

Credit Opinion: Sparebanken Hedmark

Global Credit Research - 20 Jan 2012

Hamar, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A1/P-1
Bank Financial Strength	C-
Baseline Credit Assessment	(Baa1)
Adjusted Baseline Credit Assessment	(Baa1)

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Opinion

SUMMARY RATING RATIONALE

Moody's rates Sparebanken Hedmark A1/C-/P-1. The C- bank financial strength rating (BFSR), which translates into a baseline credit assessment (BCA) of Baa1, reflects Sparebanken Hedmark's sound local franchise, sound capital levels and resilient retail business. However, the rating is primarily constrained by the bank's limited geographic outreach and some borrower and industry concentration in its loan book.

Sparebanken Hedmark's global local currency (GLC) deposit rating of A1 receives a three-notch uplift from its Baa1 BCA. This is based on our assessment of a very high probability of systemic support for the bank if necessary. This reflects its importance to the Norwegian market and its membership of the SpareBank 1 Alliance, although we only factor in a low probability of support from SpareBank 1 Alliance.

Credit Strengths

- Solid market position and brand recognition in the county of Hedmark, eastern Norway
- Sound capitalisation
- Benefits of membership of the SpareBank 1 Alliance in terms of cross selling opportunities, shared operations and risk management practices
- Funding profile underpinned by a large deposit base

- Resilient earnings from retail banking operations

Credit Challenges

- Core profitability under pressure in the competitive Norwegian banking market
- Asset quality vulnerable to potential house price falls or rising interest rates
- High credit risk concentration, albeit somewhat lower than most of Nordic rated peers

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

An upgrade of the BFSR or the GLC deposit rating could be triggered by: (i) a sustained improvement in core banking earnings; or (ii) some reduction in the bank's credit risk concentrations.

What Could Change the Rating - Down

The BFSR could be downgraded if there is: (i) any deterioration in asset quality or capitalisation that exceeds Moody's expectations; (ii) any change in the risk profile of the bank; or (iii) any sign that the bank is unable to sustain its market positions. The GLC deposit rating could be downgraded if: (i) the BFSR deteriorates; or (ii) Moody's current assessment of the probability of systemic support for the bank declines.

Recent Results

Sparebanken Hedmark reported pre-tax income of NOK457 million in Q1-Q3 2011, down from NOK642 million in the corresponding period of 2010. The lower result is mainly explained by lower income from financial investment (-60% or -35% when adjusting for the NOK124 million one-off gain from the Nordito-PBS merger in 2010). Core banking earnings in the form of net interest income and fee and commission income were up 5%, chiefly supported by modest volume growth as well as a more efficient liquidity allocation. Excluding the one-off positive effect from the change in the pension legislation in 2010, operating expenses were flat year-on-year. Loan loss provisions were slightly higher than in the corresponding 2010 period. The bank's Tier 1 ratio stood at 14.2% at end-September 2011.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Sparebanken Hedmark's currently assigned ratings are:

Bank Financial Strength Rating

BFSR is two notches lower than the C+ outcome of Moody's bank financial strength scorecard. Based on Moody's loss expectations for Sparebanken Hedmark's loan portfolio as well as high credit risk concentration, we believe that the bank's financial strength is more consistent with a C- BFSR.

Qualitative Factors (50% weighting)

Franchise Value

Trend: Neutral

Sparebanken Hedmark is a regional savings bank with a sound market position in eastern Norway in the county of Hedmark, where Moody's estimates it commands market shares of almost 40% for lending and

around 50% for deposits. Though we acknowledge the bank's dominant position in its home county and are mindful that the competition in Hedmark is less fierce than in other regions in Norway, we note that the size of the market where it operates is very limited and its national market share is marginal, just above 1%.

In addition, Sparebanken Hedmark's franchise value benefits from its membership in the SpareBank 1 Alliance, which consists of 17 savings banks across Norway, together constituting one of the leading banking groups in Norway. The SpareBank 1 brand enjoys strong name recognition in a wide range of segments including fund management, life and non-life insurance. These are provided by joint product companies owned by SpareBank 1 Gruppen (Baa1/P-2, a holding company owned by the member banks including Sparebanken Hedmark which owns 12%) and distributed by the member banks.

Moody's notes that, in December 2011, one of the SpareBank 1 banks (SpareBank 1 SR-Bank, rated A1/C-/P-1) has converted to a limited liability company (ASA) from an equity certificate company. While we do not expect this to result in any material change in the Alliance's strategy, we will continue to monitor the change and its effect on the dynamics of the Alliance.

