Sandnes Sparebank Issuer Rating Report

POSITIVE
BBB+

Overview

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

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 2018) and when the Norwegian FSA clarifies which debt is MREL-eligible, we expect to rate senior unsecured MREL-eligible debt one notch below the Issuer Rating and senior unsecured non-MREL-eligible 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.

Highlights

- Founded in 1875, Sandnes Sparebank is a well-established savings bank in Sandnes, one of the major cities in the region of Rogaland in south-west Norway.
- 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 takes comfort from the change in risk appetite as well as the significant clean-up of the corporate loan portfolio.
- Though the current management team has been in place only since 2017, the bank's 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.
- 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. While the Norwegian economy is recovering from the 2014-2015 decline in oil prices, the local economy remains subject to more cyclicality as it is the centre of the country's oil and gas industry.
- 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.

Ratings & Outlook

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

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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 (Sandnes) is considered the bank of the city of Sandnes in south-west Norway. Serving about 42,000 retail customers and about 5,000 corporate customers, the bank's main office and branch is in the city center. In addition, the bank has two other small branches – in Stavanger (five employees) and Oslo (two 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.

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 concentrated on reducing the bank's risk profile.

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.

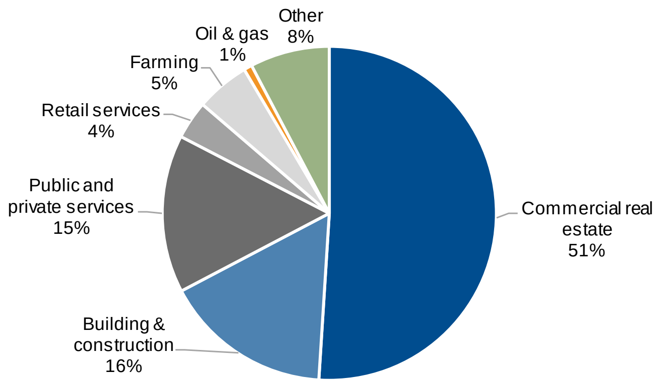
Over the last several years, management has diligently addressed the issues arising from previous more aggressive and riskier business practices. For example, Sandnes no longer has a trading portfolio and FX loans are no longer actively marketed to existing or potential clients.

While corporate lending, which has been the driver of loan losses, continues to comprise one-third of the loan book, the composition and risk profile of this lending has materially changed. The proportion related to real estate has moderated whereas lending to agriculture and services 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).

Under the bank's internal risk classification, the proportion of lending considered to be in the lowest- and low-risk categories (expected loss rate below 0.35%) has grown while the medium- and highest-risk categories have declined. (Figure 2).

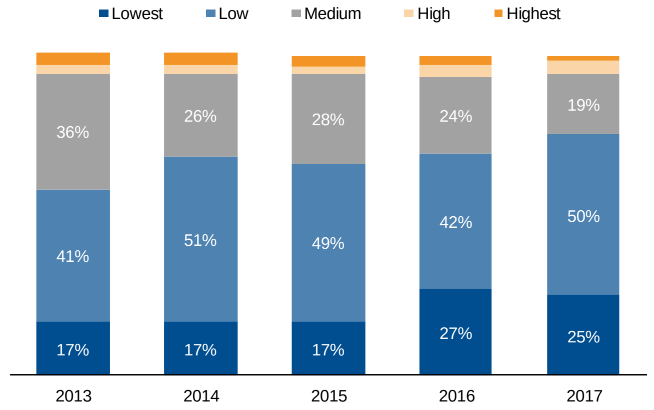
[1] Established by smaller Norwegian savings banks in 1997. There are currently about 70 member banks, with assets ranging from NOK 1bn to NOK 27bn.

Figure 1: Composition of corporate portfolio (NOK 7bn)



Note: Data as of 3Q 2018.
Source: Company data, Scope Ratings.

