Sandnes Sparebank Issuer Rating Report

POSITIVE
BBB+

Overview

Scope assigns an Issuer Rating of BBB+ to Sandnes Sparebank with a Positive Outlook. The rating agency also assigns a rating of BBB to senior unsecured debt, with a Positive Outlook.

As Norway is part of the EEA, its banks are expected to comply with BRRD, including MREL requirements. In line with our bank rating methodology (May 2019) and when legislation concerning MREL debt is finalised in Norway, we expect to rate non-preferred senior unsecured debt one notch below the Issuer Rating and senior unsecured debt at the same level as the Issuer Rating.

The Issuer Rating of BBB+ with Positive Outlook also applies to Sandnes Sparebank Boligkreditt AS, a wholly owned subsidiary of Sandnes Sparebank. Sandnes Sparebank Boligkreditt provides secured funding for its parent, through the issuance of covered bonds.

Ratings & Outlook

Issuer Rating	BBB+
Senior unsecured debt rating	BBB
Outlook	Positive
Covered bond rating: (Sandnes Sparebank Boligkreditt)	AAA
Covered bond rating outlook	Stable

Highlights

- Founded in 1875, Sandnes Sparebank is a well-established savings bank based in Sandnes, one of the major cities in the region of Rogaland in south-west Norway. While the Norwegian economy has recovered from the 2014 decline in oil prices, the region remains more exposed to cyclicality as it is the centre of the country's oil and gas industry.
- Prior to the start of the financial crisis in 2008, the bank had become focused on corporate lending and real estate development which led to loan losses and poor profitability. Subsequent management teams have since returned the bank to its savings bank roots and have materially reduced the bank's risk profile. Scope acknowledges the change in risk appetite as well as the significant clean-up of the corporate loan portfolio.
- With the steps that have been taken to reduce risk, improve efficiency and strengthen prudential metrics, Scope expects the bank to be more resilient in future downturns.
- Though the current management team has been in place only since 2017, a strategy focused on increasing customer value to generate profitable growth is showing encouraging signs of success. The bank is gaining new retail clients and both brand awareness and market share are increasing.
- As with other Norwegian and Nordic banks, Sandnes relies to a material degree on market funding. The use of covered bonds as well as maintaining a high-quality liquidity portfolio helps to mitigate this risk.
- The Positive Outlook reflects the expectation that the changes in strategy and culture being implemented will result in more consistent operating performance, improved asset quality, and earnings stability.

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Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Management's commitment to returning the bank's business model to its savings bank roots.
- Significant progress made in de-risking the bank.
- Strengthened financial profile provides better protection against an operating environment exposed to the cyclical oil and gas industry.
- Material reliance on market funding mitigated somewhat by active liquidity management.

Rating change drivers

Consistent track record of operating performance. The current senior management team has been in place since 2017 and has been implementing measures to improve the sustainability and predictability of earnings. Demonstrating earnings stability over time would be viewed positively.

A decline in the operating environment which substantially impacts profitability. Sandnes operates in one region of Norway which is materially exposed to the cyclical oil and gas industry.

A change in strategic direction which increases the bank's risk profile. Over the last several years, Sandnes has been focused on de-risking. We would view negatively a change in risk appetite and a return to the riskier practices of the past as management now pursues moderate growth.

Loss of benefits arising from being a member of the Eika Alliance. In addition to being able to offer customers a broader range of products and services, Sandnes now relies on the alliance for various critical operational systems such as IT infrastructure.

Rating drivers (details)

Management's commitment to returning the bank's business model to its savings bank roots

Founded in 1875, Sandnes Sparebank is considered the bank of the city of Sandnes in south-west Norway. Serving about 42,000 retail and 5,000 corporate customers, the bank's main office and branch is in the city center. In addition, there is a branch in Stavanger with five employees. Well established in Sandnes, the bank also operates in the broader region of Rogaland, competing against Sparebank 1 SR-Bank, DNB, Danske and other smaller players.

Being part of Eika Alliance brings material benefits

Since October 2015, the bank has been part of the Eika Alliance[1] which enables Sandnes to meet customer needs with a broader range of products and services, including asset management, insurance, credit cards and car loans. Being a member of the alliance further supports cost efficiency – in particular, in banking operations and IT development and infrastructure. As the largest bank in the alliance, Sandnes' CEO is also the vice-chairman of the alliance's board.

