

MOODY'S

INVESTORS SERVICE

BANKING SYSTEM OUTLOOK

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Norway

Our outlook for Norway's banking system has been changed to stable, after having been negative since 2008. The outlook expresses our expectation of how bank creditworthiness will evolve in this system over the next 12-18 months.

Summary Opinion

We have changed the outlook on Norway's banking system to stable from negative. The stable outlook primarily reflects our expectation that over the outlook period, the strong Norwegian economy will continue to provide a secure operating backdrop for Norwegian banks that meaningfully offsets rising risks for the sector. Specifically, we expect that (1) the Norwegian operating environment will remain supportive, with low interest rates and high employment buoying asset quality; (2) banks' capital levels will remain strong enough to provide adequate buffers against potential losses; and (3) profitability will be underpinned by stable revenues and modest loan loss provisions.

At the same time, Norwegian banks' reliance on market funding poses a key risk to the system. While Norwegian banks have had ready access to capital markets due to investors' perception of Norway as a safe haven, market funds are inherently sensitive to changes in investor sentiment and therefore at risk of becoming less available and/or more expensive in times of stress.

In addition, we continue to see some longer-term risks related to the fragile economic situation in Europe, households' high debt levels, sensitivity to changes in interest rates and potentially over-inflated house prices. Combined, these factors could have negative impacts on households' and corporates' debt-repayment capacity.

Operating Environment. The Norwegian economy's strength provides a core element of our stable outlook for the Norwegian banking sector. We expect the domestic economy to grow by over 3% in 2012-13, and unemployment to remain around its currently very low level (3% at end-September 2012). Although Norway's economy is sensitive to developments in the euro area, we believe the government's robust balance sheet provides it with considerable financial flexibility to dampen the effects of a cyclical downturn in the real economy.

Asset Quality and Capital. Asset quality will remain strong over the outlook period in our view, although we see medium-term risks as rising. We do not expect a material increase in problem loans in banks' retail loan books as long as interest rates and unemployment remain low; however, in the longer run, elevated household indebtedness and a protracted rise in house prices may undermine the sustainability of the banks' currently sound residential mortgage performance. We also continue to view banks' often substantial exposure to commercial real estate and, in some cases, shipping as a challenge to their corporate loan books' credit quality. Against this backdrop, we view Norwegian banks' recently strengthened capital levels (aggregate Tier 1 ratio improved by 1.4 percentage points to 12.4% in the twelve months to end-September 2012) as adequate to withstand a moderate deterioration in asset quality.

Profitability and efficiency. Over the outlook period, we expect that banks' revenue generation will continue to be underpinned by moderate lending growth and recently increased lending margins, mitigating the negative impact of continued high funding costs. Effective cost containment and relatively limited loan loss provisions will also be supportive factors to banks' bottom lines.

Currently, most of our standalone ratings for Norwegian banks carry stable outlooks. These stable outlooks primarily reflect the banks' solid fundamentals, which supported them throughout the recent recession, and our view that Norwegian banks can withstand a modest credit stress at their current rating levels. The debt and deposit ratings for the four rated banks in the SpareBank 1 alliance are on review for downgrade as we are re-assessing our assumptions on the levels of mutual support available to banks in the alliance.¹

FIGURE 1

Outlook overview

Category	Outlook
Operating environment	Stable
Asset quality and capital	Stable
Funding and liquidity	Negative
Profitability and efficiency	Stable
Systemic support	Stable
Overall banking system outlook	Stable

Definition of Banking System Outlook

Banking system outlooks represent our forward-looking assessment of fundamental credit conditions that will affect the creditworthiness of banks in a given system over the next 12-18 months. As such, banking system outlooks provide our view of how the operating environment for banks, including macroeconomic, competitive and regulatory trends, will affect asset quality, capital, funding, liquidity and profitability. Banking system outlooks also consider our forward-looking view of the systemic support environment for bank creditors.

Since banking system outlooks represent our forward-looking view on credit conditions that factor into our bank ratings, a negative (positive) outlook suggests that negative (positive) rating actions are more likely on average.

Rating Universe

This report focuses on the 14 rated Norwegian financial institutions (see Figure 2). These institutions account for the bulk of the Norwegian banking market, holding over 80% of system assets as of year-end 2011. The remainder of the banking system comprises smaller, local banks. The average (asset-weighted) standalone bank financial strength rating (BFSR) for Norwegian banks is C-, equivalent to a baa1 standalone credit assessment, or C-/baa2 un-weighted. The weighted-average global local-currency deposit rating is A1 (A2 un-weighted).

¹ For more details, please see our [press release](#), published on 6 December 2012

FIGURE 2
Moody's rated institutions in Norway

Bank name	Total assets at end-September 2012 (Euro bn)	Standalone credit assessment	LT deposit rating	Parent / coop / RLG support	Systemic support
DNB Bank ASA	287.38	baa1/Sta	A1/Sta	0	3
Nordea Bank Norge ASA	81.17	baa1/Sta	Aa3/Sta	2	2
SpareBank 1 SR-Bank ASA	18.82	baa2/Sta	A2/RuR down	1	2
Sparebanken Vest	17.10	baa1/Sta	A2/Sta	0	2
SpareBank 1 SMN	15.02	baa2/Sta	A2/RuR down	1	2
SpareBank 1 Nord-Norge	10.08	baa1/Sta	A1/RuR down	1	2
Sparebanken Møre	6.82	baa2/Sta	A2/Sta	0	2
Sparebanken Hedmark	5.88	baa1/Sta	A1/RuR down	1	2
Sparebanken Sør	5.87	baa2/Sta	A3/Sta	0	2
Sparebanken Pluss	5.80	baa1/Sta	A2/Sta	0	2
Storebrand Bank	5.57	baa3/Sta	Baa1	1	1
Sparebanken Sogn og Fjordane	4.93	baa2/Sta	A3/Sta	0	2
Sparebanken Øst	3.91	baa2/Sta	A3/Sta	0	2
Ekspartfinans ASA*	23.26	ba3/Neg	Ba3/Neg	0	0

* Government-related issuer

Key Developments Since the Last Banking System Outlook

- » Economic growth in 2012 has been stronger than we expected.
- » The Norwegian regulator is toughening its stance on banks' credit standards (in particular, guidelines on mortgage lending now include an 85% loan-to-value cap), and is proposing that Norwegian banks reduce their reliance on covered bond funding.²
- » Norwegian banks have strengthened their Tier 1 ratios by 1.4 percentage points in aggregate in the twelve months to end-September 2012, following the regulator's requirement of a 9% minimum core Tier 1 ratio (including transitional floor)³ by end-June 2012.

Key Drivers for our Outlook

Strengths

- » The strong Norwegian economy provides a stable operating backdrop, and most Norwegian banks remain focused on the local economy.
- » Bank asset quality is sound, helped by low interest rates and high employment.
- » Earnings generation is resilient, compared with global peers.
- » Capital levels are adequate to absorb moderate unexpected losses.

