

## CREDIT OPINION

9 May 2016

Update

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### RATINGS

#### Sparebanken Hedmark

Domicile	Hamar, Norway
Long Term Rating	A2
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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## Sparebanken Hedmark

### BCA Review for Upgrade Following Acquisition of Bank 1 Oslo Akershus; Deposit Ratings Affirmed

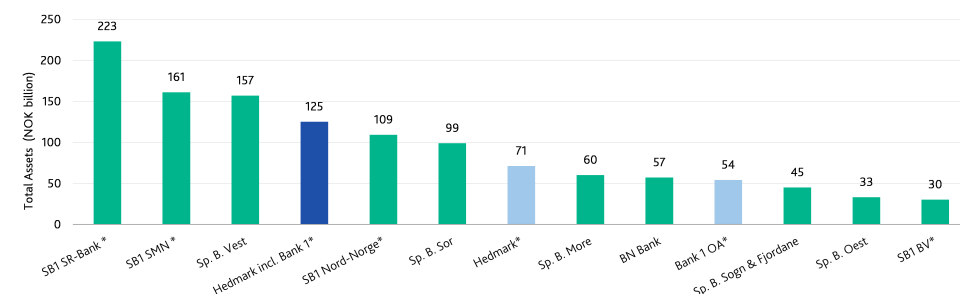
#### Summary Rating Rationale

Sparebanken Hedmark's deposit ratings of A2/P-1 take into account its adjusted baseline credit assessment (BCA) of baa1, as well as the protection provided to its depositors and senior debtholders through our loss given failure (LGF) analysis that translates into two notches of rating uplift for deposits and senior debt. The bank's adjusted BCA of baa1 reflects its standalone BCA of baa2 (on review for upgrade) combined with Moody's expectation of affiliate support from the Sparebank 1 Alliance (a consortium of 17 Norwegian banks), which provides one additional notch of rating uplift. We also assign a Counterparty Risk Assessment (CR Assessment) of A1(cr) long term and Prime-1(cr) short term.

In April 2016, we placed on review for upgrade the bank's baseline credit assessment (BCA) of baa2 following the regulatory approval provided to Sparebanken Hedmark on 18 April 2016 for the acquisition of Bank 1 Oslo Akershus (B1OA, not rated). We believe the acquisition of B1OA could bring about certain benefits that currently exert upward pressure on the bank's standalone credit profile. These would include improvements in its asset quality and funding profile, as well as deeper geographical and earnings diversification, greater reach in the Oslo area and opportunities for further expansion of its customer base. Although the transaction could also place some downward pressure on the bank's capital and profitability metrics over the medium term, we note that the combined group, that would be the fourth largest savings bank in Norway, will still boast relatively strong financial metrics.

Exhibit 1

#### Combined Sparebanken Hedmark and Bank 1 Oslo Akershus will be Norway's 4th Savings bank



Notes: \* = Members of the SpareBank 1 Alliance

Source: Moody's Investor Services and Sparebanken Hedmark's 2015 Audited Annual Report

Sparebanken Hedmark's BCA of baa2 takes into account its strong asset quality position with a very low level of problem loans of 1.2% in 2015, on the back of its predominantly retail credit profile, and also its strong common equity Tier 1 (CET1) capital ratio (17.2% in December 2015). In addition, the bank's standalone credit profile considers its satisfactory return on tangible assets (1.7% in December 2015), but also its funding profile with some reliance on covered bonds, although with a comfortable liquidity.

## Credit Strengths and Challenges

- » Sparebanken Hedmark's ratings are supported by its Very Strong- Macro Profile
- » Capital levels are the strongest among peers
- » Asset quality metrics are in line with Norwegian average
- » The bank's funding profile is underpinned by a sizeable deposit base but exhibits some reliance on market funding
- » Strong profitability, but an increase in Bank 1 Oslo Akershus stake will exert pressure
- » Large volume of deposits and junior debt resulting in deposit ratings benefiting from a very low loss-given-failure rate
- » Low probability of government support results in no additional uplift versus BCA for debt and deposits

## Rating Outlook

In April 2016, we affirmed Sparebanken Hedmark's deposit ratings with stable outlook. The affirmation of the bank's deposit ratings reflects the balance between the potential improvement in the bank's stand-alone credit profile following the acquisition of B1OA, and the constrained affiliate support from the SpareBank 1 Alliance, which is incorporated into the bank's deposit ratings. If Sparebanken Hedmark's BCA were upgraded to baa1, affiliate support will no longer provide rating uplift, reflecting the relative strength of the SpareBank 1 Alliance (SpareBank 1 Nord-Norge (baa1/A1 Stable), and SpareBank 1 SMN (baa1/A1 Stable)). This drives the current stable outlook on deposit ratings.

