

**Credit Opinion: Sparebanken Hedmark**

Global Credit Research - 11 Dec 2012

Hamar, Norway

**Ratings**

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*A1/P-1
Bank Financial Strength	C-
Baseline Credit Assessment	(baa1)
Adjusted Baseline Credit Assessment	(baa1)

\* Rating(s) within this class was/were placed on review on March 9, 2012

**Contacts**

Analyst	Phone
Soline Poulain/London	44.20.7772.5454
Richard (Blake) B. Foster/London	
Simon Harris/London	

**Key Indicators**

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

	[2]9-12	[2]12-11	[2]12-10	[2]12-09	[2]12-08	Avg.
Total Assets (NOK billion)	43.3	43.2	41.8	41.5	42.4	[3]0.5
Total Assets (EUR million)	5,877.3	5,581.5	5,354.4	5,006.0	4,355.6	[3]7.8
Total Assets (USD million)	7,561.1	7,245.5	7,183.1	7,182.4	6,054.5	[3]5.7
Tangible Common Equity (NOK billion)	5.4	5.1	4.9	4.5	3.8	[3]9.5
Tangible Common Equity (EUR million)	736.3	658.6	632.0	537.8	387.2	[3]17.4
Tangible Common Equity (USD million)	947.3	854.9	847.8	771.5	538.3	[3]15.2
Net Interest Margin (%)	2.3	2.4	2.3	2.1	2.4	[4]2.3
PPI / Avg RWA (%)	1.9	1.9	2.8	2.2	1.2	[5]2.0
Net Income / Avg RWA (%)	1.8	1.4	2.5	1.1	0.1	[5]1.4
(Market Funds - Liquid Assets) / Total Assets (%)	17.5	21.8	23.5	25.9	27.0	[4]23.1
Core Deposits / Average Gross Loans (%)	79.7	74.7	71.4	67.0	66.1	[4]71.8
Tier 1 Ratio (%)	13.8	14.8	15.1	14.1	11.5	[5]13.9
Tangible Common Equity / RWA (%)	21.5	19.3	19.7	18.0	15.3	[5]18.8
Cost / Income Ratio (%)	64.2	63.6	50.3	55.6	69.6	[4]60.6
Problem Loans / Gross Loans (%)	1.9	2.4	2.4	2.2	1.4	[4]2.1
Problem Loans / (Equity + Loan Loss Reserves) (%)	10.8	14.4	14.7	14.9	10.5	[4]13.1

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel II & IFRS reporting periods have been used for average calculation

## Opinion

### RECENT CREDIT DEVELOPMENTS

On 6 December 2012 Moody's confirmed Sparebanken Hedmark's C- /baa1 standalone credit assessment and its A1 long-term senior debt ratings. The confirmation of the bank's ratings mainly reflects Moody's view that Sparebanken Hedmark's retail-focus (close to 60% of on-balance-sheet loans were to private customers at end-September 2012) renders it less susceptible to a deterioration in asset quality, especially given our expectation that interest rates and unemployment will continue to support borrowers' repayment capacities in the foreseeable future. In addition, we take comfort from Sparebanken Hedmark's large deposit base (around 75% of total funding at end-September 2012) and its Tier 1 ratio, which at 13.8% (IRB including transitional arrangements, excluding year to date profit) at end-September 2012, is higher than that of many of its rated peers. However, we continue to see downside risks in the banks' concentrated corporate book, in particular its sizeable exposure to the real estate and construction sectors (18% of on-balance-sheet loans at end-September 2012).

Following the rating downgrades of three of the four rated members of the SpareBank 1 alliance, Moody's placed Sparebanken Hedmark's A1 long-term debt and deposit ratings under review for downgrade. During the review period, Moody's will assess the impact of alliance members' reduced credit strengths on their ability to provide support to each other. Currently the ratings agency expects that the banks' debt ratings may be lowered by up to one notch.

Unless otherwise stated, all figures shown are from the bank's annual and interim financial reports.

### SUMMARY RATING RATIONALE

Sparebanken Hedmark's current C- BFSR, which maps to baa1 on the long-term scale, reflects Sparebanken Hedmark's robust local franchise, sound capital levels and stable retail banking operations but are constrained by the bank's limited geographic reach and some borrower and industry lending concentrations.

Sparebanken Hedmark's current 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 high probability of systemic support for the bank if necessary and its importance to the Norwegian market. Moody's is however likely to gradually reduce such unusual support uplift as regulators globally consider implementing bank resolution regimes. Furthermore, we factor in support from its membership of the SpareBank 1 Alliance, although we assess the probability of support from the Alliance as low.

