

Global Credit Research - 27 Mar 2015

Norway

## Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*Baa2/P-2
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa3

\* Rating(s) within this class was/were placed on review on March 17, 2015

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## Key Indicators

### Helgeland Sparebank (Consolidated Financials)[1]

	[2]12-14	[3]12-13	[3]12-12	[3]12-11	[3]12-10	Avg.
Total Assets (NOK billion)	25.8	26.0	24.6	22.8	20.2	[4]6.4
Total Assets (EUR million)	2,846.3	3,108.3	3,352.0	2,943.2	2,585.4	[4]2.4
Total Assets (USD million)	3,444.2	4,283.1	4,419.2	3,820.7	3,468.4	[4]-0.2
Tangible Common Equity (NOK billion)	1.8	1.7	1.6	1.5	1.4	[4]6.7
Tangible Common Equity (EUR million)	201.8	207.4	220.8	190.5	181.1	[4]2.7
Tangible Common Equity (USD million)	244.2	285.8	291.1	247.3	242.9	[4]0.1
Problem Loans / Gross Loans (%)	0.6	0.8	0.6	1.3	1.2	[5]0.9
Tangible Common Equity / Risk Weighted Assets (%)	13.1	12.7	12.1	11.4	11.4	[6]13.1
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.6	9.2	7.5	14.6	13.5	[5]10.3
Net Interest Margin (%)	1.8	1.8	1.6	1.5	1.6	[5]1.7
PPI / Average RWA (%)	2.2	2.2	1.6	1.4	1.4	[6]2.2
Net Income / Tangible Assets (%)	0.9	0.8	0.5	0.4	0.5	[5]0.6
Cost / Income Ratio (%)	45.8	44.3	51.5	54.5	60.2	[5]51.3
Market Funds / Tangible Banking Assets (%)	35.6	33.0	45.4	46.0	41.8	[5]40.4
Liquid Banking Assets / Tangible Banking Assets (%)	17.5	18.2	16.9	18.4	15.5	[5]17.3
Gross Loans / Total Deposits (%)	151.7	159.4	177.0	174.0	168.3	[5]166.1

Source: Moody's

[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

## Opinion

### SUMMARY RATING RATIONALE

On 17 March, we placed Helgeland Sparebanken's Baa2 long-term deposit rating on review for upgrade. The bank's baa3 standalone baseline credit assessment (BCA), adjusted BCA and short-term ratings remain unchanged.

Helgeland Sparebank's BCA primarily reflects its solid capital position and low problem loan levels. However, the rating is constrained by the bank's limited geographical reach and concentrated loan book, its reliance on market funding and its weak profitability.

The review was prompted by the implementation of our Loss Given Failure (LGF) analysis, which is a component of our new methodology for rating banks globally, combined with our view that the likelihood of potential government support may decrease. Our LGF analysis takes into account the risks facing the different debt and deposit classes across the liability structure, if the bank were to enter resolution.

### HELGELAND SPAREBANK'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

As a purely domestic bank, Helgeland Sparebank's operating environment is in Norway. We therefore align the bank's Macro Profile with that of Norway at `Very Strong-`. Norwegian banks benefit from operating in an affluent and developed country. Norway has 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 banking system's relatively small size compared with GDP.

### Rating Drivers

- Positive measures to increase capital levels, which are in line with peers
- Intense competition in local market is likely to weigh on margins and profitability
- Asset quality metrics are good, but downside risk from exposure to more volatile sectors and high credit concentration
- Sizeable deposit base, but material market funding reliance
- Large volume of deposits and junior debt, resulting in deposit ratings benefiting from a very low loss-given-failure rate

### Rating Outlook

The introduction of our new methodology, specifically our advanced LGF analysis, prompted placement of Helgeland Sparebank's long-term deposit rating on review. We apply our LGF analysis to institutions that are subject to an operational resolution regime. While not subject to the European Union's (EU) Bank Recovery and resolution Directive (BRRD), we consider that Norway - as a member of the European Economic Area (EEA) - will look to introduce legislation, or other tools that include mechanisms similar to those in the BRRD. We base our views on public comments from Norwegian authorities, as well as the government's track record of mirroring EU banking regulations. Our advanced LGF analysis of Helgeland Sparebank's long-term deposits led us to place the rating on review for upgrade.

The review will focus on the liability structure, particularly the amount of deposits, senior long-term outstanding debt and the amount of debt subordinated to it.