² See: [Norway Considers Limiting Covered Bonds: Credit Positive for Unsecured Bank Creditors](#), October 2012

³ In Norway, the transitional floor means that, in the calculation of capital requirement and capital adequacy figures, risk-weighted assets shall not be lower than 80% of risk-weighted assets as measured in accordance with Basel I.

- » Banks have slightly lengthened their funding maturity profiles and increased their liquidity buffers, mitigating short-term refinancing risks.

Weaknesses

- » The Norwegian banking system is largely market funded, exposing the banks to a deterioration in investor sentiment and market fluctuations.
- » Banks are generally highly exposed to the commercial real estate sector, and some banks also have substantial exposures to the shipping sector, for which we foresee a bleak outlook.
- » Most banks' commercial loan portfolios display high borrower concentrations, largely reflecting the concentrated Norwegian corporate market, which is serviced by a limited number of larger banks.
- » Over the longer term, interest-rate hikes or a drop in property prices could impair banks' asset quality as households are highly indebted and house prices have increased rapidly.
- » Further deterioration in the euro area economies could affect growth prospects for the Norwegian economy and exporting companies and, in turn, bank's asset quality and profitability.

Operating Environment

We see the strong Norwegian economy as a core element of the stable outlook for Norwegian banks, and expect the operating environment to remain supportive over the outlook period, reflecting above-average domestic economic growth and high employment. However, we note that high and increasing household indebtedness and elevated house prices pose longer-term risks.

Above-average economic growth will support banks' operations over the outlook period

The sound economic conditions and outlook for Norway are key drivers for moving our outlook to stable. We expect Norway's real GDP to grow by 3.5% and 3.0% in 2012 and 2013,⁴ respectively, which is substantially higher than our projections for the euro area (-1.0%/0.0% and -0.5%/0.5% in 2012 and 2013, respectively).⁵ Our forecast for Norway primarily reflects our expectations that the economy will benefit from high investments in the oil sector and continued growth in private consumption, supported by income growth and low unemployment.

Norway's economy is, though, exposed to the still slow economic growth in Europe, which accounts for almost 70% of its exports,⁶ and to a decline in oil and gas prices as the hydrocarbon sectors account for around one-third of government revenues. Nevertheless, the Norwegian government's robust balance sheet, including its large sovereign wealth fund of nearly NOK4 trillion (around EUR540 billion) and as reflected in its Aaa stable rating, provides sufficient financial resources and flexibility to dampen the effects of a downturn in the real economy. In addition, we note that Norway, unlike members of the euro area, has its own policy framework (monetary, fiscal and macro prudential) and currency, which provide additional flexibility in responding to potential crises.

⁴ Source: [Moody's Statistical Handbook – Country Credits](#), November 2012

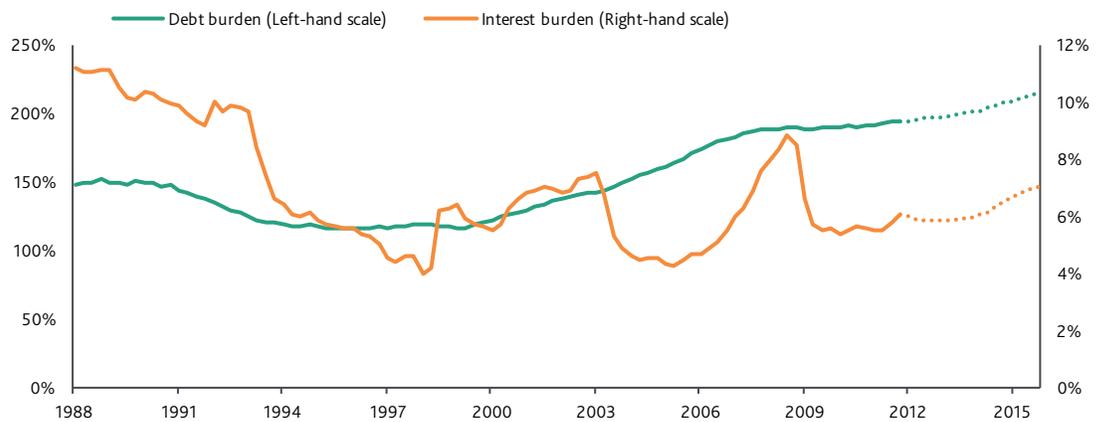
⁵ Source: [Update to the Global Macro-Risk Outlook 2012-14: Slow Adjustment to Weigh on Growth](#), November 2012

⁶ Note: The figure excludes exports of ships, oil platforms, crude oil, condensates and natural gas. Source: Statistics Norway

Borrowers' repayment capacity will continue to be supported by low interest rates and high employment over the outlook period

We expect modest inflation, the strong Norwegian krone and low interest rates in the rest of Europe will contribute to continued low policy rates in Norway. In October 2012, the Norwegian Central Bank kept the key policy rate unchanged at 1.5% and noted an expectation that stable rates will continue until at least March 2013.⁷ However, higher interest rates pose a risk in the longer run: Norwegian household debt is largely based on floating rates and the Ministry of Finance estimates that a five percentage point increase in interest rates would leave 23% of households with a financial margin (annual income after tax, less interest expense and necessary costs of living) below one month's salary.⁸

FIGURE 3
Household debt burden and interest burden*



* Debt burden: debt as a percentage of disposable income adjusted for estimated reinvested share dividends for 2000-05 and redemption/reduction in equity capital for 2006-2015; Interest burden: interest expenses after tax as a percentage of disposable income adjusted for estimated reinvested share dividends 2000-2005 and redemption/reduction of equity capital for 2006-15, plus interest expenses.

Source: Norges Bank

Another supporting factor to households' creditworthiness over the outlook period is the high level of domestic employment. Indeed, Norway boasts the lowest unemployment rate in Europe at only around 3% at end-September 2012,⁹ and we expect this level to be sustained in 2013. Furthermore, Norway offers a generous social security system, with the unemployed receiving, on average, 62.4% of their previous salary for up to two years after becoming unemployed.¹⁰

Corporate bankruptcies also declined in 2012; according to Statistics Norway the number of bankruptcies dropped by 14% in the twelve months to end-September 2012.

