

**ISSUER IN-DEPTH**

15 January 2018

Rate this Research


**RATINGS**
**SpareBank 1 SR-Bank ASA**

LT Senior Unsecured	A1 negative
LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

**SpareBank 1 SMN**

LT Senior Unsecured	A1 negative
LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

**SpareBank 1 Ostlandet**

LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

**SpareBank 1 Nord-Norge**

LT Senior Unsecured	A1 negative
LT Deposits	A1 negative
Baseline Credit Assessment	baa1
CR Assessmen (LT/ST)	Aa3(cr) / P-1(cr)

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## SpareBank 1 SR-Bank, SpareBank 1 SMN, SpareBank 1 Ostlandet and SpareBank 1 NN

FAQ: Sparebank 1 banks illustrate Moody's approach to non-consolidated covered bonds

The four rated Sparebank 1 Alliance savings banks ([SpareBank 1 SR-Bank](#), [SpareBank 1 SMN](#), [SpareBank 1 Ostlandet](#) and [SpareBank 1 Nord-Norge](#)) in Norway (Aaa stable) do not consolidate their covered bond loans into their financial statements. This is because the banks issue covered bonds through jointly-owned companies that none of them individually hold a majority stake in. However, we incorporate the assets and liabilities associated with these instruments in the banks' balance sheets in our credit analysis, as we believe this better captures the Sparebank 1 Alliance banks' true financial and economic position. Below we answer frequently-asked questions regarding the rationale for our approach, and the consequent adjustments we make to the banks' financials.

The four savings banks have traditionally issued covered bonds through their jointly-owned covered bond entities, SpareBank 1 Boligkreditt (residential mortgages loans) and SpareBank 1 Naeringskreditt (commercial real estate mortgages). Neither the assets transferred to these companies, nor the liabilities they issue, are consolidated into the banks' audited financial statements. The four banks' reported financial ratios are therefore not directly comparable with those of other Norwegian and global banks, which fully own their covered bond companies.

In our credit analysis we consolidate the banks' covered bonds reflecting the fact that the banks in practice retain the credit risk associated with the underlying mortgage loans, even though these are transferred on a "true sale" basis to the covered bond entities for accounting purposes. Our approach is underpinned by the fact that the banks have typically, in practice, replaced any loans in the cover bond pool that are more than 30 days overdue with new performing loans or those whose loan-to-value ratio has increased above a certain threshold. The consolidation of these loans therefore enables a direct comparison between these banks and their local/global peers, and allows for less qualitative adjustment on each of the banks' scorecards to derive their standalone credit profiles.