We expect the underlying financial fundamentals of Sparebanken Hedmark to remain relatively strong and commensurate with a BCA higher than its current baa2, according to the banking scorecard using pro-forma consolidated ratios for the two entities. Our review for upgrade of the BCA will consider the consolidated financial statements for the group, which we expect in the second half of 2016, and the relative impact of the acquisition on the bank's BCA. Once consolidated financials are published, we will re-examine the bank's credit metrics in order to confirm our projections and the higher scorecard outcome. Moreover, we will also assess (1) the expected qualitative benefits for the bank from this acquisition, (2) the bank's plans for operational integration of the two entities, and (3) any potential challenges in realising efficiencies and economies of scale.

## Factors that Could Lead to an Upgrade

Upward rating pressure could develop if Sparebanken Hedmark demonstrates: (1) Good asset quality in its consolidated retail and corporate books; (2) continued access to capital markets and improved liquidity; and/or (3) stronger earnings generation without an increase in its risk profile. In addition, further upward pressure could emerge following the takeover of B1OA, if the bank is able to further strengthen its customer base, and enhance its product offering and franchise.

## Factors that Could Lead to a Downgrade

Future downward rating pressure could arise if: (1) Sparebanken Hedmark's problem loan ratio increases above our system-wide expectation of approximately 2%; (2) financing conditions become more difficult; (3) its risk profile increases, as a result of increased exposures to more volatile sectors, for example, resulting in asset quality deterioration; and/or (4) the macroeconomic environment deteriorates more than Moody's estimates, leading to adverse developments in the Norwegian real-estate market.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

## Key Indicators

Exhibit 2

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

	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>3</sup>	12-12 <sup>3</sup>	12-11 <sup>3</sup>	Avg.
Total Assets (NOK billion)	55.8	49.8	47.4	44.1	43.1	6.6 <sup>4</sup>
Total Assets (EUR million)	5803.9	5485.3	5669.7	6012.3	5568.8	1.0 <sup>4</sup>
Total Assets (USD million)	6304.8	6637.5	7812.5	7926.5	7229.1	-3.4 <sup>4</sup>
Tangible Common Equity (NOK billion)	8.3	7.3	6.4	5.8	5.3	11.9 <sup>4</sup>
Tangible Common Equity (EUR million)	866.3	807.8	765.8	784.0	686.4	6.0 <sup>4</sup>
Tangible Common Equity (USD million)	941.1	977.5	1055.2	1033.6	891.1	1.4 <sup>4</sup>
Problem Loans / Gross Loans (%)	1.2	1.4	1.6	2.1	2.4	1.7 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	22.1	20.0	20.7	23.5	21.7	21.0 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.3	7.2	9.2	12.1	14.9	10.0 <sup>5</sup>
Net Interest Margin (%)	2.3	2.3	2.4	2.3	2.4	2.3 <sup>5</sup>
PPI / Average RWA (%)	2.5	2.2	2.2	2.3	1.7	2.4 <sup>6</sup>
Net Income / Tangible Assets (%)	1.7	1.9	1.5	1.0	0.7	1.4 <sup>5</sup>
Cost / Income Ratio (%)	52.9	54.5	58.6	60.7	64.9	58.3 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	22.3	19.7	19.5	20.6	25.2	21.5 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	13.6	11.5	13.9	13.6	14.6	13.4 <sup>5</sup>
Gross loans / Due to customers (%)	130.8	128.5	123.5	126.0	134.3	128.6 <sup>5</sup>

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Source: Moody's Financial Metrics

## Detailed Rating Considerations

SPAREBANKEN HEDMARK'S RATINGS ARE SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

As a domestically oriented bank, Sparebanken Hedmark's operating environment is in Norway, and the bank's Macro Profile is thus aligned with that of Norway at Very Strong-. Norwegian banks benefit from operating in an affluent and developed country with very high economic, institutional and government financial strength as well as low susceptibility to event risk. The main risks to the system stem from a high level of household indebtedness and domestic banks' reliance on market funding. However, these risks are offset by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared to GDP.