Figure 2: Improved risk profile of corporate portfolio



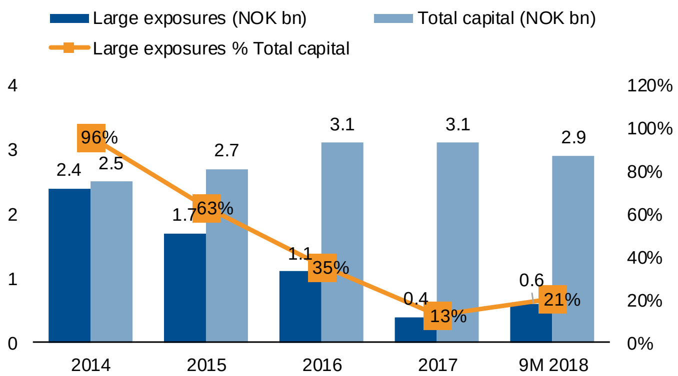
Note: Lowest risk category = expected loss <0.05%; low = 0.05%-0.35%; medium = 0.35%-1.5%; high = 1.5%-2.5%; highest = >2.5%.
Source: Company data, Scope Ratings

Importantly for the stability of future earnings, the magnitude and concentration of large lending exposures has been significantly reduced (Figure 3). Instead, they are being replaced by a greater number of smaller SME loans. (Figure 4). Management considers this to be the appropriate lending strategy for a savings bank such as Sandnes.

Meanwhile, the retail lending portfolio, which accounts for two-thirds of the total is almost entirely comprised of mortgage lending. As of 3Q 2018, 88% of mortgage loans have a loan-to-value (LTV) below 85%, with the weighted average LTV being around 64%.

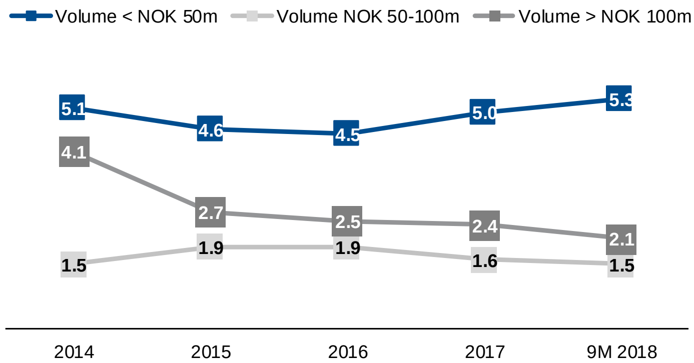
As of 3Q 2018, the non-performing loan ratio has fallen to 2.1%, from a peak of more than 6% in 2010 and 2011. Loan loss provisions stand at 54%. Throughout 2018, management has guided to lower loan losses. As of October 2018, the guidance was NOK 30-60m, down from NOK 50-90m early in the year. In 2017, loan losses were NOK 72m.

Figure 3: Declining large exposures



Note: Large exposures are defined under regulation as exposures >10% of total capital. Source: Company data, Scope Ratings

Figure 4: Growing proportion of smaller loans



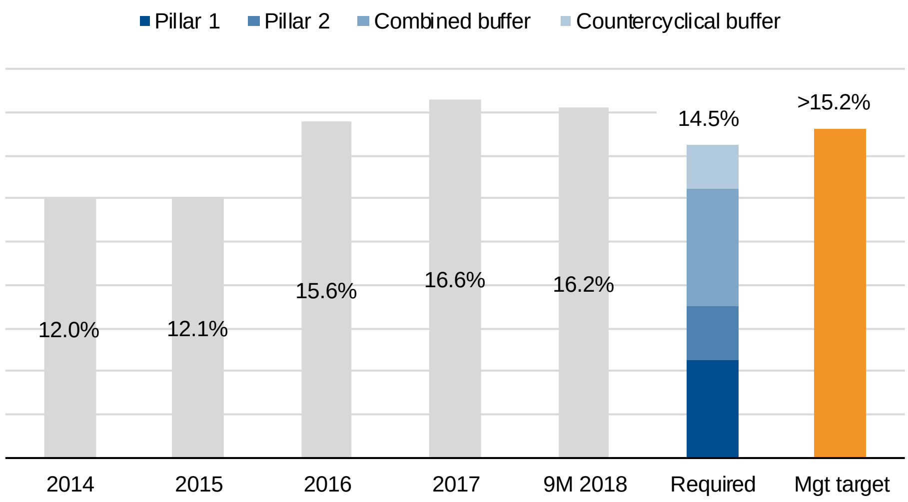
Source: Company data, Scope Ratings

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

With lower loan losses and improved operational efficiency, the bank's financial profile is becoming increasingly sound. This is further supported by the bank's strengthened solvency position. As of 3Q 2018, the CET1 capital ratio was 16.2% and the Tier 1 leverage ratio was 9.7%, up from 12% and 7%, respectively in 2014.