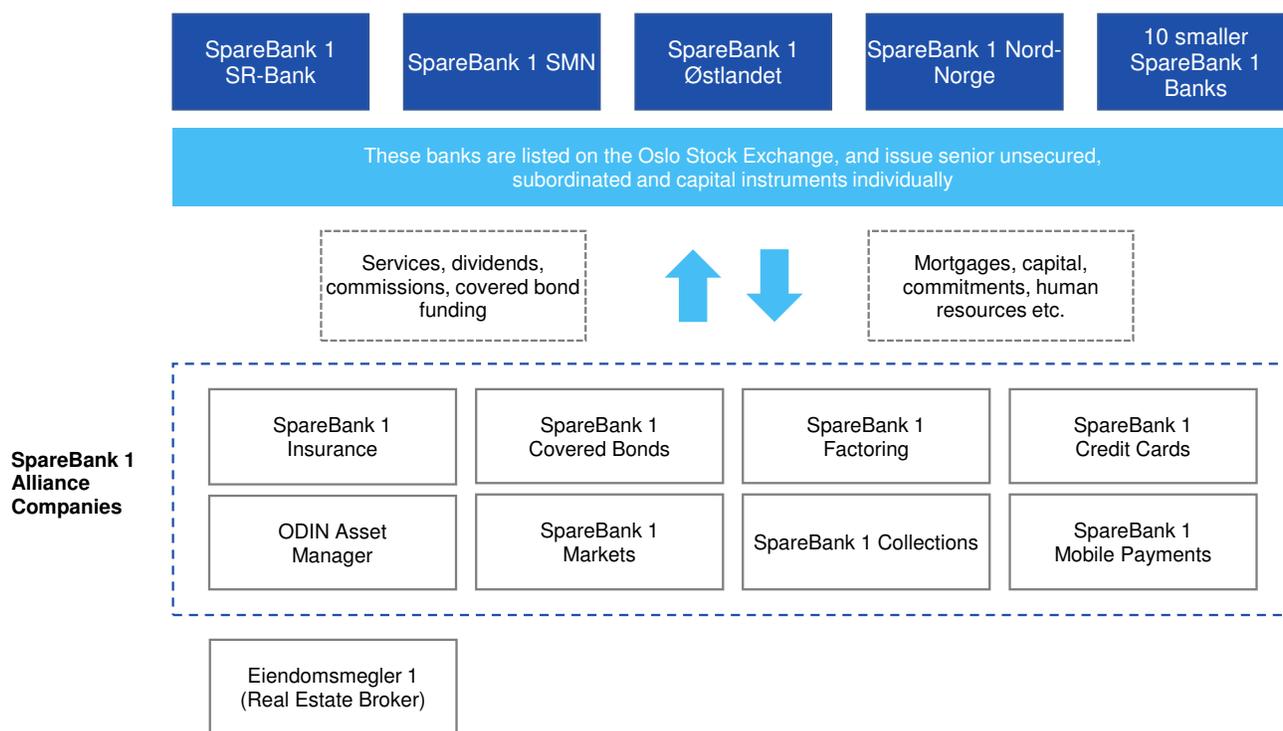
In general, our consolidation adjustments have not had any impact on the banks' fundamental credit standing, as the aforementioned adjustments made to their financial ratios have remained limited in scope. In particular, our assessment of asset risk, profitability, market funding, and liquidity have been affected only marginally.

### Why do the SpareBank 1 Alliance Banks not consolidate the covered bond loans issued by their jointly-owned covered bond companies?

The SpareBank 1 Alliance consists of 14 independent savings banks, which cooperate on branding and use a shared platform for other services, including their jointly-owned covered bond companies (see Exhibit 1). These entities are not majority-owned by any of the banks (the four rated Alliance banks have a combined shareholding of around 68% of SpareBank 1 Boligkreditt, the residential mortgage covered bond entity; see Exhibit 2). As a result, none of the Alliance banks records the mortgage loans that they transfer to the covered bond companies in their consolidated balance sheets. We believe this approach does not fully and accurately reflect the banks' true underlying financial position, nor the credit risks they face.