CAPITAL LEVELS ARE THE STRONGEST AMONGST PEERS

Sparebanken Hedmark exhibits the strongest capital levels amongst its Norwegian rated peers. At end-December 2015, the bank's Tangible Common Equity (TCE) to risk weighted assets (RWA) ratio stood at 22.1%, and its Tier 1 Capital ratio was 17.2%, already in line with updated capital requirements. The bank's equity of NOK 8.7 billion consists entirely of retained earnings and represented 15.6% of the balance sheet.

We expect the acquisition of B1OA to reduce the combined group's common equity Tier 1 (CET1) capital ratio to around 15.3% based on December 2015 figures. The bank plans to list on the Oslo stock exchange and issue equity certificates (60% of its primary capital) in the second half of 2016, if market conditions are acceptable, following the acquisition of B1OA, which we view positively as it would improve access to capital markets and increase the bank's visibility to international investors.

Looking ahead, we expect the combined group to maintain a relatively conservative dividend payout policy in order to ensure strong capital buffers at all times and relative to its peers, a distinctive feature of the bank in the last few years.

ASSET QUALITY METRICS ARE IN LINE WITH NORWEGIAN AVERAGE

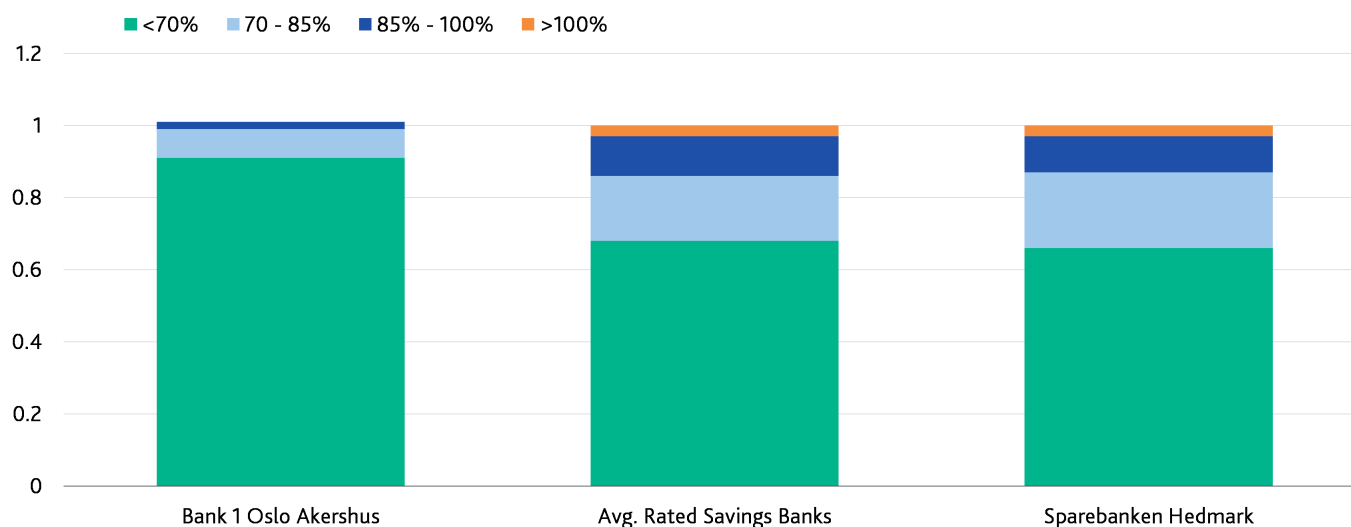
Sparebanken Hedmark's asset quality metrics improved somewhat in recent years, as its problem loan ratio (as measured by impaired loans as a percentage of total loans) decreased to 1.2% of on-balance-sheet loans at end-December 2015 from 2.1% at year-end 2012, which is in line with the rest of Moody's-rated Norwegian banks. Sparebanken Hedmark's loan portfolio benefits from a substantial

proportion of retail loans at 55.5% of the total loan book (68.1% when including loans transferred to mortgage funding entities), mostly in the form of mortgages. While the performance of the bank's retail book has been particularly strong in recent years, we expect that any more significant slowdown in the economy would undermine the bank's asset quality.