⁷ Source: [Norges Bank's press release dated 31 October 2012](#)

⁸ Source: Norwegian Ministry of Finance's [Financial Markets Report](#), May 2012

⁹ Source: Statistics Norway

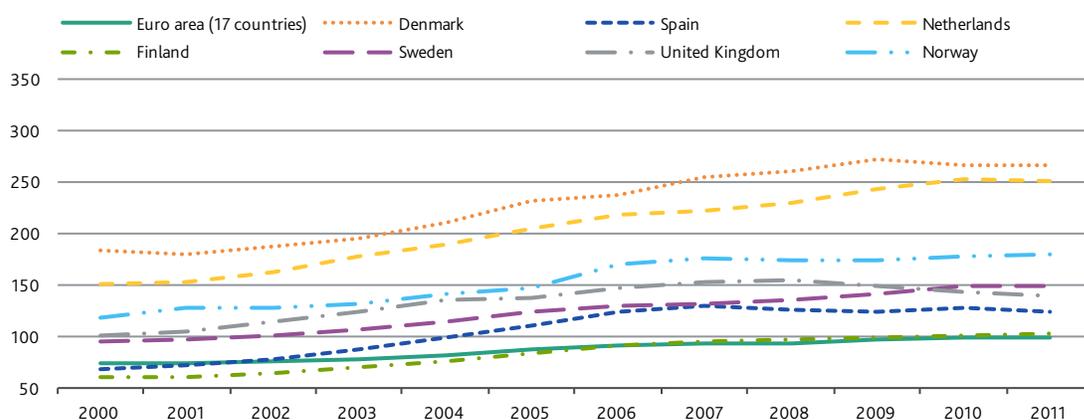
¹⁰ Source: The Norwegian Labour and Welfare Administration, [Unemployment Benefits](#)

However, elevated house prices and household indebtedness pose risks in the longer run

While we expect that low interest rates will continue to support households' repayment capacity over the outlook period, high indebtedness and rapid growth in house prices pose a long-term risk.

Norwegian households are among the most indebted in Europe (see Figure 4), with debt levels rising to almost 180% of disposable income from around 120% in 2000. While high home-ownership (approximately 85% of households)¹¹ and elevated house prices partly explain the high debt-to-income ratio, in our view these debt levels, combined with widespread usage of variable rate loans and a sizeable proportion of interest-only loans,¹² exacerbates households' vulnerabilities to an increase in interest rates or income declines.

FIGURE 4
Household gross debt / disposable income (% , averages per country)



Source: Eurostat

House prices have increased markedly since 1995 (see Figure 5) and currently are at an unprecedented high level. The increase has been partly supported by lower interest rates, rising household income (median income increased by 34% between 2000 and 2010 in fixed-price terms),¹³ and increasing demand (partly due to net migration) amid lower growth in housing stocks.

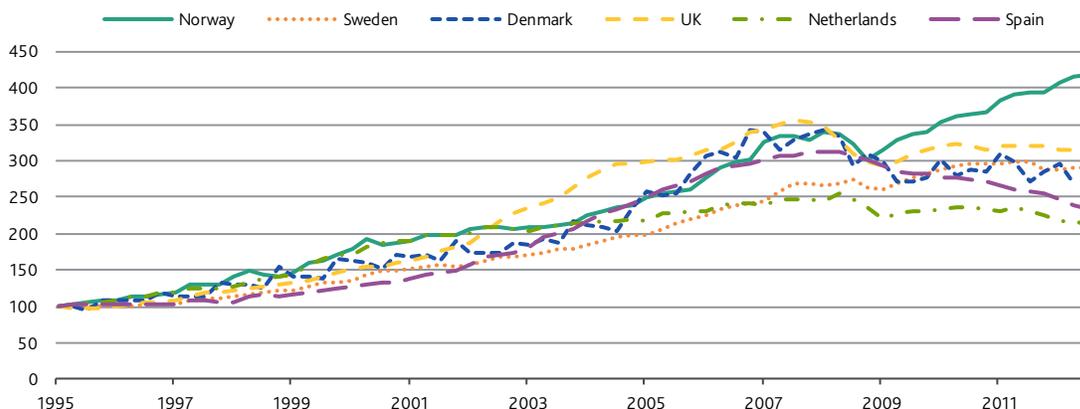
While we do not anticipate a sudden house price correction over the outlook period, we see an increasing risk of an eventual decline in house prices over the longer run.

¹¹ Source: European Mortgage Federation, Hypostat 2010, published in November 2011. Data as of end-2010.

¹² According to the survey conducted by Finanstilsynet in July and August 2012 on loans granted by the 28 largest banks after 1 June 2012, around 95% of the surveyed loans had variable interest rates and one in six loans was interest-only. Source: Finanstilsynet's [Boliglånsundersøkelsen 2012](#), December 2012 (in Norwegian).

¹³ Source: [Statistics Norway](#)

FIGURE 5
House prices in a selection of European countries (Index Q1 1995 = 100)



Source: Norges Bank

Households' high debt burden and sensitivity to changes in interest rates are long-term credit-negative factors which would accentuate the impact of a drop in house prices on Norwegian banks' asset quality. Mitigating factors supporting households' creditworthiness over the outlook period include high employment rates, continued growth in incomes, substantial assets (although a significant part is tied in less liquid assets such as real estate and insurance savings products) and increasing saving rates (around 13% of disposable income in 2011, compared to 11% in 2010).¹⁴

We also see increased house construction and regulatory changes – if phased in gradually – as likely dampening factors to elevated house prices. Statistics Norway reported a recent upswing in housing starts (in the period from January-October 2012 new housing construction was 7% higher than in the same period in 2011). The regulator's guidelines for prudent residential mortgage lending could also ease the upward pressures on house prices. Potential restrictions on banks' usage of covered bonds would also likely help to slow housing markets, as a substantial portion of residential mortgages is financed by covered bonds.

For more details on this topic, please also see our Special Comment: [Norwegian Banks: Credit Profiles Are Sensitive to Elevated House Prices](#), published in October 2012.

Asset Quality and Capital

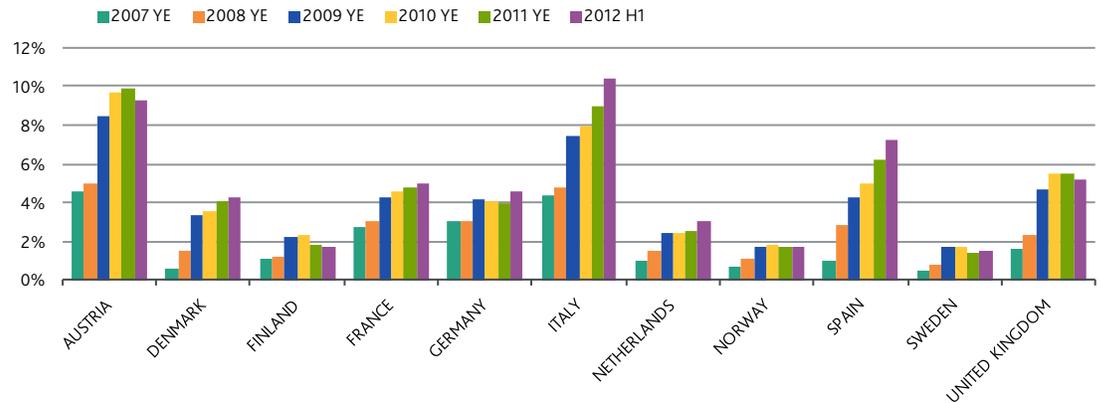
In our view, asset quality will remain a positive credit factor for Norwegian banks in the next 12-18 months as borrowers' repayment capacity will remain supported by good economic fundamentals. We also view stricter capital requirements and banks' associated capital increases as credit positive.