Scope considers regulatory requirements for Norwegian banks to be relatively stringent. All banks, regardless of size, are subject to a systemic risk buffer of 3% and the current countercyclical capital buffer requirement is 2%.[2] With a Pillar 2 requirement of 2.5%, Sandnes' current minimum CET1 requirement is 14.5%. Meanwhile, management targets a CET1 ratio of at least 15.2%.

Figure 5: Development of CET1 capital vs. requirement



Note: Source: Company data, Scope Ratings

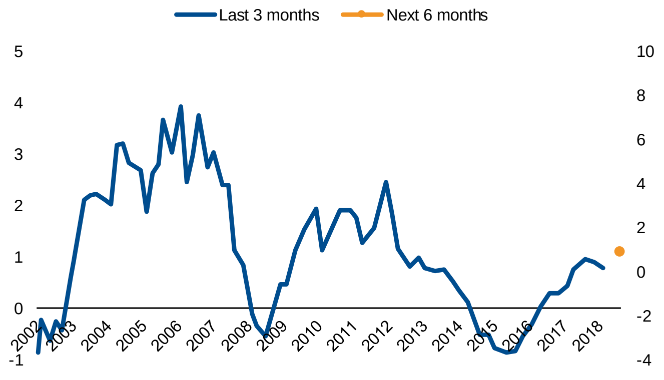
To support its customer-focused strategy, Sandnes in 2017 obtained approval from the Norwegian FSA to distribute customer dividends; the second bank in Norway to do so. The amount of the dividend depends on the bank's profits as well as the balance of a customer's deposits and loans. Customer dividends act as a marketing tool for building stronger customer relationships, but also prevent the dilution of equity capital certificate investors in the bank. Further, 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 which is 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 (Figure 6).

The local economy is recovering from the 2014-2015 decline in oil prices and investments, with unemployment converging to the national level (Figure 7). From a peak in the summer of 2013, home prices in Rogaland having been trading sideways while nationally prices have continued to climb. Meanwhile, management believes that for the local commercial real estate market the worst has passed, although there remains spare capacity.

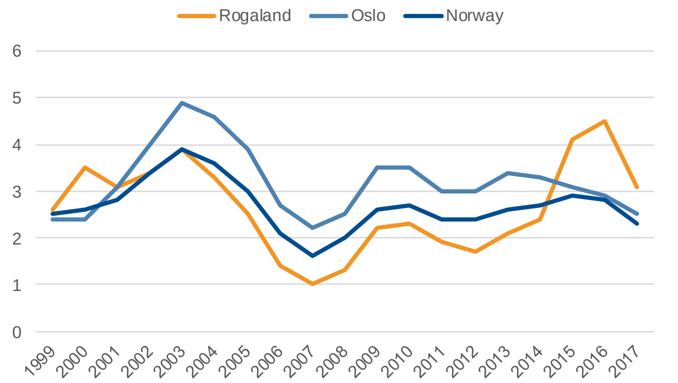
[2] From 31 December 2019, the countercyclical capital buffer requirement is expected to rise to 2.5% from the current 2%.

Figure 6: 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 2018

Figure 7: Unemployment rates (%)



Source: Statistics Norway

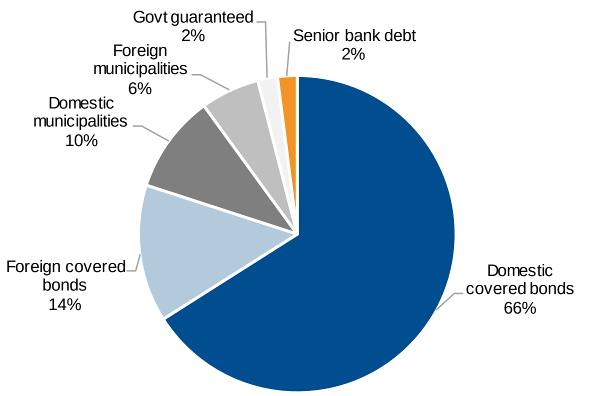
Material reliance on market funding mitigated somewhat by active liquidity management.

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 a 50% deposit-to-loan ratio is the natural level for the bank. While more deposits could be obtained this would likely mean attracting less stable, larger deposits or being more aggressive with deposit pricing.