#### Rating Drivers

- Robust local retail franchise in the Hedmark county in eastern Norway
- Sound capital position and adequate asset quality, albeit somewhat weaker than peers
- Fierce competition in Norway undermining the bank's ability to sustain current better-than-average profitability
- High credit risk concentration to single borrowers and high real estate exposures
- Benefits of membership in the SpareBank 1 Alliance in terms of cross selling opportunities, shared operations and risk management practices

#### Rating Outlook

Sparebanken Hedmark's baa1 BCA carries a stable outlook. The bank's A1 long-term debt and deposit ratings are under review for downgrade, as Moody's reassesses the availability of support from other banks in the SpareBank 1 alliance in light of the recent rating downgrades of three of the four rated members of the SpareBank 1 alliance.

#### What Could Change the Rating - Up

Rating upgrades are unlikely in the near future, for the reasons described in the "Recent Credit Development" section above. A limited amount of upward rating momentum could develop if Sparebanken Hedmark demonstrates (i) sustained good asset quality in its retail and corporate loan books, including in the more volatile segments, (ii) continued good access to capital markets and improved liquidity position, and/or (iii) stronger earnings generation without an increase in its risk profile.

## What Could Change the Rating - Down

While the current standalone rating already incorporates a degree of expected further deterioration, it could decline further if (i) Sparebanken Hedmark's asset quality deteriorates more than we anticipate, (ii) financing conditions become more difficult and/or (iii) its risk profile increases, for example as a result of increased exposures to more volatile sectors.

Downwards pressures on the bank's debt ratings are more imminent, as reflected by the current review for downgrade. Debt ratings could be downgraded if Moody's assesses that the availability of support from other banks in the SpareBank 1 alliance has been reduced.

## Recent Results

Sparebanken Hedmark reported pre-tax income of NOK439 million in Q1-Q3 2012, a slight decrease from NOK457 million in Q1-Q3 2011. The stable performance of core banking income (net interest income and commission income from mortgages transferred to SpareBank 1 Boligkreditt were 4% higher in Q1-Q3 2012 than in the corresponding 2011 period) and income from the newly-consolidated accounting subsidiary Consis AS were more than offset by lower income from financial investments and increased expenses. Loan loss provisions remained at relatively low levels (NOK19 million).

Sparebanken Hedmark's Tier 1 ratio stood at 15.2% (including year to date profit) at end-September 2012.

## DETAILED RATING CONSIDERATIONS

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

### Bank Financial Strength Rating

The assigned BFSR is one notch 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.

#### -- Well Established Regional Franchise

With regional loan and deposit market shares of 34% and 49% accordingly, Norwegian savings bank Sparebanken Hedmark is enjoying a sound local market position. The bank is operating from the county of Hedmark in eastern Norway where competition is slightly less fierce than in the rest of Norway. The national market share is however notably smaller at roughly 1-1.5%.

Counteracting some of the competitive powers from other savings banks and the National champion bank DNB is the membership in the SpareBank 1 Alliance, consisting of 17 savings banks across Norway. The banks in the Sparebank 1 Alliance together owning the holding company SpareBank 1 Gruppen are collaborating regarding products, distribution and risk management among other areas.

In January 2012, one of the SpareBank 1 banks (SpareBank 1 SR-Bank, rated A2/C-/P-1, under review for downgrade) was 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 but continue to monitor the development of the group.

The main constraint for the assessment of Sparebanken Hedmark's franchise value is the limited geographical diversification outside of its home county.

#### -- Relatively High Usage of Market Funding

Sparebanken Hedmark's deposit base, where 65% are retail deposits, accounts for almost two thirds of total funding and provides a good funding basis. Even though the reliance on wholesale funding is gradually decreasing, it is still notable with a loan-to-deposit ratio of around 140%, although less than many Norwegian peers.

Sparebanken Hedmark benefits from access to covered bond markets, together with the other members of SpareBank 1 Alliance, through SpareBank 1 Boligkreditt covered bonds backed by residential mortgages) and SpareBank 1 Næringskreditt (covered bonds backed by commercial mortgages). Furthermore by year-end 2011 Sparebanken Hedmark had transferred retail mortgages worth NOK9.9 billion to SpareBank 1 Boligkreditt.

At year end 2011 liquid assets accounted for around 15% of total assets and comprised cash and deposits with the central bank and the securities portfolio (which includes senior bonds, covered bonds and limited 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's liquidity is generally more geared toward market funding than that of its European peers, but somewhat less than many of its Nordic peers. In addition, in common with other SpareBank 1 banks, we positively note the bank's good liquidity management and its access to the covered bond market.