Our assigned Asset Risk score also reflects the bank's exposure to the real estate, building and construction sectors, which we consider particularly vulnerable to less favorable economic conditions due to declining oil and gas prices as well as falling investment levels. The exposure is relatively material at over 21% of on-balance-sheet loans at end-December 2015. The rest of the portfolio is mainly focused on SMEs and diversified across industries. The bank also exhibits high borrower concentration, albeit at a somewhat lower level than most of its Nordic rated peers.

We expect Sparebanken Hedmark's asset quality metrics to improve following the acquisition of B1OA in view of B1OA's strong asset quality position with a very low level of problem loans (0.24% in 2015, compared to 1.24% for Sparebanken Hedmark). We consider that B1OA's predominantly retail credit profile will be supportive to the combined group's asset quality, limiting the downside risks from credit impairments. B1OA's average loan book LTV is considerably lower (weighted 50%) than Sparebanken Hedmark's, and Moody's rated Norwegian average (see chart below).

Exhibit 3  
Average loan book LTV



Source: Moody's Investor Services and Sparebanken Hedmark's 2015 Audited Annual Report and Bank 1 Oslo Akershus's 2015 Audited Annual Report

#### LIQUIDITY - SUBSTANTIAL DEPOSIT BASE, SOME RELIANCE ON MARKET FUNDING BUT LESS THAN MANY PEERS

Sparebanken Hedmark's funding position is underpinned by a substantial deposit base, which accounted for almost 73% of on-balance-sheet funding at end-December 2015, with nearly 60% of the bank's deposits originated from the retail sector.

We globally reflect the relative stability of covered bonds compared to unsecured market funding through a standard adjustment in our scorecard. Sparebanken Hedmark has increasingly used covered bond funding, which is done off-balance-sheet through specialised companies it jointly owns together with the other members of SpareBank 1 Alliance (SpareBank 1 Boligkreditt for residential mortgages and SpareBank 1 Næringskreditt for commercial mortgages). At end-December 2015, Sparebanken Hedmark had transferred retail mortgages worth NOK16.8 billion to SpareBank 1 Boligkreditt and NOK0.6 billion commercial mortgages to SpareBank 1 Næringskreditt (i.e., equivalent to 28.5% of total loans incl. loans transferred to covered bond companies).

Whilst we positively view the diversification benefit of covered bond funding, our assessment of the bank's funding structure reflects our view that Sparebanken Hedmark has some reliance on market funds - a common feature at Nordic banks - but to a lesser degree than peers: Market funding accounted for 22.3% of the bank's tangible assets at end-December 2015 (28.8% when adjusting for covered bonds), a share that has been stable over the years.

At end-December 2015, liquid assets accounted for 13.6% of tangible assets (11.4% at end-December 2014) excluding refinancing of the covered bond companies and, according to the bank, cover funding needs for 18 months (assuming 6% lending growth and 2.6% growth in deposits). The portfolio consists of cash and deposits with the central bank, senior bonds, covered bonds and limited equity investments. The holdings are concentrated on Norwegian securities, which could be a source of vulnerability from a concentration risk point of view, but are positive in terms of currency risk. In addition, the bank reported an LCR of 120.8% at the end of 2015. We do not expect the consolidated group's funding profile to change significantly to that of Sparebanken Hedmark, with market funding reliance to be around 31% of total tangible banking assets, mainly driven by the issuance of covered bonds. B1OA's standalone market funding ratio (in-line with our methodology assumptions for covered bonds) was 29.3% at end-2015.

#### STRONG PROFITABILITY, BUT AN INCREASE IN BANK 1 OSLO AKERSHUS STAKE WILL EXERT PRESSURE

The take-over of B1OA will exert some downward pressure on Sparebanken Hedmark's profitability metrics. B1OA's earnings profile is weaker than Sparebanken Hedmark's as the bank operates in a more competitive area than Hedmark, resulting in significantly lower margins while its operations lack efficiency. As a result, we expect some softening of the combined entity's profitability metrics due to the increase in risk-weighted assets and B1OA's lower net interest margins, while return on tangible assets could drop significantly to below 0.8%.