Under previous management, Sandnes had become focused on corporate lending and real estate development. With the onset of the financial crisis in 2008, this led to elevated loan losses and poor profitability. In the ensuing years, the subsequent management team worked to reduce the bank's risk profile.

Renewed focus on retail clients showing signs of success

In 2017, the management team was again refreshed, with four of six members changing – the CEO, CFO, head of retail clients and head of customer experience (a new position). The current strategy is based on increasing customer value to generate profitable growth. This includes raising brand awareness above 60%, improving the customer experience ranking above 70% and lowering funding costs by fostering market confidence. The renewed focus on retail clients is bearing fruit. For the first time in many years, the bank is gaining new private customers, brand recognition is up, and retail market share is also developing positively.

Significant progress made in de-risking the bank

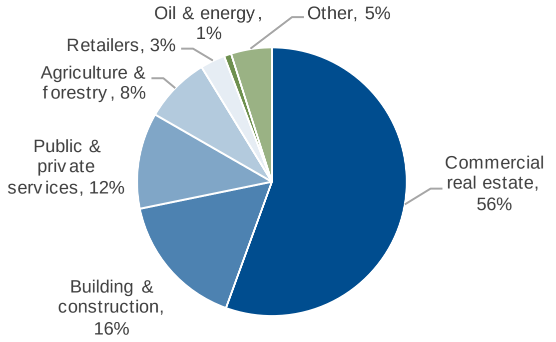
Over the last several years, management has diligently addressed the issues arising from previous more aggressive and riskier business practices. For example, Sandnes no longer has a trading portfolio and FX loans are no longer actively marketed to existing or potential clients.

Limited direct exposure to oil and gas industry

While corporate lending, historically the driver of loan losses, continues to comprise one-third of the loan book, the composition and risk profile of this portfolio has materially changed. For instance, exposure to real estate has moderated whereas lending to agriculture has grown. Management's policy is to avoid direct exposure to the oil and gas industry as well as to more cyclical industries such as fisheries, hotels and restaurants (Figure 1). The bank is also increasingly incorporating ESG factors into its lending and investment decisions. For example, no more than 3% of the loan and investment portfolios should finance energy production based on fossil fuels and oil and gas extraction.

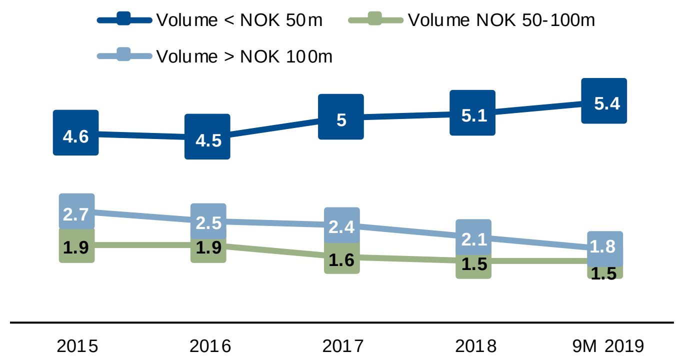
[1] Established by smaller Norwegian savings banks in 1997. There are currently about 65 member banks, with assets ranging from NOK 1bn to NOK 28bn.

Figure 1: Corporate loan portfolio (NOK 6.9bn)



Note: Data as of 3Q 2019.
Source: Company data, Scope Ratings.

Figure 2: Growing proportion of smaller SME loans



Source: Company data, Scope Ratings

Ongoing efforts to reduce concentration risks in corporate portfolio

Importantly for the stability of future earnings, the magnitude and concentration of large lending exposures has been significantly reduced. Instead, they are being replaced by a greater number of smaller SME loans. (Figure 2). Management's strategy is to continue reducing concentration risks in the corporate loan portfolio.

The retail portfolio, which accounts for two-thirds of the total loan book is almost entirely comprised of residential mortgages. As of 3Q 2019, 85% of mortgage loans have a loan-to-value (LTV) below 85%, with the weighted average LTV around 64%.

