

## FITCH AFFIRMS NORWEGIAN SAVINGS BANKS

Fitch Ratings-London-09 October 2017: Fitch Ratings has affirmed SpareBank 1 Nord-Norge's (SNN) Long-Term Issuer Default Rating (IDR) at 'A', SpareBank 1 SMN's (SMN) and SpareBank 1 SR-Bank's (SR) Long-Term IDRs at 'A-', and Sandnes Sparebank's Long-Term IDR at 'BBB'. The Outlooks on all Long-Term IDRs are Stable. A full list of rating actions is at the end of this rating action commentary.

The rating actions were part of Fitch's periodic review of Norwegian savings banks.

### KEY RATING DRIVERS

#### IDRS, VRS AND SENIOR DEBT

The affirmations of the ratings of SNN, SMN and SR (collectively Sparebanken) are based on their strong regional franchises, healthy profitability, resilient asset quality and sound capital ratios. The ratings also factor in risks arising from lower oil prices and significant rises in property prices in recent years, geographically concentrated lending and liquidity management in the context of the banks' wholesale funding reliance.

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

Sandnes's ratings reflect good pre-impairment profitability, adequate asset quality and sound capital ratios, and its entrenched regional presence in south-west Norway. Its ratings are constrained by the bank's smaller franchise relative to domestic peers, and by still significant geographical and obligor loan concentration.

Fitch expects the Sparebanken's asset quality to remain strong, despite a recent oil-related increase in impaired loans for some banks, driven by a relatively stable operating environment and conservative underwriting standards. Concentration risk relating to large exposures is reducing and Fitch expects the banks to continue to implement solid strategies based on low-risk business models focused on retail and SME customers. Impaired and non-performing loans for the Sparebanken represented between 0.7% and 1.4% of gross loans at end-June 2017.

The sharp fall in oil prices and the consequent slowdown of economic growth in the country have translated into asset-quality pressure in certain portfolios, particularly in lending to the offshore service vessels (OSV) segment. We do not expect this to spread more widely and forecast mainland GDP (excluding oil and gas extraction and shipping) to grow by 1.9% in 2017 and to about 2% annually in 2018 and 2019.

SR and SMN have the highest exposures to oil and gas lending among the Sparebanken, representing 7% and just over 4% of gross on-balance-sheet lending, respectively, at end-June 2017. OSV companies are particularly under pressure due to a combination of high fixed costs and reduced demand for vessels. Both banks have been restructuring a material part of these portfolios in recent years. SMN's oil and gas lending is made up almost entirely of OSVs, compared with about 60% for SR. We expect loan impairment charges (LICs) to be largely contained to the OSV segment, but the risk is heightened in SR's entire oil and gas exposure. SR and Sandnes's lending books are concentrated in south-west Norway, the primary base for the oil industry, and the banks are therefore also sensitive to more widespread contagion effects from lower oil activity.

A significant property price correction is a key sensitivity for the banks. Fitch does not expect such a scenario to lead to a significant deterioration of the quality of the banks' retail lending,

although reduced consumption would be likely to negatively affect their SME portfolios. SNN is less exposed to this risk, due to the lower house prices in north Norway than elsewhere in the country and the large public-sector presence.

Sandnes's impaired and non-performing loans accounted for 3.7% of gross loans at end-June 2017. A significant share of the impaired loans relate to legacy commercial real estate (CRE) loans, which in our assessment includes building and construction and property management lending. Although management has made progress in reducing concentration in this segment since its peak in 2008, it remains a significant risk. The bank's efforts to shorten maturities and reduce high loan-to-value CRE lending are positive for the rating. Net lending to the oil and gas sector is minimal.

Sparebanken and Sandnes have good pre-impairment profitability and the regional franchises support stable revenue generation. Net interest income is the main source of revenue, but the banks are also gradually strengthening fee income from ancillary products such as insurance, wealth management and real-estate brokerage. Cost-efficiency is acceptable, with cost-to-income ratios between 43% and 55% in 1H17.

LICs for the Sparebanken have averaged below 20% of pre-impairment profitability in recent years. Fitch expects SR and SMN to continue to report higher than average LICs in 2017, although they should be lower than in 2016 and easily absorbable. Sandnes reported a net loss in 2015 due to some specific large LICs relating to certain large exposures, which we do not expect to be repeated. However, this highlights the continued risk the bank faces from its sizeable obligor concentration.