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.

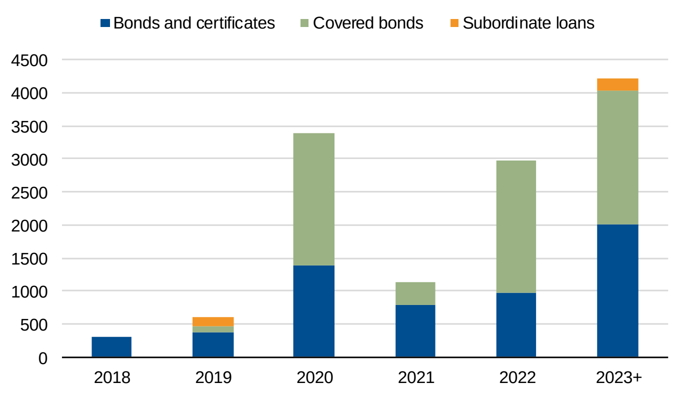
To mitigate refinancing risks, the bank maintains a high-quality liquidity portfolio. As of 3Q 2018, the liquidity portfolio amounted to NOK 3.3bn excluding cash and was comprised primarily of covered bonds and government paper (Figure 9). The bank also prefers to issue in smaller size to manage refinancing risks. As well, Scope notes that the current management team actively and regularly communicates with investors, providing a very comprehensive level of information about the bank.

Figure 9: Breakdown of liquidity portfolio (NOK 3.3bn)



Note: Data as of 3Q 2018.
Source: Company data, Scope Ratings

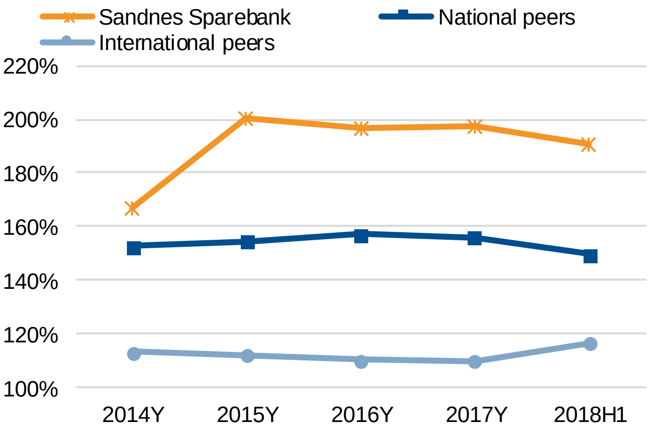
Figure 10: Maturity profile (net maturities) (NOK m)



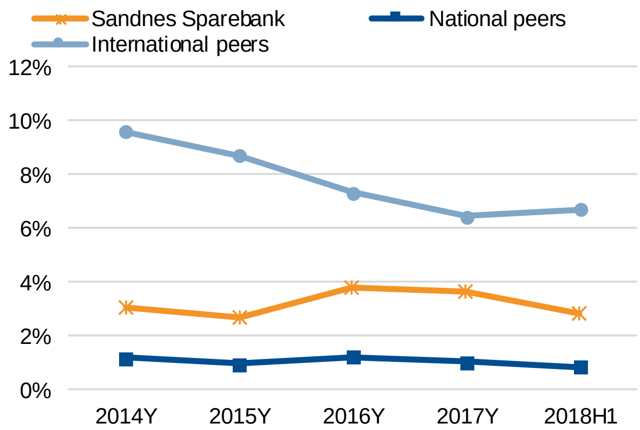
Note: Data as of 3Q 2018.
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