We expect problem loans will remain low over the next 12-18 months

We expect asset quality at Norwegian banks will remain a positive credit factor. Problem loans stood at 1.7% of gross loans as of end-September 2012 for banks rated by Moody's, and we do not expect a material increase in this figure over the outlook period (see Figure 6).

¹⁴ Source: Eurostat

FIGURE 6
Problem loan ratio at rated banks in a selection of European countries



Source: Moody's Banking Financial Metrics

Household mortgages accounted for around half of total loans outstanding as of year-end 2011.¹⁵ Loan performance in this segment has been sound: non-performing mortgage loans stood at around 1% (including loans transferred to mortgage companies) as of year-end 2011.

As discussed above, we expect banks' retail credit quality will continue to be supported by the low interest-rate environment, high employment and strong social security schemes in Norway over the outlook period, although we see some longer-term risks related to high indebtedness and elevated house prices.

Following the regulator's guidelines for prudent residential mortgage lending laid out in March 2010 (and tightened in December 2011 and May 2012),¹⁶ banks are now required to place more emphasis on underwriting criteria. A survey of lending practices conducted by Finanstilsynet in summer 2012¹⁷ showed that banks are largely following these guidelines: 17% of loans surveyed had a loan-to-value (LTV) over 85%, an improvement compared to the previous year's survey which pointed to 26% of surveyed loans with an LTV over 90%. In addition, one out of six loans surveyed in 2012 was non-amortising, compared to one out of four in the 2011 survey. We view these developments as credit-positive for Norwegian banks, as they partly mitigate our concerns over rising house prices and households' repayment capacity. However, the levels of high-LTV and non-amortising loans remain relatively high and are a source of concern.

Performance of corporate loan books is partly dependent on global economic outlook

While we expect corporate credit quality to remain supported by the strong domestic economic environment and good activity levels in the oil industry, we view this loan category as generally more vulnerable to business cycles and economic growth outside of Norway.

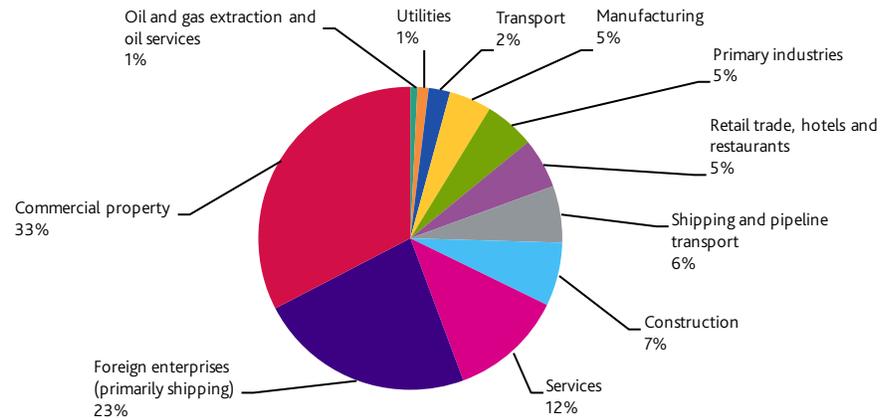
¹⁵ Source: Statistics Norway (Financial corporations. Loans and deposits by county, 2011) and Finanstilsynet (Risk Outlook 2012)

¹⁶ The guidelines primarily stipulate that (1) a loan may normally not exceed 85% of the value of the property (in 2011 the percentage was 90%); (2) the LTV should include all loans on a property; (3) the rules for deviations must be set by the board of the bank; (4) loans with an LTV of 70% or higher must be amortising from the first interest payment; (5) loans with variable amounts cannot exceed a 70% LTV; and (6) the household budget has to withstand an interest-rate increase of 5 percentage points. See Finanstilsynet's press releases [9/2010](#) (3 March 2010), [44/2011](#) (1 December 2011) and [524](#) (7 May 2012) (in Norwegian).

¹⁷ The survey was conducted in July and August 2012 on loans granted by the 28 largest banks after 1 June 2012. Source: [Finansielle Utviklingstrekk 2012](#), October 2012 – Tema III Boliglånsretningslinjene (in Norwegian)

In addition, Norwegian banks' corporate asset quality is highly dependent on developments in the commercial real estate and shipping sectors, which together accounted for more than half of banks' corporate loans at year-end 2011 (around 25% of total loans), as shown in Figure 7.

FIGURE 7
Banks' corporate loan books



Source: Norges Bank

Norwegian banks are highly exposed to commercial real estate markets (over 30% of corporate loans at year-end 2011). While we expect that favourable domestic economic conditions will continue to support demand for commercial property in the next 12-18 months, developments in this sector could be hindered by slower international growth. The outlook for commercial real estate also depends on investor appetite, which was recently sharpened by attractive rental yields relative to bond yields in the context of low long-term interest rates. Although most investment in the sector is domestic which is typically less volatile than foreign investment, appetite could fall depending on the attractiveness of other asset classes.

The outlook for the highly cyclical shipping sector (over 20% of corporate loans at year-end 2011) is currently bleak, with continued overcapacity, protracted low freight rates and declining ship values.¹⁸ While we note that impairments and losses from these exposures have so far been contained by the restructuring of loan agreements, we expect a moderate increase in associated provisioning levels over the outlook period and the potential for large losses in this segment due to the typically large loan size. However, a sizeable portion of Norwegian banks' shipping exposure is to the offshore sector, which has so far been supported by high oil prices and increased investments in exploration and production.