Exhibit 1

#### The SpareBank 1 Alliance cooperation creates efficiencies and scale benefits

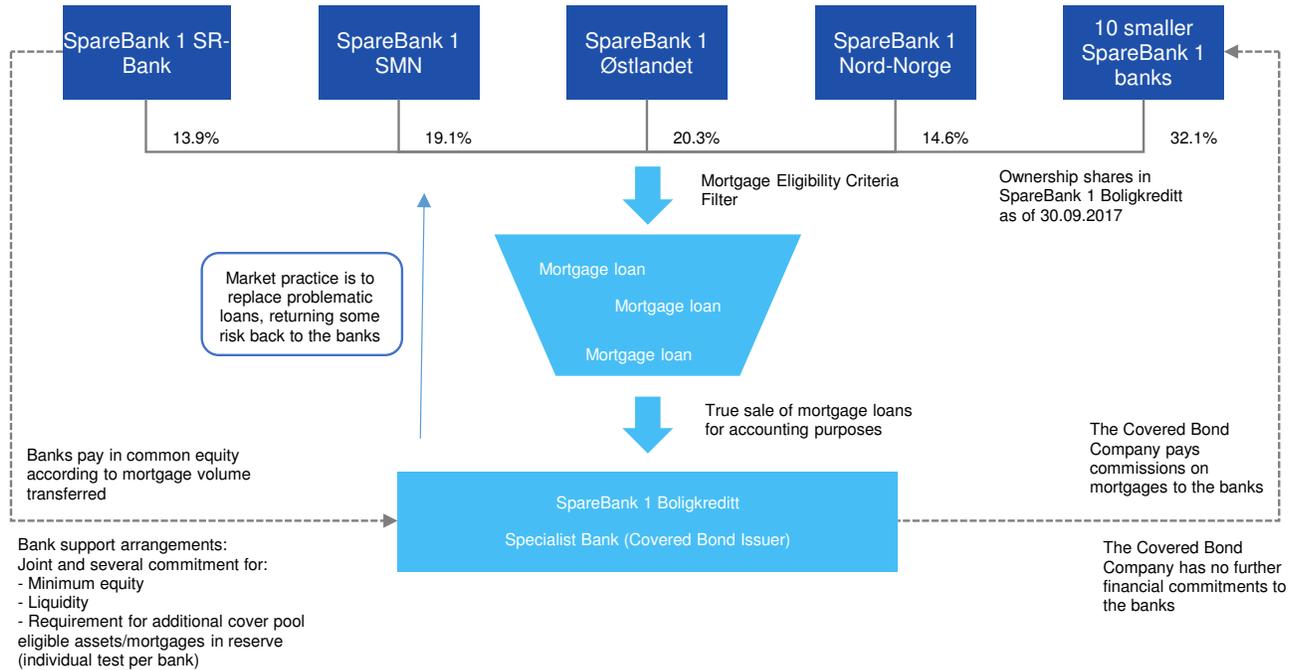


Source: Company reports and presentations

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Exhibit 2

**Sparebank 1 Boligkreditt is jointly owned by all 14 Alliance banks**



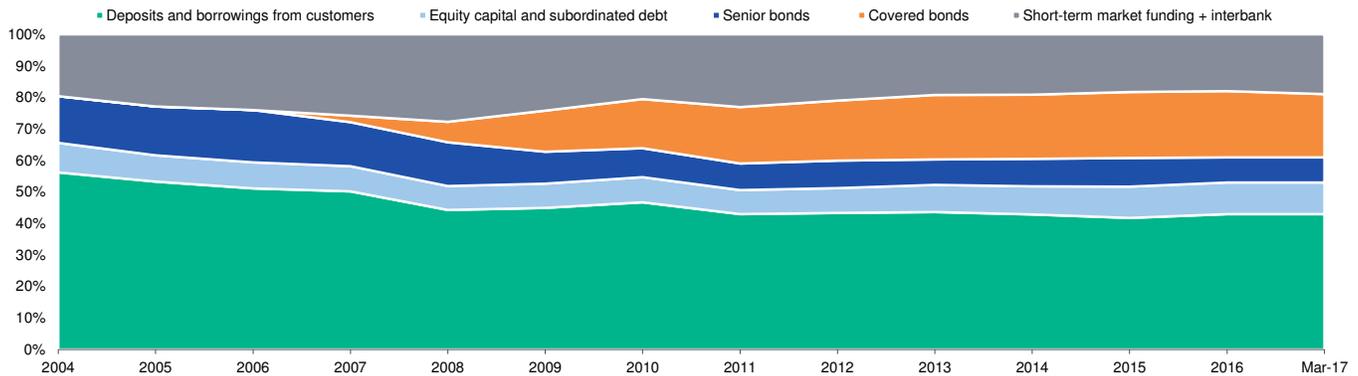
Source: Company reports and presentations

**How important is covered bond funding for these banks, and what is the advantage of using these specialist covered bond companies?**

Covered bonds are of significant importance in the funding structure of the Norwegian banking system (see Exhibit 3). Most rated Norwegian banks use wholly-owned companies to issue covered bonds, which are therefore fully consolidated into the banks' financial statements.