Despite Sparebanken Hedmark's strong presence in its home county, the D+ score for franchise value is constrained by the bank's low geographic diversification.

Risk Positioning

Trend: Neutral

Sparebanken Hedmark is organised as independent entity without external owners. The highest body, the Committee of Representatives, is comprised of 40 depositors, employees and public appointees and is responsible for electing the Board of Directors members. The CEO is not a member of the Board of Directors, which consists of 7 members. We note that risk management is an independent function although it reports to the CEO and not directly to the board. In addition, Sparebanken Hedmark benefits from SpareBank 1 Alliance's focus on credit risk modelling and from the fact that members of the Alliance continue to learn from each other's best practices. In our view, the quality of financial reporting is good compared with that of its peers.

Moody's views Sparebanken Hedmark's market risk appetite as limited. The bank's internal limit for interest rate risk is NOK45 million in relation to a 1% change in interest rates, its maximum level of equity investments is set at NOK150 million and it targets gross foreign currency positions below NOK200 million. Overall, Sparebanken Hedmark's market risk appetite, as measured by the aforementioned internal limits, is capped at some 10% of its YE 2010 Tier 1 capital. According to the same measures, the actual market risk at YE 2010 was below 4% of Tier 1 capital. In the past years, some further volatility has arisen from the bank's investments in related companies, primarily SpareBank 1 Gruppen (12%), BNBANK (stake sold in 2009) and Bank 1 Oslo (12%).

Sparebanken Hedmark scores C for risk positioning, with its high credit risk concentration its main constraining factor.

Regulatory Environment

For a discussion about the regulatory environment, please see Moody's Banking System Outlook on Norway.

Operating Environment

Trend: Neutral

The operating environment score takes into account the economic stability, integrity and corruption in the country as well as the legal system. The unadjusted score for Norway's operating environment is B and is

constrained by a score of C for economic stability, primarily as a result of volatility in oil prices. To reflect the fact that offshore revenues are allocated to the Government Pension Fund and have a limited impact on the mainland economy, we calculate the score for economic stability as the average of the standard deviations of GDP growth both including (25% weight) and excluding offshore revenue (75% weight), which results in an adjusted score of B. Consequently, the adjusted score for operating environment is B+. For further discussion of the operating environment, please see Moody's latest Banking System Outlook on Norway.

Quantitative Factors (50% weighting)

Profitability and Efficiency

Trend: Weakening

Sparebanken Hedmark is reliant on net interest income, which has represented around 70% of its operating income in recent years. We note that net interest income has been supported by some relatively good growth in the loan book (approximately 7% in 2009, 8% in 2010 and 5% Q1-Q3 2011, including loans transferred to SpareBank 1 Boligkreditt). We also believe less intense competition in Hedmark has helped keeping net interest margins somewhat higher than the national average. Fee and commission income has been growing steadily in recent years due to continued successful product cross-selling and higher commissions received from mortgages transferred to the covered bond company. As most of its European peers, Sparebanken Hedmark experienced volatility in its earnings as a result of variations in the value of its financial investments.

Sparebanken Hedmark's efficiency as measured by its cost-to-income ratio is relatively good at just above 50%. The impact of loan loss provisions on earnings remains low and has improved over the last few years. We do however note that gross doubtful and impaired commitments remain relatively high at 2.5% at end-Q3 2011.

Sparebanken Hedmark's profitability score of C compares well with those of its European peers. However, we believe these good levels will be difficult to maintain, especially as it is highly uncertain whether the high contribution from the securities will be repeated, and therefore assign a weakening trend.

Liquidity

Trend: Neutral

Sparebanken Hedmark's liquidity is underpinned by a large deposit base, which accounts for almost two thirds of total funding, and retail deposits that represent over 60% of total deposits. At end-Q3 2011 the deposit-to-gross loan ratio was around 70%, meaning the bank is somewhat reliant on market funding, albeit relatively less than its Norwegian rated peers. In addition, Sparebanken Hedmark benefits from access to covered bonds, jointly with other members of the SpareBank 1 Alliance through SpareBank 1 Boligkreditt.

In 2011 Sparebanken Hedmark issued NOK2.15 billion senior unsecured funding with maturities ranging between 1-7 years. Furthermore by Q3 2011 Sparebanken Hedmark had transferred retail mortgages worth NOK8.5 billion to SpareBank 1 Boligkreditt.

The SpareBank 1 banks have also established a company issuing covered bonds backed by commercial mortgage loans, SpareBank 1 Næringskreditt, but so far most of the loans transferred to the entity are from BNbank.