We also note that, similar to most of their Nordic peers, Norwegian banks generally exhibit high borrower concentration in their corporate books, which could accentuate the extent and the pace of losses in the event of a significant economic downturn.¹⁹

¹⁸ Please also see [Global Shipping Industry: Outlook Remains Negative as Oversupply and High Bunker Oil Prices Constrain Performance](#), May 2012

¹⁹ Nordic Banks: [Single-Client Concentration Survey Shows High Albeit Reducing Exposures](#), August 2011

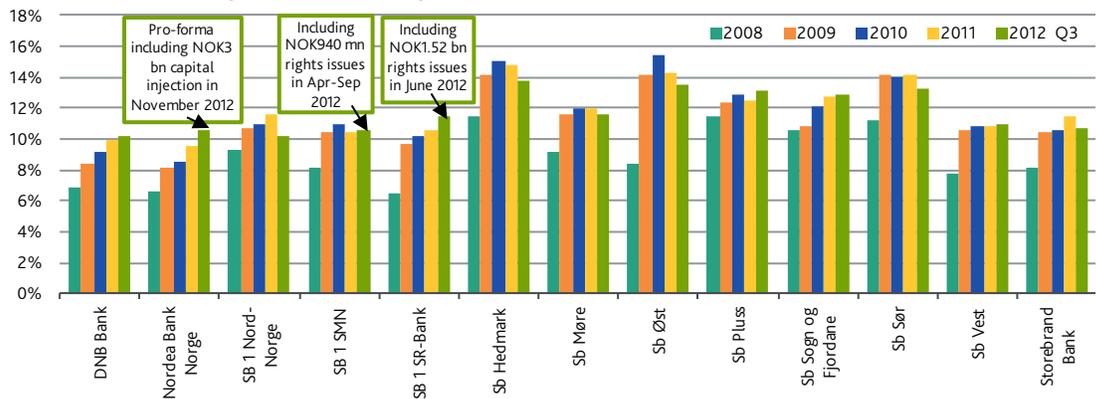
Strengthened capital buffers increase banks' resilience to asset-quality deterioration

In our view, Norwegian banks are adequately capitalised to absorb potential credit loss under our adverse scenario, but their performance in our highly-adverse scenario is undermined by their sizeable exposures to more volatile industries, which results in a Tier 1 capital erosion of over 3% percentage points (based on year-end 2011 risk-weighted assets).²⁰

At end-September 2012, Norwegian banks reported an aggregate Tier 1 ratio of 12.4% (including transitional floors). The banks' regulatory capital ratios were recently bolstered following the regulator's requirement that all banks maintain a core Tier 1 ratio above 9%, in line with the European Banking Authority's recapitalisation plan for banks.²¹ Some banks strengthened their capital (see Figure 8) with either rights issues (e.g., SpareBank 1 SR-Bank, SpareBank 1 SMN) or internal group capital injections (e.g., DNB Bank,²² Nordea Bank Norge).

FIGURE 8

Tier 1 ratios at Norwegian banks and capital increases in 2012



Source: Moody's

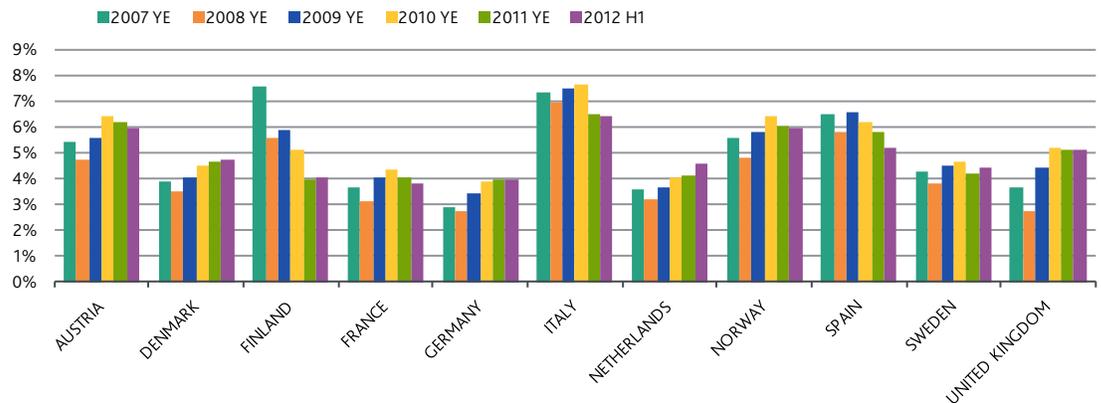
On an un-weighted basis, with equity accounting for just over 6% of total assets at end-September 2012, Norwegian banks in our rating universe compared well to most of their European peers (see Figure 9).

²⁰ For more details on Moody's stress testing approach, please refer to the Special Comments [Moody's Approach to Estimating Bank Credit Losses and their Impact on Bank Financial Strength Ratings](#), and [Moody's Approach to Estimating Nordic Banks' Credit Losses](#) published in May 2009 and July 2009, respectively.

²¹ See Finanstilsynet's [press release 45/2011](#), December 2011

²² DNB Bank's core Tier 1 was raised in Q4 2011 using internal capital resources available in DNB ASA (the Group's holding company).

FIGURE 9

Leverage ratio (Equity/Total Assets) at rated banks in a selection of European countries

Source: Moody's Banking Financial Metrics

Furthermore, Norwegian authorities will likely undertake additional initiatives to enhance banks' capitalisation in 2013. In fact, in its most recent Financial Stability Report, the Norwegian Central Bank stated that banks should continue to strengthen their capital ratios. The recommendations cited in the report include the introduction of supplemental capital requirements for systemically important banks and measures to increase risk-weights on residential mortgages to reflect high household indebtedness. According to calculations from Finanstilsynet based on year-end 2011 data, applying standard risk weights of 20% and 35% for residential mortgage loans would result in a reduction in aggregate Tier 1 ratios (excluding transitional floor) of 0.5 and 1.3 percentage points, respectively, for banks using the Internal Ratings Based (IRB) method to calculate risk-weighted assets. We would view such initiatives as credit positive for Norwegian banks, although we note that increased capitalisation requirements for IRB banks would likely have a detrimental effect on their profitability.

Funding and Liquidity

Reliance on market funds remains a key system vulnerability.

High usage of market funding exposes banks' to changes in investor confidence

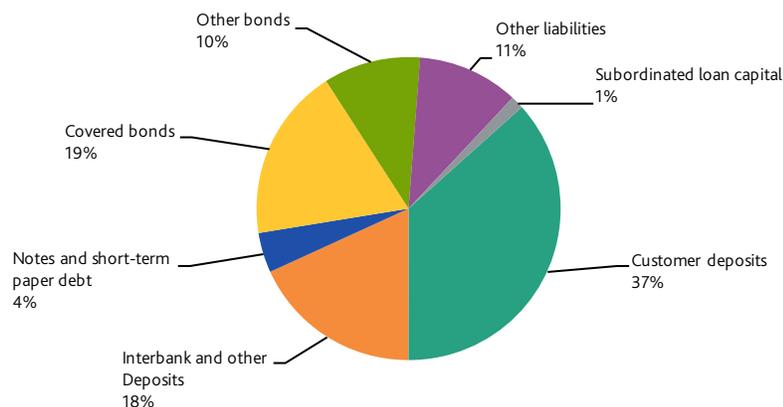
Although their relative share has been decreasing in the last decade, deposits constitute a sizeable portion of Norwegian banks' and covered bond companies' funding (close to 40% of funding in aggregate at end-June 2012, although we note the share is typically higher for smaller banks). Bank deposits have historically been a reliable source of funding for Norwegian banks and their stability would be supported by a potential increase in the size of the deposit guarantee fund currently being considered by the Ministry of Finance.²³

However, Norwegian banks are generally reliant on capital markets for the bulk of their funding (around 60% of total funding, including covered bond companies, at end-September 2012, see Figure 10). While Norwegian banks have benefitted from the system's reputation as a safe haven and experienced better access to capital markets than many of their European counterparts, we view this high reliance on market funds to be a material risk factor, as it increases the banks' sensitivity to changes in investor sentiment. In addition, funds with maturities of less than three months accounted

²³ See Ministry of Finance's [press release 38/2012](#), October 2012

for 27% of total market funding. These are typically due to larger banks borrowing from international banks at attractive rates, and the net refinancing risk is largely mitigated by sizeable balances deposited with foreign central banks.