We consider the probability of government support for the bank's long-term deposits to be low, which would reduce the uplift from its unsupported level to nil. After we conclude the review, we expect to upgrade the long-term deposit rating by one notch.

### What Could Change the Rating - Up

As stated in the rating rationale, the bank's ratings are under review in response to the implementation our LGF

analysis, which is a component of our new banking methodology.

### **What Could Change the Rating - Down**

After we complete our review, downward pressure might develop following (1) an increase in credit risk - such as increased exposure to more volatile sectors, or weaker creditworthiness of its major customers; (2) a significant weakening of its funding or liquidity position; and/or (3) a weakening in asset quality.

In addition, we believe that the bank financial strength rating (BFSR) could come under pressure from external factors, such as a less supportive macroeconomic environment, or substantially adverse developments in the Norwegian real-estate market.

### **DETAILED RATING CONSIDERATIONS**

#### **POSITIVE MEASURES TAKEN TO INCREASE CAPITAL LEVELS, WHICH ARE IN-LINE WITH PEERS**

At year-end 2014, Helgeland Sparebank had a Tangible Common Equity (TCE) ratio of 13.15%, which is higher than the 12.7% ratio at year-end 2013. We view the bank as being adequately capitalised in light of its risk profile. Its capitalisation is in line with its rated Norwegian peer group. The bank has determined a new capital plan for 2014-2018, where it aims to increase its capital ratio in line with new capital requirements. It is also considering the use of subordinate loans or tier 1 instruments if necessary. Our assigned Capital score reflects this strength, as well as the bank's 8% TCE/tangible banking assets ratio, which is well within international standards.

#### **INTENSE COMPETITION IN THE LOCAL MARKET IS LIKELY TO PRESSURE MARGINS AND PROFITABILITY**

Helgeland Sparebank derives almost 60% of its 2014 pre-tax income from its retail operations, excluding other, not divided operations. We view retail operations as being typically more resilient. Its primary source of earnings is net interest income, which has accounted for over 80% of its net revenue in the last few years. Net interest income improved in 2014, primarily as a result of higher lending margins and loan growth, with 4% growth year-on-year. The bank's net interest margin remained at the same level as the previous year, at 1.75%, following interest rate reductions in mortgages and deposits. We expect margins to remain under pressure as the competitive situation is persistently strong, especially in the retail market.

Net interest income as a share of tangible assets was at 0.87% for 2014, which was slightly above the 0.7% three-year average. Loan losses remained low, at NOK44 million at year-end 2014, in line with 2013. The cost - to-income ratio, at 46%, was slightly higher than in 2013. This is because changes in the arrangement with differentiated payroll tax increased costs. The bank will likely incur further loan losses from volatile segments, such as real estate and construction, as Norway's operating environment has been slightly tougher than in recent years, which is reflected in our Profitability score.

#### **GOOD ASSET QUALITY METRICS, BUT THERE ARE DOWNSIDE RISKS FROM EXPOSURES TO MORE VOLATILE SECTORS AND HIGH CREDIT CONCENTRATIONS**

Helgeland Sparebank's problem loan ratio (impaired loans as percentage of total loans) was around 0.6% at year-end 2014, lower than most of its Norwegian peers. We note that a large portion of the problem loans relate to the real estate and construction sectors. Moreover, the bank's substantial involvement in these industries (around 17% of gross loans, or 187% of Tier 1 capital in 2014), which are typically cyclical, poses a risk to its future asset quality. In addition, the bank's loan book exhibits high single-borrower concentration - while this is typical at Nordic banks, it could accelerate the extent and pace of any deterioration in asset quality.

Of retail loans, almost 70% brought some stability to the bank's loan book at year-end 2014. This asset class has historically proven more resilient and is supported by households' sound financial position. However, in our opinion, the sustained increase in house prices combined with the high level of household indebtedness pose long-term risks to the banking sector in general, and may undermine Helgeland Sparebank's ability to sustain the currently strong asset quality metrics of its retail book in the future. Our assigned Asset Risk score reflects our view that the bank is vulnerable to less favorable economic conditions due to declining oil and gas prices as well as falling investment levels.

#### **SIZEABLE DEPOSIT BASE BUT MATERIAL MARKET FUNDING RELIANCE**

Helgeland Sparebank's funding profile reflects a sizeable deposit base, largely from retail customers, which constituted almost 60% of funding at year-end 2014. We view this positively, particularly given the relatively

diverse nature of the deposit base.