Asset quality of loan book has materially improved

The quality of the loan book continues to improve, with problem loans as percentage of gross loans steadily falling to 1.3% as of 3Q 2019, from a peak of more than 5% in 2010 and 2011 (Figure 3).

Strengthened financial profile provides better protection against an operating environment exposed to the cyclical oil and gas industry

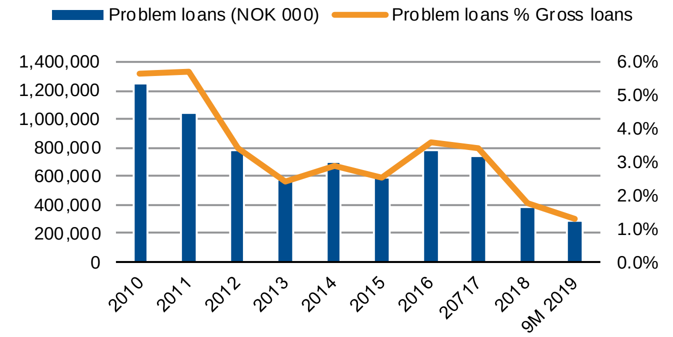
With loan losses normalising and operational efficiency improving, the bank's financial profile is becoming increasingly sound. This is further supported by the bank's strengthened solvency position. As of 3Q 2019, the CET1 capital ratio was 16% (16.3% with proportionate consolidation of stake in Eika Alliance) and the Tier 1 leverage ratio was 9.6%, up from 12% and 7.4%, respectively in 2014.

Awaiting updated Pillar 2 requirement

Scope considers regulatory capital requirements for Norwegian banks to be relatively stringent. All banks, regardless of size, are subject to a systemic risk buffer of 3% and by year-end a countercyclical buffer of 2.5%. Based on the current Pillar 2 requirement of 2.5%, Sandnes' minimum CET1 requirement will be 15% at year-end.

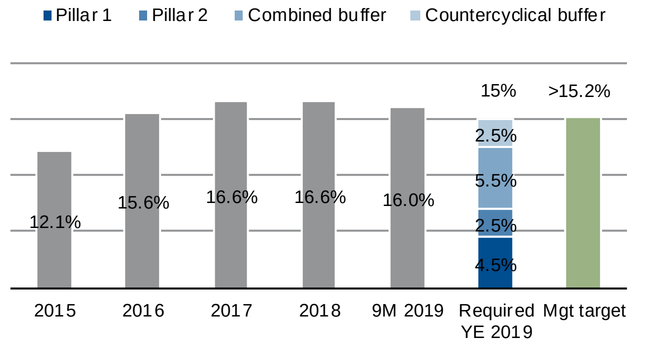
Management, however, expects an updated Pillar 2 requirement by year-end to reflect the bank's improved risk profile. As well, the introduction of the SME discount factor is estimated to have a positive impact of 30bps. In the meantime, the bank targets a CET1 ratio of at least 15.2% (Figure 4).

Figure 3: Development of problem loans



Source: Company data, Scope Ratings.

Figure 4: Development of CET1 capital



Source: Company data, Scope Ratings

Use of customer dividends supports retail focused strategy

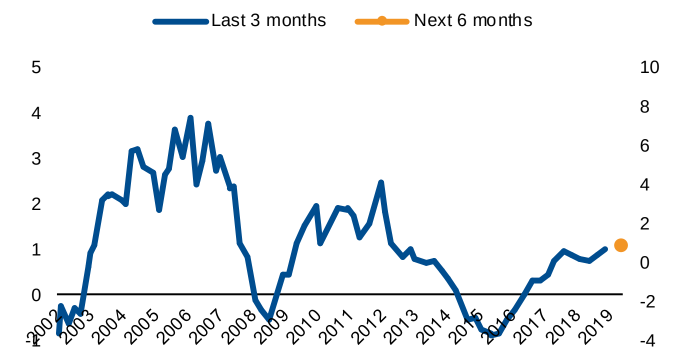
To support its customer-focused strategy, Sandnes in 2017 was the second bank to obtain approval from the Norwegian FSA to distribute customer dividends. The amount of the dividend depends on the bank's profits as well as the balance of a customer's deposits and loans. Customer dividends act as a marketing tool for building stronger customer relationships, but also prevent the dilution of equity capital certificate investors in the bank. In addition, management sees customer dividends as a way of utilizing excess capital in line with the core values of a savings bank.

