S1B and S1N).

Commercial real-estate lending accounted for between around 10% (SMN) and 15% (SR-Bank) of loans at end-2018. The quality of these portfolios benefits from relatively modest vacancy rates and, when disclosed, the share of impaired loans in these portfolios is roughly in line with the overall impaired loans ratios of the banks. An economic slowdown could harm the quality of these exposures through weakening cash flows and falling collateral values. The combination of high real-estate prices, relatively higher vacancy rates and declining rental prices in local areas most exposed to the petroleum industry is a risk for the banks.

Exposures to commercial property mostly relate to buy-to-let investments and are typically in long-term contracts with high-quality tenants. A modest proportion is to development projects, and then largely to residential housing projects with a high degree of pre-sales. Exposure to other cyclical industries, such as fish farming, is moderate at 5%-10% loans for the three banks.

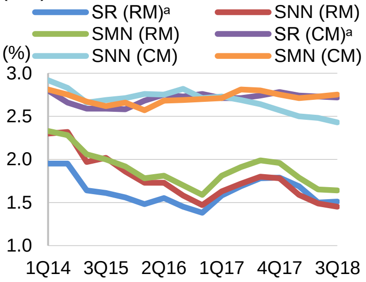
Earnings and Profitability

Stable Performance

The Sparebanken have good pre-impairment profitability, which we expect will continue in 2019. The banks benefit from resilient revenue generation, reflecting stable banking models weighted towards traditional commercial banking, and supported by their strong regional franchises. Net interest income was between 56% (SMN) and 63% (SR-Bank) of total income in 2018.

Lending Margin

Retail Market (RM), Corporate Market (CM)

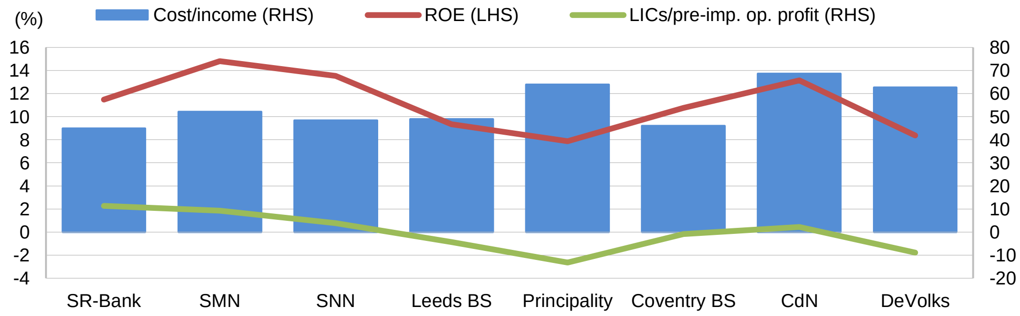


Avg. customer interest rate measured against 3m moving avg. or avg. NIBOR
[a] Margin incl. cov. bond companies
Source: Fitch Ratings, Banks

Retail lending margins softened in 2018 as a result of rising NIBOR, although this was offset by improving deposits margins. Corporate lending margins have been more stable, although SNN has experienced some margin erosion. However, SNN's net interest income margin has remained stable and above peers (owing to lower interest expenses and better deposits margins). Fitch does not expect a return to pre-crisis practices of market share-driven lending and believes that retail margins are likely to benefit from generally rising interest rates in 2019.

Key Performance Metrics

(1H18)



Source: Fitch Ratings, Banks

Commission income has been steadily increasing as a proportion of total revenue for the Sparebanken and is a reflection of the Alliance banks' focus on the cross-selling of ancillary products, such as insurance, wealth management and real-estate brokerage, and the support from the jointly owned SpareBank 1 Gruppen.

Good Cost Efficiency

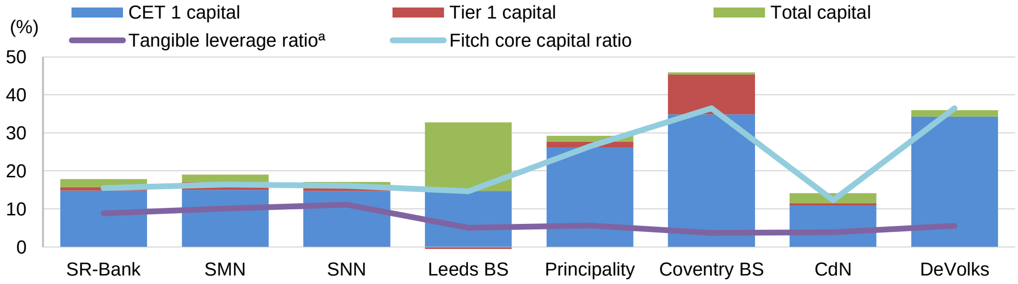
Cost efficiency compares favourably with international peers and remains a strong focus for the management teams. LICs are generally low, averaging below 20% of pre-impairment profit from 2015-2018. They have been decreasing gradually since 2016, from 27% for SR-Bank and 21% for SMN, due to oil-related exposures.