Market funding accounted for almost 37% of the bank's tangible assets at year-end 2014. Covered bond funding has grown significantly since 2009, when Helgeland Boligkreditt AS (the bank's wholly owned covered bond company) was established. Under our methodology, we reflect the stability of covered bonds relative to unsecured market funding through a standard adjustment in our scorecard. However, we do not expect that, size-wise, Helgeland Sparebank will have the capacity to make larger benchmark issuance. This ultimately restricts its investor base.

The bank's Funding score reflects that its overall funding profile remains a fundamental weakness for Helgeland Sparebank. In addition, extensive use of covered bond funding causes structural subordination of Helgeland Sparebank's unsecured creditors, including depositors.

At year-end 2014, liquid assets accounted for 5.5 billion, or almost 18% of total assets and comprised cash, cash equivalents and assets in the bank's securities portfolio. As of year-end 2014, 91% of securities in the portfolio were rated single-A or higher. However, we note that these holdings mostly consist of Norwegian securities, which could lead to concentration risk.

## **Notching Considerations**

### **LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING**

We expect that Norway will seek to introduce legislation or other tools that include mechanisms similar to those in the EU Bank Resolution and Recovery Directive (BRRD). We assume residual tangible common equity of 3%; losses post-failure of 8% of tangible banking assets; a 25% run-off in "junior" wholesale deposits; and a 5% run-off in preferred deposits. We assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

For Helgeland Sparebank's long-term deposit ratings, our review will consider the likely impact on loss-given-failure of the volume of deposits and the amount of debt subordinated to them. We expect this will result 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.

Helgeland Sparebank is a local savings bank with a well-established market position in Helgeland, a district in the county of Nordland. Although its national market share is negligible, based on the bank's latest audited annual report and Statistics Norway, we estimate that Helgeland Sparebank commands a market share of about 13% for lending and 17% for deposits in the county. In addition, we view the banking market across most of Norway as being competitive. We consider that Helgeland has very limited pricing power, compared with the larger national and regional players. Therefore, we consider the likelihood of government support for debt and deposits as being low. This is likely to result in no ratings uplift for the Preliminary Rating Assessment.

## **Foreign Currency Deposit Rating**

Helgeland Sparebank's Baa2 (under review for upgrade) foreign currency deposit rating is unconstrained, given that Norway has a country ceiling of Aaa.

About Moody's Bank Scorecard

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## **Rating Factors**

**Helgeland Sparebank**

<b>Macro Factors</b>	
<b>Weighted Macro Profile</b>	<b>Very Strong -</b>

<b>Financial Profile</b>						
<b>Factor</b>	<b>Historic Ratio</b>	<b>Macro Adjusted Score</b>	<b>Credit Trend</b>	<b>Assigned Score</b>	<b>Key driver #1</b>	<b>Key driver #2</b>
<b>Solvency</b>						
<b>Asset Risk</b>						
<i>Problem Loans / Gross Loans</i>	0.7%	aa1	← →	baa3	Geographical concentration	Sector concentration
<b>Capital</b>						
<i>TCE / RWA</i>	13.1%	a1	← →	a3	Access to capital	
<b>Profitability</b>						
<i>Net Income / Tangible Assets</i>	0.7%	baa2	← →	baa2	Expected trend	
<b>Combined Solvency Score</b>		a1		baa2		
<b>Liquidity</b>						
<b>Funding Structure</b>						
<i>Market Funds / Tangible Banking Assets</i>	35.6%	ba2	← →	ba2	Market funding quality	
<b>Liquid Resources</b>						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	17.5%	baa2	← →	baa2	Stock of liquid assets	
<b>Combined Liquidity Score</b>		ba1		ba1		

<b>Financial Profile</b>	<b>baa3</b>
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<b>Qualitative Adjustments</b>	<b>Adjustment</b>
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
<b>Total Qualitative Adjustments</b>	<b>0</b>

Sovereign or Affiliate constraint	Aaa
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Scorecard Calculated BCA range	<b>baa2 - ba1</b>
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<b>Assigned BCA</b>	<b>baa3</b>
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Affiliate Support notching	0
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<b>Adjusted BCA</b>	<b>baa3</b>
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<b>Instrument Class</b>	<b>Loss Given Failure notching</b>	<b>Additional notching</b>	<b>Preliminary Rating Assessment</b>	<b>Government Support notching</b>	<b>Local Currency rating</b>	<b>Foreign Currency rating</b>
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Deposits	--	--	--	--	Baa2 RUR Possible Upgrade	Baa2 RUR Possible Upgrade
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