Along with its lower risk profile and strengthened solvency position, Sandnes is better positioned against the more cyclical market that it operates in. The bank's home market of Sandnes sits within the broader region of Rogaland, the third largest urban area in Norway and the centre of the country's oil and gas industry. Consequently, the region enjoys relatively high wealth levels but also greater economic volatility.

Unemployment in local market has recovered to national level

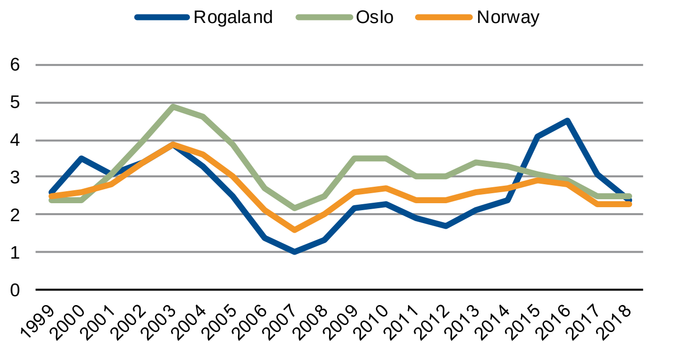
The local economy has largely recovered from the 2014-2015 decline in oil prices and investments, with unemployment converging to the national level (Figure 6). From a peak in the summer of 2013, home prices in Rogaland having been relatively stable over last few years. Meanwhile, management believes that the worst has passed for the local commercial real estate sector, although there remains spare capacity.

Figure 5: Production growth expectations – southwest region



Note: Left-hand scale = index. The index ranges from -5 to +5, where -5 indicates a sharp fall and +5 indicates strong growth. Right-hand scale = annualized percent. Source: Norges Bank's regional network survey – Nov 2019

Figure 6: Unemployment rates (%)



Source: Statistics Norway

Material reliance on market funding mitigated to some extent by active liquidity management

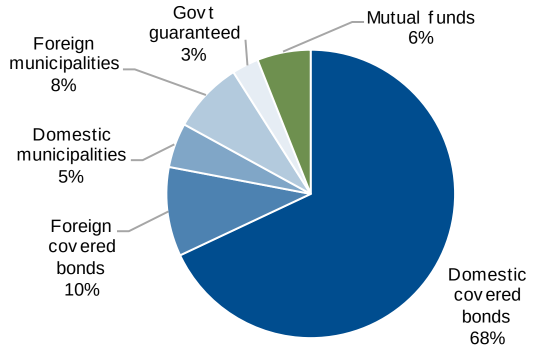
In common with other Norwegian and Nordic banks, Sandnes relies to a substantial degree on market funding, with deposits accounting for about half of funding needs. Management believes that the natural level for the bank is a 50% deposit-to-loan ratio. While more deposits could be obtained this would likely mean attracting less stable, larger deposits or being more aggressive with deposit pricing.

Covered bonds an important and relatively stable source of market funding

Covered bonds which have proven to be a reliable source of market funding account for another quarter of the bank's funding. The bank has its own covered bond issuing entity, Sandnes Sparebank Boligkreditt, but also has flexibility to issue from the covered bond issuing entity of the Eika Alliance. The remaining funding source is primarily senior debt.

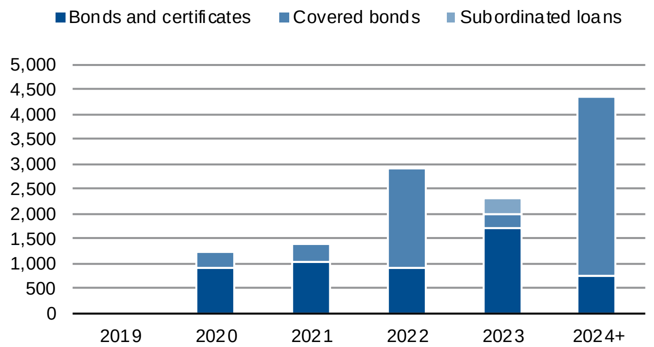
To mitigate refinancing risks, the bank maintains a high-quality liquidity portfolio. As of 3Q 2019, the liquidity portfolio amounted to NOK 3.3bn excluding cash and was comprised primarily of covered bonds and government paper (Figure 7). The bank also prefers to issue in smaller size to manage refinancing risks. As well, Scope notes that the management team actively and regularly communicates with investors, providing comprehensive information about the bank.