At end-Q3 2011 liquid assets accounted for around 15% of total assets and comprised cash and deposits with the central bank and the securities portfolio, which mainly comprise senior bonds and covered bonds

from financial institutions as well as other issuers and a limited amount of equity investments. We note that holdings are concentrated on Norwegian securities, which could be a source of vulnerability from a concentration risk point of view. Sparebanken Hedmark' score for liquidity is C-. It primarily reflects its high reliance on market funds, which we expect to continue, hence the neutral trend.

Capital Adequacy

Trend: Neutral

Sparebanken Hedmark exhibits one of the strongest capitalisation amongst its Norwegian rated peers. At end-Q3 2011, the Tier 1 ratio, as calculated under Basel II's standardised approach, stood at 14.2%. The bank's Tier 1 capital does not include hybrid capital. The bank did not need to increase its capital over the financial crisis, unlike many of its European peers, and we assess its current capital buffer to be adequate to withstand potential credit losses. Sparebanken Hedmark applies Basel II standard approach in calculating its capital adequacy requirement for credit risk.

Sparebanken Hedmark scores A for capital adequacy. We expect the bank will seek to maintain the current capital levels and thus hold a neutral trend for this factor.

Asset Quality

Trend: Weakening

Sparebanken Hedmark's loan portfolio benefits from a substantial proportion of retail loans, mostly in the form of mortgages (around 60% excluding loans transferred to SpareBank 1 Boligkreditt and almost 70% including them). However, it comprises a sizeable exposure to property management and construction approximately 14%, which we assess as relatively more volatile sectors. The rest of the portfolio is mainly to SMEs and diversified across industries. The bank also exhibits high borrower concentration, albeit somewhat lower than most of its Nordic rated peers.

Asset quality metrics have deteriorated somewhat in recently as loan losses rose to NOK24 million in Q3 2011 from NOK18 million in the equivalent period of 2010 but remain lower than most European peers. Loan loss reserve coverage decreased to 40% of problem loans at end-Q3 2011. We also caution household indebtedness has increased in recent years, making customers more vulnerable to interest rates rises, although we take comfort in the still low unemployment levels in Norway. Overall, we believe Sparebanken Hedmark's asset quality metrics and therefore consider the trend to be weakening.

The score for asset quality is C+. While we positively view Sparebanken Hedmark' sound asset quality, we caution that the sustained increase in house prices in Norway may have underrated the level of impairment by inflating collateral value.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A1 to Sparebanken Hedmark. The rating is supported by its Baa1 BCA and the Aaa local currency deposit ceiling of Norway, which is considered the underlying support provider. Given the bank's importance to its region, and the region's importance to the national economy of Norway, Moody's assesses as high the probability of systemic support in the event of a stress situation. We are however likely to gradually reduce such unusual support uplift as such support mechanisms are phased out, as banks' stand-alone profiles improve, and as regulators globally consider implementing bank resolution regimes.

Foreign Currency Deposit Rating

Foreign currency deposit ratings are unconstrained given that Norway has a country ceiling of Aaa. Sparebanken Hedmark's foreign currency deposit rating is A1.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Ratings

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. An Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C	
Factor: Franchise Value						D+	Neutral
Market Share and Sustainability			x				
Geographical Diversification					x		
Earnings Stability			x				
Earnings Diversification [2]							
Factor: Risk Positioning						C	Neutral
Corporate Governance [2]	--	--	--	--	--		
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management		x					
- Risk Management			x				
- Controls	x						
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
Credit Risk Concentration	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management			x				
Market Risk Appetite		x					
Factor: Operating Environment						B+	Neutral
Economic Stability		x					
Integrity and Corruption		x					

Legal System	x						
Financial Factors (50%)						C+	
Factor: Profitability						C	Weakening
PPI / Average RWA - Basel II			2.07%				
Net Income / Average RWA - Basel II			1.24%				
Factor: Liquidity						C-	Neutral
(Mkt funds-Liquid Assets) / Total Assets				16.89%			
Liquidity Management			x				
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio - Basel II	13.57%						
Tangible Common Equity / RWA - Basel II	17.67%						
Factor: Efficiency						C	Neutral
Cost / Income Ratio			58.49%				
Factor: Asset Quality						C+	Weakening
Problem Loans / Gross Loans			2.03%				
Problem Loans / (Equity + LLR)		13.37%					
Lowest Combined Score (15%)						C-	
Economic Insolvency Override						Neutral	
Aggregate Score						C	
Assigned BFSR						C-	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral



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