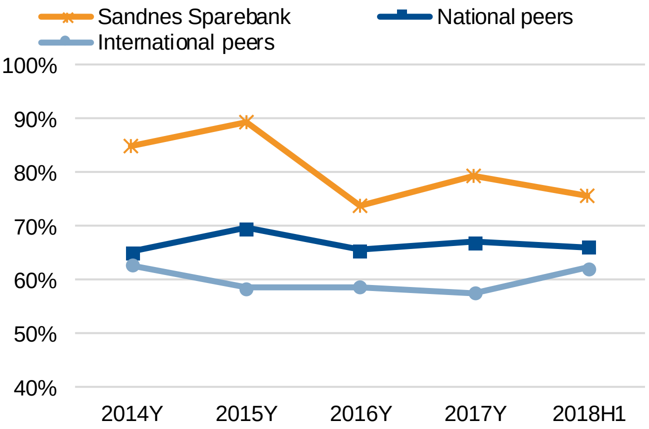
Net customer loans % Deposits



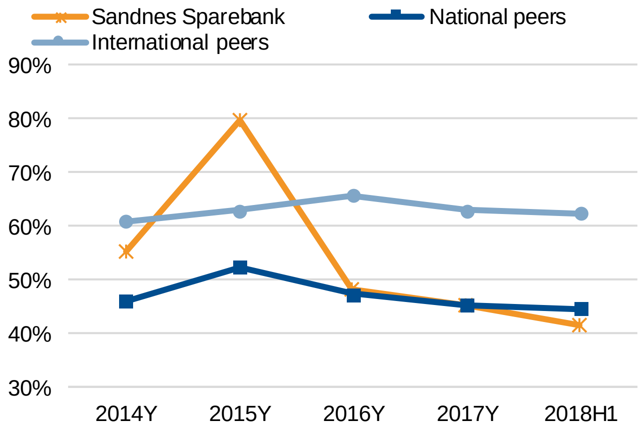
Non-performing loans % Net loans



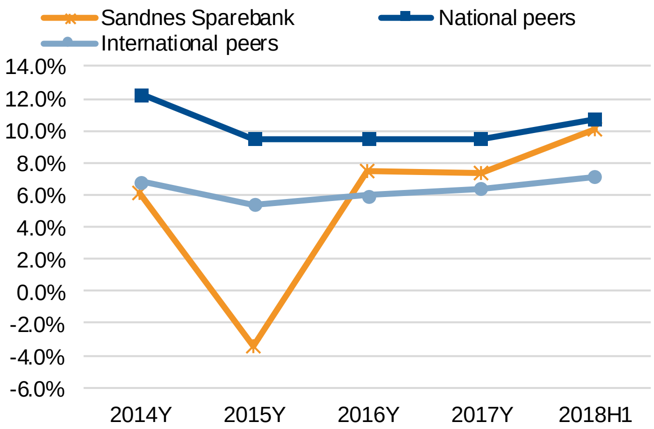
Net interest income % Operating income



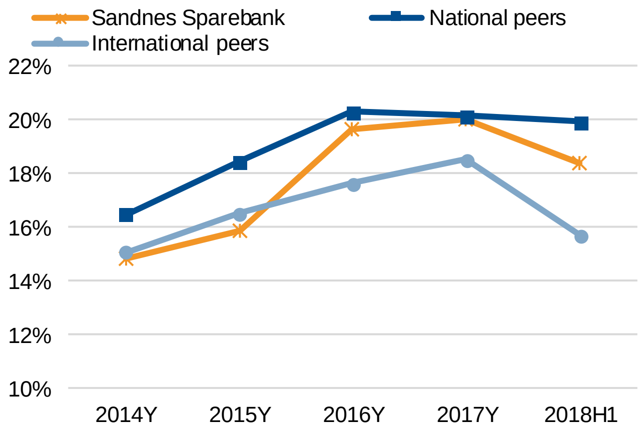
Costs % Income



Return on average equity (%)



Total capital ratio (transitional) (%)



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: Hypo-Bank Burgenland and Bausparkasse Wustenrot do not report 2018 H1 figures.
Source: SNL