Figure 7: Breakdown of liquidity portfolio (NOK 3.3bn)



Note: Data as of 3Q 2019.
Source: Company data, Scope Ratings

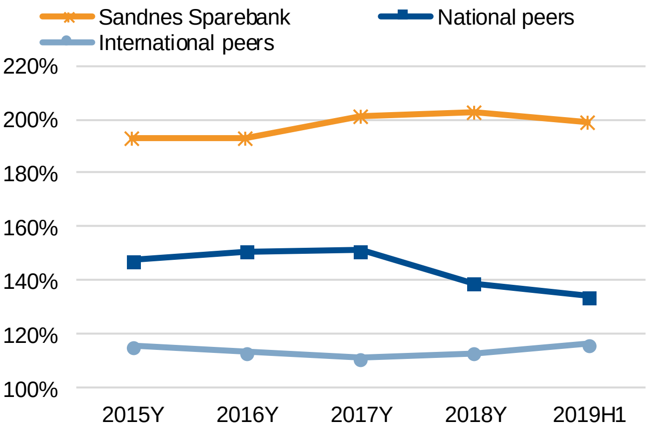
Figure 8: Maturity profile (net maturities) (NOK m)



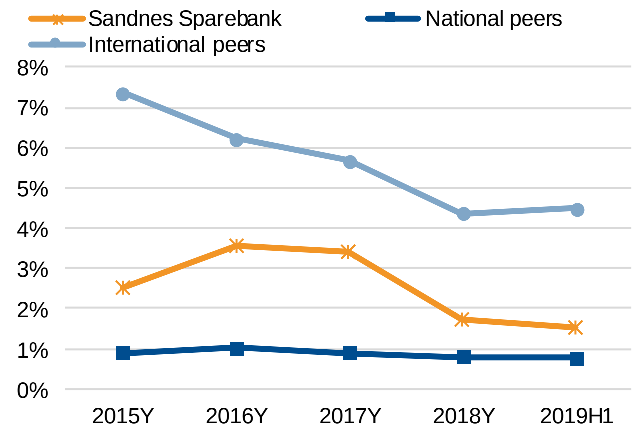
Note: Data as of 3Q 2019.
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