FIGURE 10
Banks' and covered bond companies' funding structure at end-September 2012



Source: Moody's calculation based on Norges Bank

Covered bonds have become an important source of funding

One of the factors behind the increased reliance on market funds compared to historical levels has been the rapid growth of the covered bond market in Norway following its inception in June 2007, and as these securities were largely used in the government swap scheme in 2008-09.²⁴ This source of funding has provided a more stable and cheaper source of funding to Norwegian banks and accounted for around 30% of banks' and covered bond companies' market funding at end-September 2012. We also positively view the fact that covered bonds typically have longer maturities than unsecured funds.

The Norwegian covered bond market has not been as long-established as those in Denmark and Sweden for example. However, it has functioned well and we consider it to be a relatively stable source of funding, in part due to the demand for such assets by domestic investors given the limited alternatives for highly rated assets in Norwegian krone.

In the wake of the rapid growth in the market, though, Norwegian authorities have recently stated that they are considering taking measures to curb banks' use of covered bonds. If implemented, we would view such initiatives as credit-positive for banks as they would not only limit the amount of pledged assets unavailable for unsecured bondholders in a liquidation, but as they would also incentivise banks to better diversify their funding profiles. However, we caution that such limitations would have to be implemented carefully as access to covered bond markets is essential for banks' funding mixes in the current environment.²⁵

Going forward, we expect banks will continue to rely on covered bond markets for long-term funding, particularly as they will need to refinance NOK54 billion and NOK84 billion of maturing covered bonds used in the government's swap scheme in 2013 and 2014, respectively. While banks will need

²⁴ In October 2008, the Ministry of Finance implemented an arrangement whereby banks were able to swap covered bonds (OMFs) for government treasury bills for an agreed period. Banks could then either retain the bills or sell them in the market. The scheme was phased out in the autumn 2009 as the need for it was reduced and traditional investor markets improved.

²⁵ Please also see [Norway Considers Limiting Covered Bonds: Credit Positive for Unsecured Bank Creditors](#)

to refinance sizeable amounts in these two years, we expect the government's provision of early termination of swap agreements will give banks some flexibility to better spread refinancing over time.

Improved structural liquidity positions mitigate banks' reliance on market funding

We note that banks have increased the maturity of their market funding, which we consider to be credit-positive. Long-term funds (equity, deposits and market funds with maturities over one year) covered 101% of banks' illiquid assets at end-June 2012, which is 10 percentage points higher than three years ago. The improvement is mainly attributable to the increased usage of covered bonds, which typically have longer maturities than unsecured debt (often three years).

Despite these positive developments, Norwegian banks do not currently meet the liquidity requirements that the Basel Committee and Capital Requirements Regulations (CRR) intend to implement. Norwegian authorities reported that, as of end-2011, of the 17 largest banks reporting the Net Stable Funding Ratio (NSFR), just over half met the 100% requirement and just one bank met the Liquidity Coverage Ratio (LCR) requirement. This is largely due to the exclusion of covered bonds from the 'level one' category, the definition of which is still under discussion.

Nevertheless, Finanstilsynet's alternative calculation of banks' short-term liquidity ratio, which includes all assets eligible as collateral in Norges Bank (regardless of the LCR definition), pointed to a healthy average of 140% at end-June 2012. Therefore, the finalisation of the definition of liquid assets is crucial in determining Norwegian banks' ability to meet the Basel Committee's CRR liquidity ratios, particularly the treatment of covered bonds.

Profitability and Efficiency

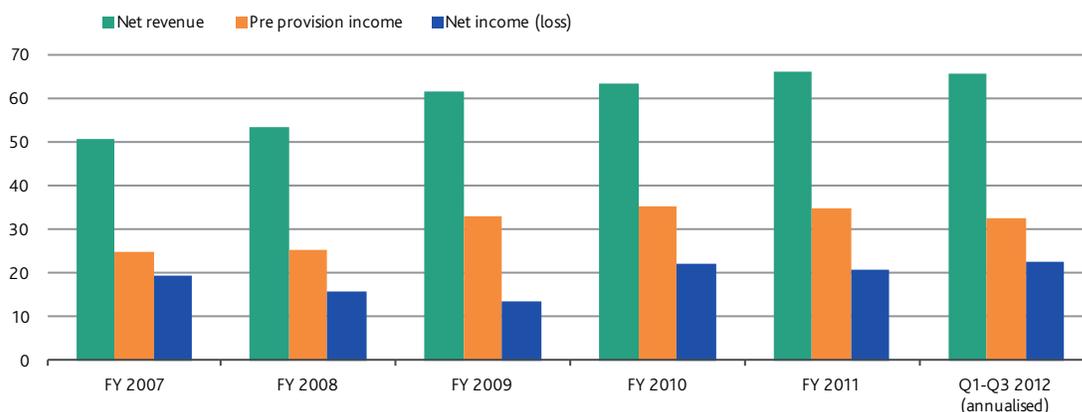
We expect banks' earnings performance will be supported by stable loan growth, continued cost containment and limited loan loss provisions.

We expect profitability to remain stable

Earnings at Norwegian banks have proven resilient (see Figure 11) and have been less affected by the financial crisis than those in many other European banking systems (see Figure 12), largely due to their limited credit costs, which we expect will remain moderate over the outlook period.