Sparebanken Hedmark's main source of earnings is net interest income, representing around 56% of its operating income in 2015 (when including fees from loans transferred to the covered bond company). The bank's cost-to-income ratio (according to Moody's adjusted metrics) was almost 52.9% at end December 2015, slightly higher than the average of the Norwegian rated peers; while loan loss provisions remained low at 0.13% of average loans, lower than 0.17% at end 2014. Moody's adjusted return on tangible assets was at 1.7% at end-December 2015, slightly lower than both the 2014 level (1.94%) and the three-year average due to increased contribution from equity stakes.

Our assigned profitability score reflects our expectations that the growth of Sparebanken Hedmark will slow over the coming year as net interest income is under pressure due to lower interest rates and higher market funding costs. Furthermore, we expect a reduction in profitability of the Group following the acquisition of the remaining stake in B1OA. All else being equal, we would not anticipate the bank's corporate loan losses to remain at their current level as we expect Norway to experience a slightly tougher bank operating environment in 2016-17 than in recent years.

### Notching Considerations

#### LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We expect that Norway will seek to introduce legislation to implement the EU Bank Resolution and Recovery Directive (BRRD). In our LGF analysis, we assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These metrics are in line with our standard assumptions.

For Sparebanken Hedmark's long-term deposit ratings, our affirmation has considered the likely impact on loss-given-failure of the combination of their own volume and the amount of debt subordinated to them. This has resulted in a Preliminary Rating Assessment (PRA) of two notches above the BCA, reflecting very low loss-given-failure.

#### GOVERNMENT SUPPORT

The expected implementation of resolution legislation has caused us to reconsider the probability that government support would benefit certain creditors.

With regional loan and deposit market shares of around 23% and 45% (lending market share is estimated at 33% by the bank when including mortgages transferred to covered bond company), respectively, Sparebanken Hedmark has a sound local market position in the county of Hedmark in eastern Norway. The national market share is however notably smaller at roughly 0.9% in terms of loans and 1.6% in terms of deposits (based on total on-balance sheet lending in the bank's counties of operation and in the whole country according to Statistics Norway). Therefore we expect a low probability of government support for debt and deposits, resulting in no rating uplift.

## COUNTERPARTY RISK ASSESSMENT

We affirmed the bank's long-term and short-term CR Assessment of A1(cr) and P-1 (cr) respectively in April 2016.

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

## About Moody's Bank Scorecard

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## Rating Methodology and Scorecard Factors

Exhibit 4

## Sparebanken Hedmark

## Macro Factors

<b>Weighted Macro Profile</b>	<b>Very Strong -</b>	<b>100%</b>
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## Financial Profile

Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
<b>Solvency</b>						
<b>Asset Risk</b>						
Problem Loans / Gross Loans	1.4%	aa2	↓↓	a3	Geographical concentration	Sector concentration
<b>Capital</b>						
TCE / RWA	22.1%	aa1	↑↑	aa3	Expected trend	
<b>Profitability</b>						
Net Income / Tangible Assets	1.7%	aa3	↑↑	baa3	Expected trend	
Combined Solvency Score		aa2		a3		
<b>Liquidity</b>						
<b>Funding Structure</b>						
Market Funds / Tangible Banking Assets	22.3%	baa1	↓↓	baa3	Market funding quality	
<b>Liquid Resources</b>						
Liquid Banking Assets / Tangible Banking Assets	13.6%	baa3	↑↑	baa3	Stock of liquid assets	
Combined Liquidity Score		baa2		baa3		
<b>Financial Profile</b>				baa1		
<b>Business Diversification</b>				0		
<b>Opacity and Complexity</b>				0		
<b>Corporate Behavior</b>				0		
<b>Total Qualitative Adjustments</b>				0		
<b>Sovereign or Affiliate constraint:</b>				Aaa		
<b>Scorecard Calculated BCA range</b>				a3-baa2		
<b>Assigned BCA</b>				baa2		
<b>Affiliate Support notching</b>				1		
<b>Adjusted BCA</b>				baa1		

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Counterparty Risk Assessment	3	0	a1 (cr)	0	A1 (cr)	--
Deposits	2	0	a2	0	A2	A2

Source: Moody's Financial Metrics

## Ratings

Exhibit 5

Category	Moody's Rating
<b>SPAREBANKEN HEDMARK</b>	
Outlook	Stable
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	A1(cr)/P-1(cr)
Issuer Rating	A2

Source: Moody's Investors Service



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