Capitalisation and Leverage

Solid metrics

The Sparebanken's capital ratios compare well with those of international peers, despite Norwegian floors on the computation of risk weights. The use of internal ratings-based models is marginal, as highlighted by strong leverage ratios in a European context. Reported Basel leverage ratios ranged from 7.2% (SNN) to 7.7% (SR-Bank) at end-2018, compared with a minimum regulatory requirement of 5% (for non-domestic systemically important banks in Norway). SNN has a stronger capital position than its Sparebanken peers', primarily thanks to lower leverage. Unreserved impaired loans were less than 6% of Fitch Core Capital for the three banks at end-2018, a low level.

Capitalisation
End-June 2018



[a] Tangible leverage ratio: Tangible common equity/tangible assets
End-2017 for Coventry, Principality
Source: Fitch Ratings, Banks

The Sparebanken have been building buffers over their minimum regulatory requirements, and Fitch expects these to be maintained, even taking into account the recently announced increase in the counter-cyclical buffer requirement to 2.5% from 2.0% (effective 31 December 2019). The three banks target a common equity Tier 1 (CET1) ratio of at least 14.5% (SNN), including a management buffer, and 14.7% (SR-Bank, SMN), depending on their respective Pillar 2 requirements.

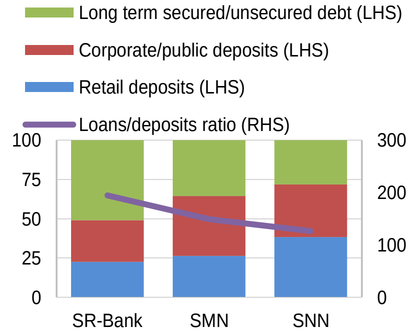
In December 2018, SR-Bank and SMN announced that following the 2018 supervisory review and evaluation process (SREP), their Pillar 2 requirements would marginally decrease to 1.7% (from 2.0%) and to 1.9% (from 2.1%), respectively. The total regulatory requirements currently amount to 13.5% (SNN, 2016 SREP), 13.9% (SMN, 2018 SREP) and 13.7% (SR-Bank, 2018 SREP), including respective Pillar 2 requirements.

Funding and Liquidity

Funding Profile Sensitive to Investor Confidence

The Sparebanken rely on wholesale funding to varying degrees, with SNN's funding mix being slightly more deposit based. All of the Sparebanken use covered bonds funding through S1B and S1N, although due to the ownership structure of these issuing entities, their balance sheets are not fully consolidated, meaning that full indirect use of wholesale funding is not included in the Sparebanken's financial reporting. At end-2018, the Sparebanken had transferred up to around 30% (SNN) of total lending to S1B and S1N.

Non-Equity Funding Mix
End-2018 (%)



Source: Fitch Ratings, Banks

The Sparebanken's funding profiles benefit from stable regional deposit franchises, with loan/deposit ratios ranging from about 130% (SNN) to 190% (SR-Bank). For SR-Bank, retail deposits account for a lower proportion of its overall deposit base compared with SMN and SNN.

In 2015, SR-Bank established its own 100%-owned covered bond vehicle, SR-Boligkreditt, and this has now become its primary issuer of covered bonds, having bought NOK58.8 billion loans from the bank at end-2018. Fitch does not expect this to fundamentally alter the shape of SR-Bank, with transferred loans still within Norwegian covered bonds legislation. SMN and SNN have continued to exclusively use S1B for mortgage covered bond funding.

Fitch expects the Sparebanken to continue to retain access to the capital markets, particularly for covered bond issuance. However, the relatively small size of Norway's domestic funding market means that covered bonds are predominantly issued abroad. SR-Bank, as the largest senior unsecured issuer among the Sparebanken, has also had to diversify internationally. While international funding creates a larger investor base, this could prove less reliable in times of stress. Fitch believes the Sparebanken will retain significant liquidity portfolios to mitigate the risk.

The banks' liquidity portfolios predominantly consist of highly rated ('AA' or higher) Nordic covered bonds and other central bank-eligible assets. Contingent liquidity sources include loan sales to respective covered bond companies, and central bank repo facilities. The Sparebanken conduct internal stress tests and maintain sufficient liquidity to be able to continue to operate without access to the wholesale markets for 12 months, based on their assumptions. The liquidity coverage ratios were 167% for SR-Bank, 172% for SNN and 183% for SMN at end-2018.

Support

Resolution Legislation Implemented

On 1 January 2019, Norwegian legislation was amended to implement the EU's Bank Recovery and Resolution Directive. Fitch believes that, as a result, senior creditors will no longer be able to rely on receiving full extraordinary support from the sovereign in the event that any of these banks becomes non-viable. In line with our approach for EU banks, we assign Support Ratings of '5' and Support Rating Floors of 'No Floor' for the Sparebanken.

Debt Ratings

The ratings of SR-Bank, SMN and SNN's senior unsecured debt are equalised with the banks' Issuer Default Ratings. SMN's and SR-Bank's subordinated debt instruments are rated one notch below the banks' respective VRs for loss severity, reflecting our expectation of below-average recovery prospects relative to senior unsecured creditors. No notching is applied for incremental non-performance risk because a write-down of the notes will only occur once the point of non-viability is reached and there is no coupon flexibility before non-viability.