Exhibit 3

**Covered bond funding has become Norwegian banks' largest source of wholesale funding**



Source: Norwegian FSA

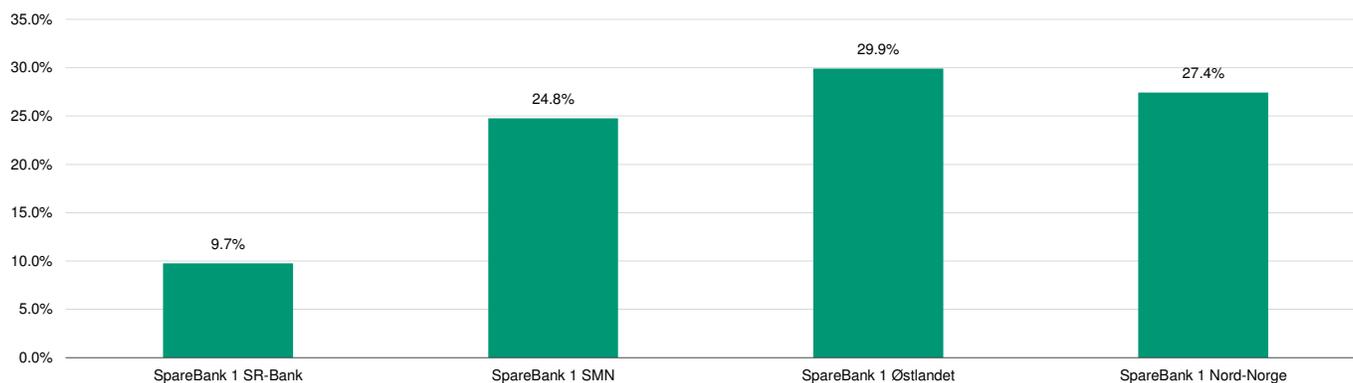
Covered bonds are a vital source of finance for the four rated SpareBank 1 Alliance Banks, funding around 23% of their total loans (including transferred loans) on average (see Exhibit 4). SpareBank 1 SR-Bank's lower reliance on SpareBank 1 Boligkreditt reflects the bank's decision in March 2015 to set-up a fully-owned covered bond company (SR-Boligkreditt AS) as part of its contingency funding plans. SpareBank 1 SR-Bank has since then channeled only part of its covered bond issuances through the jointly owned SpareBank 1

Boligkreditt entity, and has increasingly opted to use its own covered bond company in recent quarters. Including covered bonds issued through its own SR-Boligkreditt entity, the proportion of SpareBank 1 SR-Bank's loans (including transferred loans) funded by covered bonds stood at around 30% as of September 2017.

Exhibit 4

#### The banks transfer a high share of their gross loans to the jointly-owned covered bond companies

Transferred loans as a % total gross loans (including transferred loans)



Note: As of September 2017

Source: Company reports and presentations

Using SpareBank 1 Boligkreditt provides a funding cost benefit to the SpareBank 1 Alliance banks, as the company's proven track record in local and international markets helps attract strong investor interest in its bond issues. This makes the banks' covered bond funding more predictable and stable. Covered bonds are eligible for liquidity coverage ratio (LCR) purposes, and also qualify for repo transactions with the Norwegian central bank. Using SpareBank 1 Boligkreditt also allows banks to issue in a cost efficient manner, reflecting the company's scale and lean cost structure.

### Why does Moody's consolidate the banks' covered bond assets, and how are the necessary adjustments made?

We have consolidated both the loans transferred to, and the liabilities issued by, the jointly--owned covered bond companies into the banks' financial data for the last three years, including their latest quarterly 2017 results. This adjustment allows us to incorporate these items in our calculation of the four rated Alliance banks' financial metrics. We believe this provides a more accurate picture of their financial and economic position.

A key consideration behind this approach is that the Alliance banks, although not legally obliged to do so, have over the years voluntarily exchanged any loans transferred to the covered bond pool that become delinquent by 30 days or more with new performing loans. As a result, the underlying credit risk in practice remains with the banks at all times, even though these loans are transferred to the covered bond entities on a true sale basis. Alliance banks have a strong incentive to replace covered bond pool loans that become delinquent, as this helps avert potential solvency problems at the covered bond entities, which they are legally obliged to bail out.

The relationship between the covered bond companies and the banks is governed by bilateral contracts as well as Norwegian law. The legislation requires that covered bonds are issued by specialist credit institutions that must finance their lending primarily through covered bond issuance, while contractual arrangements stipulate that the owner banks must support these entities with equity and liquidity in times of stress. The owner banks must also hold a reserve of mortgages eligible for the cover pool, and use them to replace any mortgages that no longer meet the eligibility criteria. If the loan-to-value (LTV) ratio of the mortgages in the cover pool were to rise above 75%<sup>1</sup> because of a decline in house prices, then the margin paid to the banks is reduced by 50% for those loans, such that the banks are incentivized to replace the loans. As such, the banks have voluntarily replaced any loans exceeding an LTV of 75% in the past. We note however that the mortgages in the cover pool are consistently of prime quality, limiting downside risk for the Alliance banks.