The Sparebanken's capital adequacy ratios compare well with those of international peers. Their Fitch Core Capital ratios were between 15% and 17% at end-June 2017, despite Norwegian floors on the computation of risk weights. Leverage is low in a European context, with tangible equity/tangible asset ratios of around 9% and 11%.

Sandnes's capital ratios have improved in recent years, most notably through a rights issue in 2016. The end-June 2017 Fitch Core Capital ratio was 17.0%, despite the use of the standardised approach to calculate its capital requirements for both retail and corporate exposures. Leverage is low in a European context, in line with its Sparebanken peers. Nonetheless, our assessment of capital is constrained by continued high obligor concentration, and the small absolute size of the bank's equity, which makes the bank vulnerable to shocks.

Like most of their Nordic peers, the Sparebanken and Sandnes rely on wholesale funding to varying degrees. The Sparebanken have maintained access to domestic and international funding markets, particularly for covered bonds through SpareBank 1 Boligkreditt (S1B), a joint covered bonds funding vehicle for member banks of the Alliance group. SR also set up its own covered bond vehicle in 2015 and this is now its main source of covered bond funding. Fitch believes the banks will retain large liquidity portfolios to mitigate refinancing risk.

The 'F2' Short-Term IDRs of SR and SMN, and the 'F3' Short-Term IDR for Sandnes, map to the lower of the two options for the 'A-/BBB' Long-Term IDRs. Fitch believes the banks have good funding and liquidity, but their liquidity is not notably better than their rating levels would suggest.

#### **SUPPORT RATING AND SUPPORT RATING FLOOR**

In June 2017 the Norwegian Ministry of Finance proposed legislation to fully implement the EU Bank Recovery and Resolution Directive. We expect this legislation to come into force in due course. In line with our approach for EU banks and our view that 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, we have downgraded the Support Ratings of SR, SMN and SNN to '5' from '3' and revised down the Support Rating Floors to 'No Floor' from 'BB+'.

Sandnes's Support Rating and Support Rating Floor have been affirmed at '5'/'No Floor', also reflecting the bank's small size and lack of systemic importance.

For SMN, SR and SNN, there is also a possibility of institutional support for members of the Alliance from its other members. However, Fitch understands that no obligation to support member banks arises from membership of the Alliance and therefore does not factor this into the ratings.

#### SUBORDINATED DEBT

SNN, SMN and SR's subordinated debt instruments are notched down once from the banks' Viability Ratings (VRs) to reflect higher expected loss severity relative to senior unsecured creditors.

#### SUBSIDIARY AND AFFILIATED COMPANY

S1B's IDRs are aligned with those of the largest Alliance members, SR and SMN, as together with SNN (rated one notch higher), these are the most likely source of support. At end-June 2017, the combined ownership of SR, SMN and SNN in S1B was 47.6%. The ownership reflects the amount of loans sold to S1B and is updated at least annually. S1B's IDRs reflect its key role as a covered bond funding vehicle for its shareholder banks by securing competitively priced funding and access to a diversified investor base.

The Alliance banks are contractually obliged to buy covered bonds from S1B if an expected shortfall is identified 60 days before the maturity of the bond. The obligation from the shareholder banks is pro rata to the ownership, and if one or more banks are unable to fulfil their requirements, the other banks must meet the shortfall up to 2x their original shares. These bonds are eligible as collateral for repo with the Norwegian central bank.

The Alliance banks are also contractually required to maintain a minimum Tier 1 capital ratio of 9% at S1B. The obligation is also pro rata based on each bank's shareholding and is capped at 2x the original allocation. As the combined ownership is nearly 50%, the three Fitch-rated Alliance banks' combined obligation would cover the vast majority of any required liquidity or capital shortfall. We believe the Fitch-rated Alliance banks have the financial resources and the propensity to jointly support S1B, if necessary.

No VR is assigned because of S1B's close integration in the Alliance, including operational support and servicing of the mortgage assets.

#### RATING SENSITIVITIES

##### IDRS, VRS AND SENIOR DEBT

The Sparebanken's ratings are primarily sensitive to deteriorating asset quality, particularly if prolonged lower oil prices led to higher unemployment, a deterioration in CRE exposure or a significant house price correction, and if the banks are unable to absorb losses via earnings. This scenario would probably be followed by difficulties in obtaining competitively priced funding.