#### -- Passable Asset Quality And Strong Capitalisation

Asset quality metrics are stable with problem loans at around 2.4% of total loans, a comparatively high level compared to its Norwegian peers. Loan loss reserve coverage was 40% of problem loans at year-end 2011, in line with 2010.

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). While the performance in the bank's retail book has been particularly strong so far, we believe it could be undermined by less favourable interest rate and house price levels - especially as the mortgage loans remaining on the bank's balance sheet have higher loan-to-values than those transferred to the Alliance's covered bond vehicles. 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.

However, the property management and construction exposure, which we deem vulnerable to a macro economic downturn and increasing interest rates, is sizable at approximately 17% of on-balance-sheet loans. 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.

Sparebanken Hedmark exhibits one of the strongest capitalisation amongst its Norwegian rated peers. At year-end 2011, the Tier 1 ratio (standardised approach) stood at 14.8%.

We caution that the sustained increase in house prices in Norway may have underrated the level of impairment by inflating collateral value which could have a negative impact on the asset quality of Norwegian banks. Overall Sparebanken Hedmark currently benefit from satisfactory asset quality and has a good capital base to protect from potential larger losses in an adverse scenario.

#### -- Competitive Pressures On Profitability

Sparebanken Hedmark is reliant on net interest income, which represents around 70% of its operating income. To some extent, the somewhat less intense competition in Hedmark has continued to keeping net interest margins higher than the national average.

Fee and commission income has been growing in recent years partly reflecting the fact that net interest income on some mortgages have been reported as commissions after being transferred to SpareBank 1 Boligkreditt.

Cost efficiency is relatively good, given the retail-focused business mix, at just above 60% (although we note it increased from 2010 when the ratio was underrated due to one-off items). Loan losses have remained low in recent years but this good level could be difficult to sustain in a less favourable operating environment.

Overall, Sparebanken Hedmark's profitability (measured against average risk-weighted assets) is somewhat stronger than that of many of its Norwegian peers but we caution that the bank's net profitability is vulnerable to deterioration in asset quality.

#### **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. Furthermore, Sparebanken Hedmark also benefits from a low probability of support from SpareBank 1 Alliance.

## **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
<b>Qualitative Factors (50%)</b>						<b>C</b>	
<b>Factor: Franchise Value</b>						<b>D+</b>	<b>Neutral</b>
Market Share and Sustainability			x				
Geographical Diversification					x		
Earnings Stability			x				
Earnings Diversification [2]							
<b>Factor: Risk Positioning</b>						<b>C-</b>	<b>Neutral</b>
<b>Corporate Governance [2]</b>	--	--	--	--	--		
- Ownership and Org. Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
<b>Controls and Risk Management</b>		x					
- Risk Management			x				
- Controls	x						
<b>Financial Reporting Transparency</b>		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
<b>Credit Risk Concentration</b>	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
<b>Liquidity Management</b>				x			
<b>Market Risk Appetite</b>		x					
<b>Factor: Operating Environment</b>						<b>A-</b>	<b>Neutral</b>
<b>Economic Stability</b>		x					
<b>Integrity and Corruption</b>	x						
<b>Legal System</b>	x						
<b>Financial Factors (50%)</b>						<b>C</b>	
<b>Factor: Profitability</b>						<b>C</b>	<b>Weakening</b>
PPI / Average RWA- Basel II			2.30%				
Net Income / Average RWA- Basel II			1.68%				
<b>Factor: Liquidity</b>						<b>D</b>	<b>Neutral</b>
(Market funds - Liquid Assets) / Total Assets				13.42%			
<b>Liquidity Management</b>				x			

<b>Factor: Capital Adequacy</b>						<b>A</b>	<b>Neutral</b>
Tier 1 Ratio - Basel II	14.67%						
Tangible Common Equity / RWA - Basel II	18.99%						
<b>Factor: Efficiency</b>						<b>C</b>	<b>Neutral</b>
Cost Income ratio			56.46%				
<b>Factor: Asset Quality</b>						<b>C+</b>	<b>Weakening</b>
Problem Loans / Gross Loans			2.37%				
Problem Loans / (Shareholders' Equity + Loan Loss Reserves)		14.66%					
Lowest Combined Financial Factor Score (15%)						<b>D</b>	
<i>Economic Insolvency Override</i>						<b>Neutral</b>	
<b>Aggregate Score</b>						<b>C</b>	
<b>Assigned BFSR</b>						<b>C-</b>	

[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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