II. Appendix: Selected Financial Information – SandnesSparebank

	2014Y	2015Y	2016Y	2017Y	2018 9M
Balance sheet summary (NOK m)					
Assets					
Cash and interbank assets	712	892	1,149	645	963
Total securities	4,027	3,344	3,627	3,867	3,890
of which, derivatives	311	271	175	155	126
Net loans to customers	23,872	22,825	21,483	21,473	22,073
Other assets	207	222	162	115	95
Total assets	**28,818**	**27,283**	**26,420**	**26,100**	**27,021**
Liabilities					
Interbank liabilities	256	182	29	37	56
Senior debt	10,955	12,551	11,997	11,702	12,347
Derivatives	283	224	104	102	107
Deposits from customers	14,308	11,410	10,905	10,857	11,184
Subordinated debt	649	649	649	525	234
Other liabilities	222	185	153	167	185
Total liabilities	**26,672**	**25,201**	**23,837**	**23,391**	**24,114**
Ordinary equity	2,140	2,074	2,578	2,704	2,803
Equity hybrids	0	0	0	0	100
Minority interests	6	8	6	4	4
Total liabilities and equity	**28,818**	**27,283**	**26,420**	**26,100**	**27,021**
Core tier 1/Common equity tier 1 capital	2,040	1,916	2,448	2,569	2,532
Income statement summary (NOK m)					
Net interest income	475	448	442	474	347
Net fee & commission income	59	51	62	54	37
Net trading income	0	-50	47	15	3
Other income	26	53	48	54	53
Operating income	**560**	**502**	**598**	**597**	**440**
Operating expense	310	400	288	269	192
Pre-provision income	**250**	**102**	**310**	**328**	**248**
Credit and other financial impairments	39	234	112	72	30
Other impairments	12	-23	-2	0	0
Non-recurring items	-16	0	18	0	11
Pre-tax profit	**183**	**-109**	**218**	**256**	**230**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	54	-35	46	59	47
Net profit attributable to minority interests	-7	-2	0	1	1
Net profit attributable to parent	**136**	**-73**	**172**	**197**	**182**

Source: SNL

III. Appendix: Ratios – Sandnes Sparebank

	2014Y	2015Y	2016Y	2017Y	2018 9M
Funding and liquidity					
Net loans/deposits (%)	164.9%	193.2%	193.4%	201.3%	201.9%
Liquidity coverage ratio (%)	NA	108.0%	193.0%	238.0%	236.0%
Net stable funding ratio (%)	99.0%	138.0%	137.0%	117.0%	126.0%
Asset mix, quality and growth					
Net loans/assets (%)	82.8%	83.7%	81.3%	82.3%	81.7%
NPLs/net loans (%)	3.0%	2.7%	3.8%	3.6%	2.1%
Loan-loss reserves/NPLs (%)	30.0%	73.6%	52.3%	52.4%	54.0%
Net loan growth (%)	2.7%	-4.4%	-5.9%	0.0%	3.7%
NPLs/tangible equity and reserves (%)	29.9%	24.0%	26.5%	24.4%	14.6%
Asset growth (%)	0.4%	-5.3%	-3.2%	-1.2%	4.7%
Earnings and profitability					
Net interest margin (%)	1.7%	1.6%	1.7%	1.8%	1.8%
Net interest income/average RWAs (%)	2.8%	2.6%	2.8%	3.1%	3.0%
Net interest income/operating income (%)	84.9%	89.3%	73.8%	79.4%	78.8%
Net fees & commissions/operating income (%)	10.5%	10.1%	10.3%	9.0%	8.4%
Cost/income ratio (%)	55.3%	79.6%	48.2%	45.0%	43.6%
Operating expenses/average RWAs (%)	1.8%	2.4%	1.8%	1.8%	1.7%
Pre-impairment operating profit/average RWAs (%)	1.5%	0.6%	2.0%	2.1%	2.1%
Impairment on financial assets /pre-impairment income (%)	15.6%	228.5%	36.1%	22.1%	11.9%
Loan-loss provision charges/net loans (%)	0.2%	1.0%	0.5%	0.4%	0.2%
Pre-tax profit/average RWAs (%)	1.1%	-0.6%	1.4%	1.7%	2.0%
Return on average assets (%)	0.4%	-0.3%	0.6%	0.8%	0.9%
Return on average RWAs (%)	0.8%	-0.4%	1.1%	1.3%	1.6%
Return on average equity (%)	6.1%	-3.4%	7.5%	7.4%	8.9%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	12.0%	12.1%	15.6%	16.6%	16.2%
Tier 1 capital ratio (%, transitional)	13.2%	13.8%	17.5%	18.1%	17.7%
Total capital ratio (%, transitional)	14.8%	15.9%	19.7%	20.0%	18.3%
Leverage ratio (%)	7.0%	7.6%	9.9%	10.0%	9.7%
Asset risk intensity (RWAs/total assets, %)	59.1%	58.0%	59.3%	59.2%	57.8%
Market indicators					
Price/book (x)	0.6x	0.4x	0.6x	0.7x	0.8x
Price/tangible book (x)	0.6x	0.4x	0.6x	0.7x	0.8x
Dividend payout ratio (%)	28.8%	0.0%	26.0%	50.0%	NA

Source: SNL

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