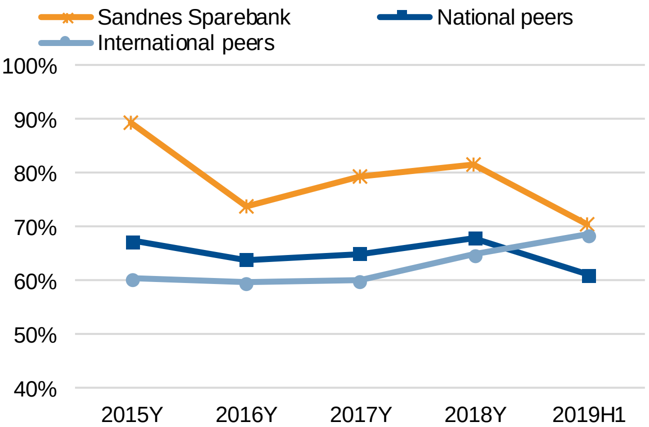
Net customer loans % Deposits



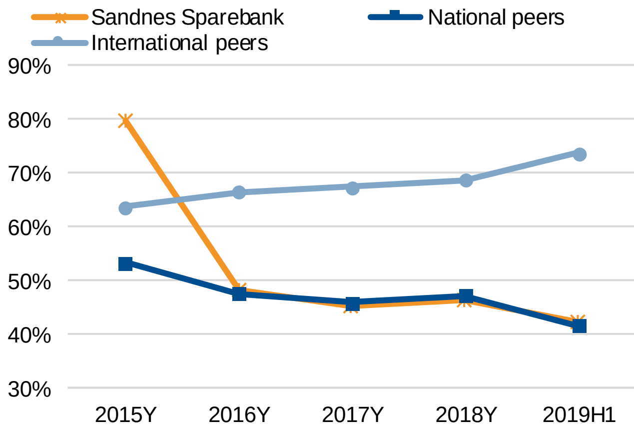
Problem loans % Net loans



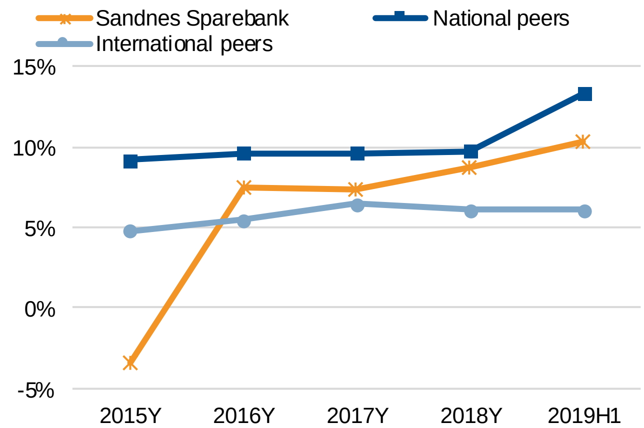
Net interest income % Operating income



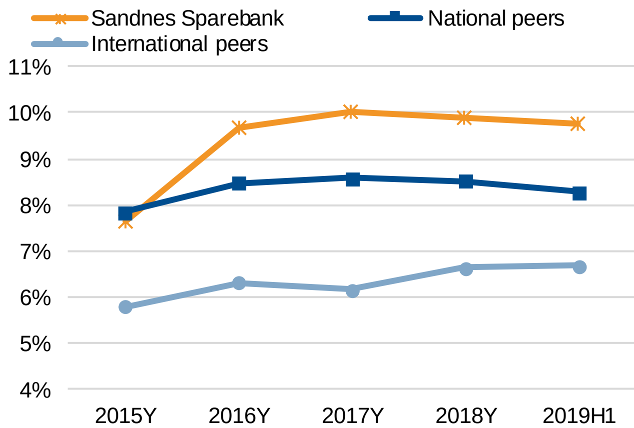
Costs % Income



Return on average equity (%)



Leverage ratio (%)



National peers: Sandnes Sparebank, Totens Sparebank, Landkreditt Bank, DNB, SpareBank 1 SMN, SpareBank 1 SR-Bank, Sparebank 1 Ostlandet, Jaeren Sparebank.
International peers: Sandnes Sparebank, Hypo-Bank Burgenland, Bausparkasse Wustenrot, Banca Popolare di Sondrio, Credito Emiliano, Kutxabank, Unicaja, Principality Building Society.

Note: 1H 2019 figures are unavailable for Hypo-Bank Burgenland and Bausparkasse Wustenrot.

Source: SNL

II. Appendix: Selected Financial Information – SandnesSparebank

	2015Y	2016Y	2017Y	2018Y	9M 2019
Balance sheet summary (NOK m)					
Assets					
Cash and interbank assets	892	1,149	645	656	516
Total securities	3,344	3,627	3,867	4,270	4,089
of which, derivatives	271	175	155	150	142
Net loans to customers	22,825	21,483	21,473	22,214	22,908
Other assets	222	162	115	69	151
Total assets	**27,283**	**26,420**	**26,100**	**27,209**	**27,664**
Liabilities					
Interbank liabilities	182	29	37	50	272
Senior debt	12,551	11,997	11,702	12,318	12,135
Derivatives	224	104	102	148	96
Deposits from customers	11,410	10,905	10,857	11,252	11,833
Subordinated debt	649	649	525	318	201
Other liabilities	185	153	167	163	163
Total liabilities	**25,201**	**23,837**	**23,391**	**24,248**	**24,700**
Ordinary equity	2,074	2,578	2,704	2,857	2,861
Equity hybrids	0	0	0	100	100
Minority interests	8	6	4	4	4
Total liabilities and equity	**27,283**	**26,420**	**26,100**	**27,209**	**27,664**
Core tier 1/ common equity tier 1 capital	1,916	2,448	2,569	2,585	2,514
Income statement summary (NOK m)					
Net interest income	448	442	474	462	344
Net fee & commission income	51	62	54	49	37
Net trading income	-50	47	15	-4	7
Other income	53	48	54	59	72
Operating income	**502**	**598**	**597**	**566**	**459**
Operating expenses	400	288	269	261	198
Pre-provision income	**102**	**310**	**328**	**305**	**261**
Credit and other financial impairments	234	112	72	24	15
Other impairments	-23	-2	0	0	0
Non-recurring items	0	0	0	0	0
Pre-tax profit	**-109**	**218**	**256**	**300**	**245**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	-35	46	59	55	36
Net profit attributable to minority interests	-2	0	1	0	0
Net profit attributable to parent	**-73**	**172**	**197**	**244**	**209**