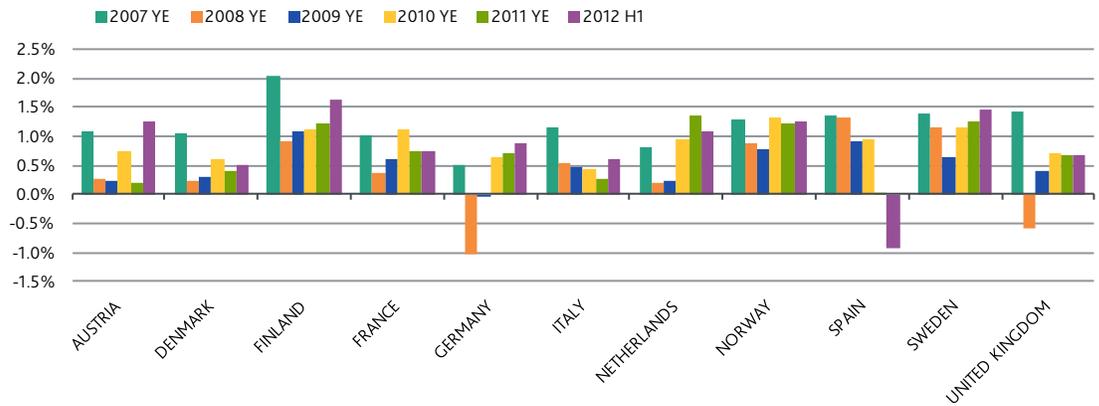
FIGURE 11

Trends in revenue and income at rated Norwegian banks



Source: Moody's

FIGURE 12

Net income % average risk-weighted assets at rated banks in a selection of European countries

Source: Moody's Banking Financial Metrics

Net interest income accounted for around 70% of banks' total operating income in the first three quarters of 2012.

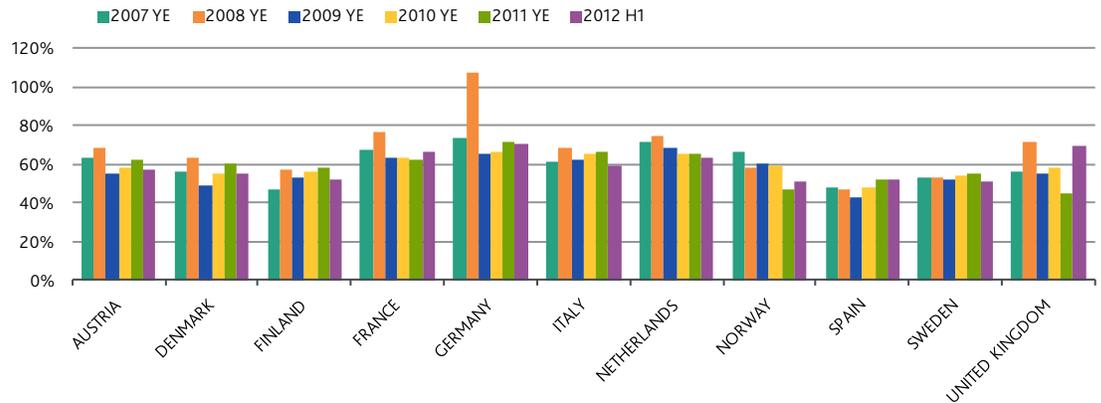
While funding costs remain relatively high and deposit margins are under downward pressure due to growing competition, banks' overall net interest margins have remained stable due to rising lending rates. In addition, in Norway, banks have the ability to increase rates on households' loans with six weeks' notice, which enhances their flexibility to pass increases in funding costs on to customers.

Fee and commission income has been a growing source of revenue for Norwegian banks (rising more than 15% between 2008 and 2011 for our rated universe) as they earn commission income rather than interest income on loans transferred to covered bond companies. We expect this source of revenue will continue to grow, albeit at a slower rate, as banks transfer more loans to covered bond companies, although the pace of transfer will likely decline from the high levels seen in most recent years.

Good efficiency will continue to support profitability

The aggregate cost-to-income ratio for rated banks was 51% in the first half of 2012 (full-year 2011: 47%, see Figure 13). The Norwegian banks' relatively strong ratios partly reflect their greater usage of internet-based banking and distribution channels relative to most continental European banks. We also note that many banks have put more emphasis on streamlining costs in recent years.

FIGURE 13
Cost-to-income ratio at rated banks in a selection of European countries



Source: Moody's Banking Financial Metrics

Despite increased requirements on liquidity and capital as well as upward pressure on salaries, we expect banks will be able to maintain good cost containment over the outlook period, which we see as key for their financial flexibility.

Systemic Support

We continue to view Norway as a high-support country. The Aaa-rated Norwegian government's ability to support banks is underpinned by its very strong financial position and the reasonable size of its banking system (around 150% of GDP at year-end 2011).²⁶ In addition, the Norwegian government has generally provided financial support to the banking system during periods of crisis, ensuring that no depositor would lose money.

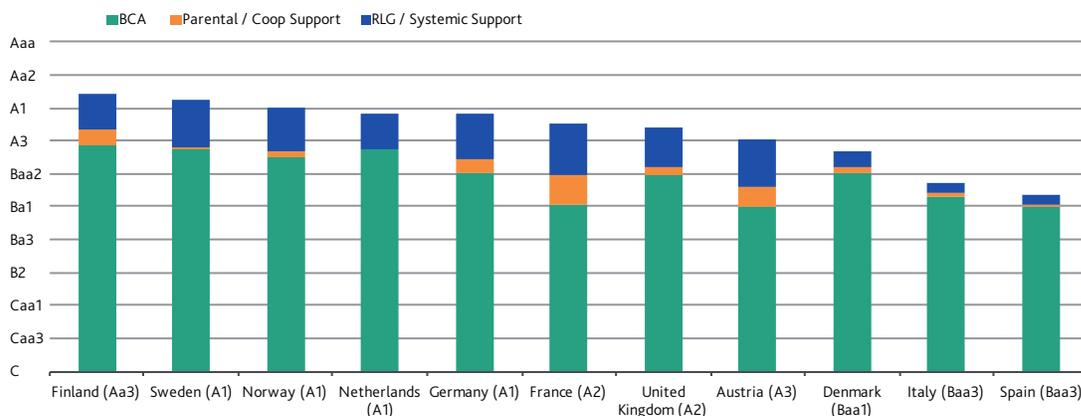
Our assessment of a generally high probability of support for Norwegian banks is reflected in the above-average systemic support uplift (see Figure 14). DNB, the largest bank in the country and 34% government-owned, receives a three-notch uplift from systemic support, while other rated banks currently receive a two-notch uplift. Our support assumptions for smaller savings banks are underpinned by our assessment that Norwegian authorities value the regional bank model and view such banks as "peripherally systemic important".²⁷ However, we believe that there are some differences among savings banks' regional importance and, in our view, some local (mostly unrated) banks are less likely to benefit from systemic support. In addition, some rated banks benefit from support from their group.

²⁶ Including covered bond companies, excluding Norwegian branches of foreign banks.

²⁷ See speech by State Secretary Morten Søberg held in June 2011 entitled "[Learning from crises](#)".