Our practice of consolidating the covered bond loans of the SpareBank 1 Alliance banks also enables more consistent direct comparisons between these banks and their local and global peers, and allows for less qualitative adjustment and fine-tuning on each of the banks' scorecards to derive their standalone credit profile.

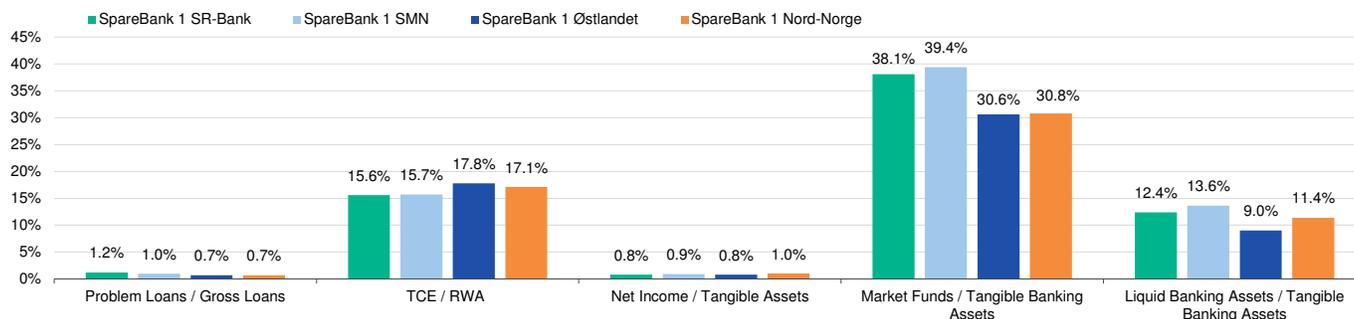
The consolidation adjustments we make generally involve adding the loans transferred to the covered bond entities back to the banks' loan books, and simultaneously adding the corresponding covered bonds to the banks' liabilities. We make a further adjustment affecting commissions on the transferred loans that the covered bond companies pay to the banks, which the banks report as part of their fee and commission income. These payments, calculated as the difference between the rate paid by the mortgage borrower and the bank's funding cost, are equivalent to the net income that the bank would have generated from the mortgage loan. We therefore deduct them from the banks' fee and commission income, and add them back to their net interest income. Covered bond companies also have the right to recover any credit losses on the purchased mortgages from the commissions they pay out to the banks.

### What impact do these adjustments have on the banks' financial ratios?

In general, the consolidation adjustments that we make have no impact on the SpareBank 1 Alliance banks' fundamental credit standing, despite some changes in the financial ratios we use in assessing their baseline credit assessments (BCA), a measure of their standalone creditworthiness. In particular, our assessment of asset risk, profitability, market funds, and liquidity are affected only marginally (see Exhibits 5 and 6).