The Stable Outlooks on the Sparebanken's ratings reflect Fitch's expectation that the operating environment in Norway will remain strong, with LICs contained largely to the OSV segment. We expect the banks to further reduce their single-name concentration, and that they will continue to strengthen capital ratios and maintain healthy liquidity buffers.

For SMN and SR, positive rating pressure could in the medium term result from sustained asset-quality improvements, most likely through the successful restructuring of the OSV portfolios, combined with continued capital strengthening. For SNN, an upgrade is unlikely due to its already

high ratings in the context of its company profile and geographical and lending concentration. The Sparebanken's structural reliance on wholesale funding means any unmitigated weakening of access to capital markets would also be negative for their ratings.

Sandnes's Stable Outlook also reflects Fitch's expectation that the bank will continue to work out its impaired legacy CRE exposures and maintain access to competitively priced market funding. An upgrade is currently unlikely, but in the medium term a material reduction in legacy CRE exposure and obligor concentration could be ratings positive. Sandnes's ratings are sensitive to reduced activity in the region should it lead to a significant house price correction or increased losses in the corporate sector.

#### SUPPORT RATING AND SUPPORT RATING FLOOR

An upgrade of the Sparebanken's Support Ratings or upward revision of their Support Rating Floors would be contingent on a positive change in Norway's propensity to support its banks. This is highly unlikely, in Fitch's view. An upward revision of Sandnes's Support Rating Floor would be also contingent on a positive change in Fitch's view of the systemic importance of the bank, which is also unlikely.

#### SUBORDINATED DEBT

Subordinated debt issued by the Sparebanken is notched down from the banks' VRs, and are therefore sensitive to any change in the VRs. The securities' ratings are also sensitive to changes in Fitch's assessment of loss severity or non-performance risk relative to that captured in the banks' VRs, although these are unlikely.

#### SUBSIDIARY AND AFFILIATED COMPANIES

S1B's ratings are sensitive to the same factors that might drive a change in the parent banks' ratings. The Stable Outlook is in line with those on the Long-Term IDRs of S1B's rated parents. As S1B's ratings are driven by expected support, downside risk to the ratings could arise if one or more of the largest owners were downgraded, or if Fitch believed their willingness or ability to support had diminished. S1B's IDRs could also be downgraded if SR, SMN and SNN's combined ownership in S1B reduced materially.

These rating actions have no impact on the ratings of the covered bonds issued by S1B.

The rating actions are as follows:

SpareBank 1 Nord-Norge:

Long-Term IDR affirmed at 'A'; Outlook Stable

Short-Term IDR affirmed at 'F1'

Viability Rating affirmed at 'a'

Support Rating downgraded to '5' from '3'

Support Rating Floor revised to 'No Floor' from 'BB+'

Senior unsecured debt affirmed at 'A'/'F1'

Subordinated debt affirmed at 'A-'

SpareBank 1 SMN:

Long-Term IDR affirmed at 'A-'; Outlook Stable

Short-Term IDR affirmed at 'F2'

Viability Rating affirmed at 'a-'

Support Rating downgraded to '5' from '3'

Support Rating Floor revised to 'No Floor' from 'BB+'

Senior unsecured debt affirmed at 'A-'/F2'

Subordinated debt affirmed at 'BBB+'

SpareBank 1 SR-Bank:

Long-Term IDR affirmed at 'A-'; Outlook Stable

Short-Term IDR affirmed at 'F2'

Viability Rating affirmed at 'a-'

Support Rating downgraded to '5' from '3'

Support Rating Floor revised to 'No Floor' from 'BB+'

Senior unsecured debt affirmed at 'A-'/F2'

Subordinated debt affirmed at 'BBB+'

SpareBank 1 Boligkreditt:

Long-Term IDR affirmed at 'A-'; Outlook Stable

Short-Term IDR affirmed at 'F2'

Support Rating affirmed at '1'

Sandnes Sparebank:

Long-Term IDR affirmed at 'BBB'; Outlook Stable

Short-Term IDR affirmed at 'F3'

Viability Rating affirmed at 'bbb'

Support Rating affirmed at '5'

Support Rating affirmed at 'No Floor'

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Applicable Criteria

Global Bank Rating Criteria (pub. 25 Nov 2016)

<https://www.fitchratings.com/site/re/891051>

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