Source: SNL

III. Appendix: Ratios – Sandnes Sparebank

	2015Y	2016Y	2017Y	2018Y	2019T3
Funding and liquidity					
Net loans/ deposits (%)	193.2%	193.4%	201.3%	203.0%	197.0%
Liquidity coverage ratio (%)	108.0%	193.0%	238.0%	171.0%	217.0%
Net stable funding ratio (%)	138.0%	137.0%	117.0%	126.0%	NA
Asset mix, quality and growth					
Net loans/ assets (%)	83.7%	81.3%	82.3%	81.6%	82.8%
Problem loans/ gross customer loans (%)	2.5%	3.6%	3.4%	1.7%	1.3%
Loan loss reserves/ problem loans (%)	73.6%	52.3%	52.4%	60.3%	54.8%
Net loan growth (%)	-4.4%	-5.9%	0.0%	3.5%	4.2%
Problem loans/ tangible equity & reserves (%)	24.0%	26.5%	24.4%	12.3%	9.5%
Asset growth (%)	-5.3%	-3.2%	-1.2%	4.3%	2.2%
Earnings and profitability					
Net interest margin (%)	1.5%	1.7%	1.8%	1.7%	1.7%
Net interest income/ average RWAs (%)	2.6%	2.8%	3.1%	3.0%	2.9%
Net interest income/ operating income (%)	89.3%	73.8%	79.4%	81.6%	75.0%
Net fees & commissions/ operating income (%)	10.1%	10.3%	9.0%	8.7%	8.0%
Cost/ income ratio (%)	79.6%	48.2%	45.0%	46.1%	43.1%
Operating expenses/ average RWAs (%)	2.4%	1.8%	1.8%	1.7%	1.7%
Pre-impairment operating profit/ average RWAs (%)	0.6%	2.0%	2.1%	2.0%	2.2%
Impairment on financial assets / pre-impairment income (%)	228.5%	36.1%	22.1%	7.8%	5.9%
Loan loss provision/ average gross loans (%)	1.0%	0.5%	0.3%	0.1%	0.1%
Pre-tax profit/ average RWAs (%)	-0.6%	1.4%	1.7%	1.9%	2.1%
Return on average assets (%)	-0.3%	0.6%	0.8%	0.9%	1.0%
Return on average RWAs (%)	-0.4%	1.1%	1.3%	1.6%	1.8%
Return on average equity (%)	-3.4%	7.5%	7.4%	8.7%	9.6%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	12.1%	15.6%	16.6%	16.6%	16.0%
Tier 1 capital ratio (%, transitional)	13.8%	17.5%	18.1%	17.3%	16.6%
Total capital ratio (%, transitional)	15.9%	19.7%	20.0%	18.6%	17.9%
Leverage ratio (%)	7.6%	9.7%	10.0%	9.9%	9.6%
Asset risk intensity (RWAs/ total assets, %)	58.0%	59.3%	59.2%	57.1%	56.8%
Market indicators					
Price/ book (x)	0.4x	0.6x	0.7x	0.7x	0.8x
Price/ tangible book (x)	NA	0.3x	0.5x	0.8x	NA
Dividend payout ratio (%)	NA	26.0%	50.0%	75.4%	NA

Note: With the proportional consolidation of Sandnes' stake in the Eika Alliance, the CET1, Tier 1 and Total capital ratios would be 16.3%, 17%, and 18.3%, respectively at 9M 2019. For YE 2018, the CET1, Tier 1 and Total capital ratios would be 16.8%, 17.4% and 18.8%, respectively.
Source: SNL

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