Exhibit 5

#### Moody's BCA scorecard ratios with the consolidation of the covered bond assets and liabilities

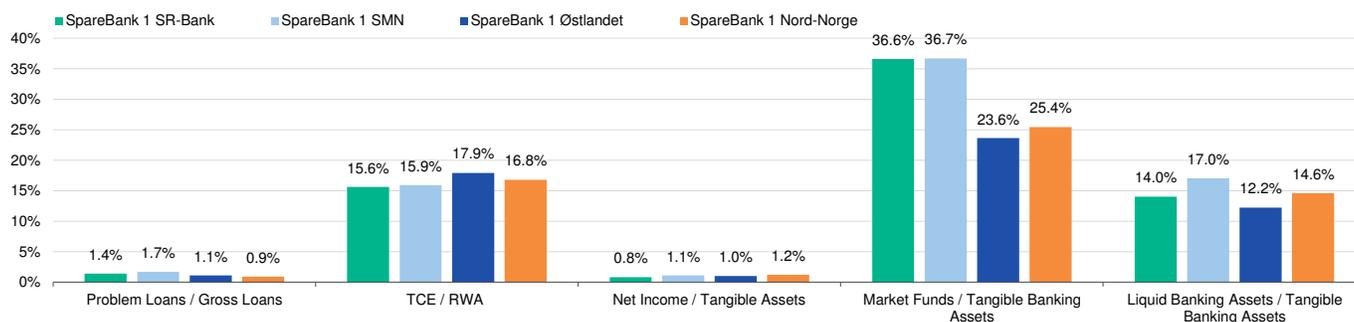


Note: Scorecard ratios include Q3 2017 financial data

Source: Moody's Investors Service

Exhibit 6

#### Moody's scorecard ratios with no consolidation of the covered bond assets and liabilities



Note: Scorecard ratios include year-end 2016 financial data

Source: Moody's Investors Service

The problem loan ratio (non-performing and doubtful loans to gross loans) of all four rated banks improves when the transferred loans are added back, reflecting the larger volume of gross loans. We see no increase in the banks' problem loans as a result of the adjustment, as the mortgages eligible for inclusion in the cover pool are of high quality.

The banks' return on tangible assets (as calculated by Moody's) decreases marginally as a result of the adjustment, reflecting their larger asset base. Their net income, meanwhile, remains unchanged, as fee and commission income is simply reclassified as net interest income. Nevertheless, this re-classification enables a more complete analysis of the banks' earnings streams and net interest margins.

The consolidation of covered bonds issued through SpareBank 1 Boligkreditt and SpareBank 1 Næringskreditt highlights the banks' significant reliance on confidence-sensitive wholesale funding. Although the banks' market funds to tangible assets ratio increases, their funding structure scores remain unchanged, partly because of qualitative analytical refinement already made for these off-balance sheet assets. The impact of re-consolidating the covered bonds is further moderated by a standard scorecard adjustment that we apply globally, as per our rating methodology for banks, to reflect the relative stability of covered bonds compared to unsecured market funding. This involves accounting for 50% of the covered bonds as deposit-like funding.

The liquid banking assets to tangible banking assets ratio declines somewhat as a result of the adjustments. The underlying core liquidity of the banks is however marginally understated by the adjusted liquidity ratio, as it does not recognize the liquid assets held by SpareBank 1 Boligkreditt and SpareBank 1 Næringskreditt, relative to peers that fully consolidate their own cover bond companies. We incorporate a positive qualitative adjustment to Alliance banks' liquidity score to reflect this additional potential source of core liquidity.

The capital score remains unaffected, because we use the regulatory risk-weighted assets and the reported regulatory capital ratios of these banks as part of our analysis. However, we focus on banks' tangible common equity (TCE), which is not necessarily the same as banks' reported common equity Tier 1 (CET1) capital.

In general, our consolidation adjustments have not had any impact on the banks' fundamental credit standing so far, as any changes in their financial ratios are immaterial. The adjustments we apply in our analysis are not significant enough to trigger at this point of time any change in our scorecard outcomes, or in the banks' ratings.

## Peer Group:

- » [SpareBank 1 SR-Bank ASA](#)
- » [SpareBank 1 SMN](#)
- » [SpareBank 1 Ostlandet](#)
- » [SpareBank 1 Nord-Norge](#)
- » [Sparebanken Vest](#)

## Moody's Related Research

### Rating actions:

- » [Moody's affirms the A1 deposit ratings of four SpareBank 1 alliance banks in Norway; negative outlook remains unchanged, September 2017 \(372888\)](#)
- » [Moody's changes rating outlook to negative for five Norwegian banks following proposed BRRD legislation; ratings affirmed, July 2017 \(369249\)](#)

### Credit opinions:

- » [SpareBank 1 SR-Bank ASA - Update following the upgrade of the bank's BCA to baa1 and ratings affirmations, September 2017 \(1092805\)](#)
- » [SpareBank 1 SMN - Update following ratings affirmations, September 2017 \(1092814\)](#)
- » [SpareBank 1 Ostlandet - Update following ratings affirmations, September 2017 \(1092877\)](#)
- » [SpareBank 1 Nord-Norge - Update following ratings affirmations, September 2017 \(1092933\)](#)

### Banking System Outlook:

- » [Banking System Outlook - Norway, August 2017 \(1076131\)](#)

### Rating Methodology

- » [Banks, September 2017 \(1065675\)](#)

### Analysis:

- » [Government of Norway – Aaa stable, October 2017 \(1094390\)](#)

## Endnotes

- 1 The maximum 75% LTV for residential mortgage loans is set under the covered bonds law and refers to the prudent market value.

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