FIGURE 14

Asset-weighted average bank long-term ratings (standalone credit assessments with support levels) in a selection of European countries



Source: Moody's Investors Service, Moody's Banking Financial Metrics

However, we expect the Norwegian authorities to follow the European Banking Authority's forthcoming crisis resolution directive. Following the European Commission's draft directive on Recovery and Resolution in June 2012, the Norwegian Central Bank reiterated its stance in favour of the implementation of resolution tools. Although we do not expect such measures to be implemented over the outlook period, they would likely lead us to reconsider the support assumptions that we factor in our ratings for Norwegian banks.

We note that Eksportfinans – whose situation has become more difficult since it had to run off its operations following the government's decision to establish a new entity to grant subsidised export loans²⁸ – did not receive any explicit support from the state. In our view, the government's decision not to extend support to the bank does not mean its willingness to support banks has decreased, as we believe that Eksportfinans' unique business model and limited systemic importance as a non-deposit taking institution make this an isolated case.

In 2012, we downgraded Norwegian banks' subordinated debt and junior subordinated debt ratings. We believe that systemic support for subordinated debt in Europe is becoming more unpredictable, due to a combination of anticipated changes in policy and financial constraints. Policy makers are increasingly unwilling and/or constrained in their support for all classes of creditors, in particular for subordinated debt holders and are keen on imposing a "burden-sharing" regime at problem banks, which is detrimental to bondholders.

²⁸ For more details, please see [Moody's press release from 22 November 2011](#)

Banking System Outlook Table

As of 8 January 2013

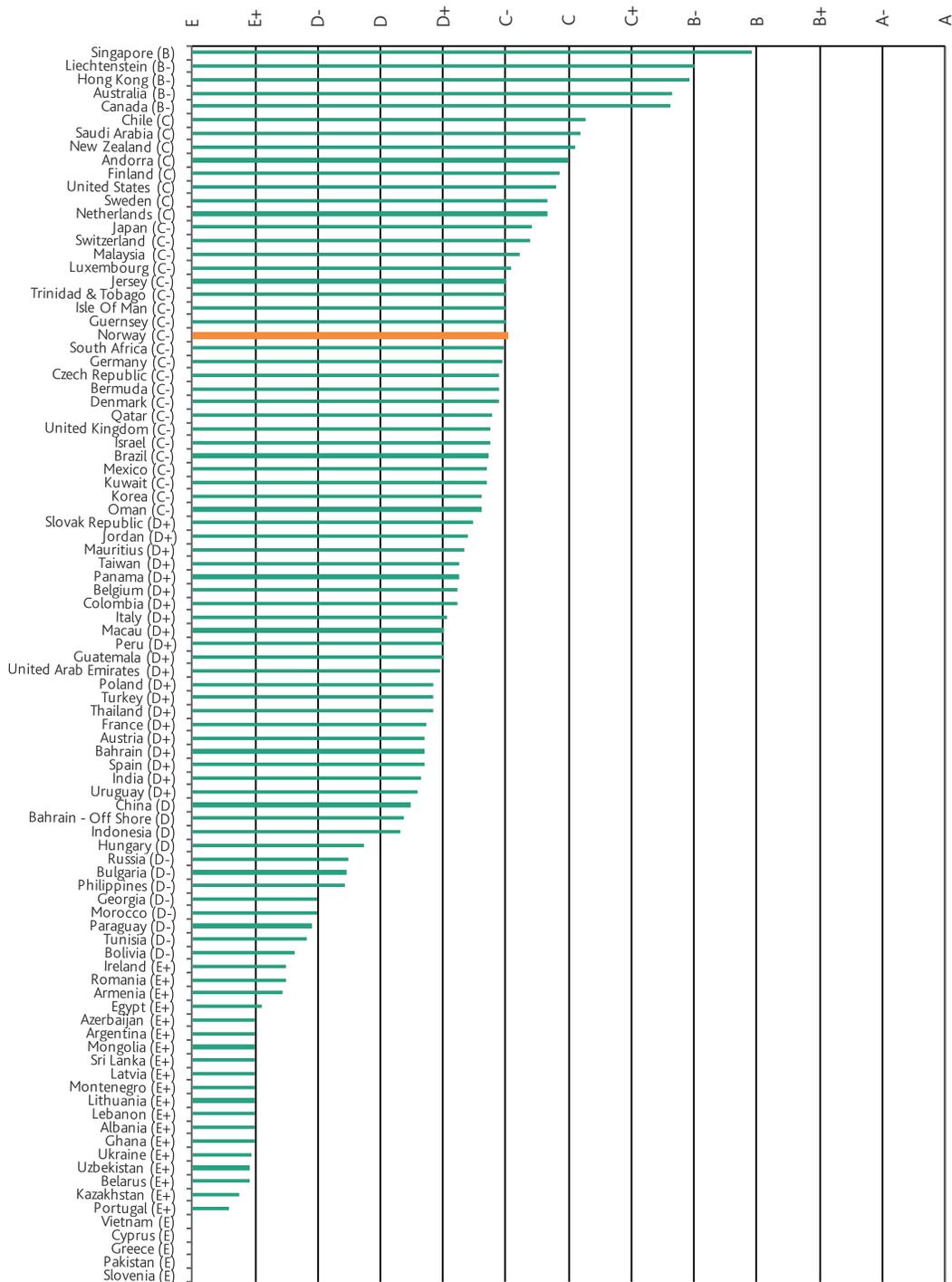
Banking System	Positive	Stable	Negative
Argentina			Negative
Australia		Stable	
Azerbaijan		Stable	
Bahrain			Negative
Baltic Countries			Negative
Belarus			Negative
Belgium			Negative
Bolivia		Stable	
Brazil		Stable	
Bulgaria			Negative
Chile		Stable	
China		Stable	
Colombia		Stable	
Cyprus			Negative
Czech Republic			Negative
Denmark			Negative
Egypt			Negative
Finland			Negative
France			Negative
Germany			Negative
Greece			Negative
Hong Kong		Stable	
Hungary			Negative
India			Negative
Indonesia		Stable	
Ireland			Negative
Israel			Negative
Italy			Negative
Japan		Stable	
Kazakhstan			Negative
Korea		Stable	
Kuwait		Stable	
Lebanon			Negative
Luxembourg			Negative
Malaysia		Stable	
Mexico		Stable	
Netherlands			Negative
New Zealand		Stable	
Norway			Negative
Oman		Stable	
Pakistan			Negative
Peru		Stable	
Philippines	Positive		

Banking System	Positive	Stable	Negative
Poland			Negative
Portugal			Negative
Qatar		Stable	
Russia			Negative
Saudi Arabia		Stable	
Singapore		Stable	
Slovakia			Negative
Slovenia			Negative
South Africa			Negative
Spain			Negative
Sweden		Stable	
Switzerland		Stable	
Taiwan		Stable	
Thailand		Stable	
Turkey		Stable	
Ukraine			Negative
United Arab Emirates			Negative
United Kingdom			Negative
United States			Negative
Uruguay		Stable	
Uzbekistan		Stable	
Vietnam			Negative

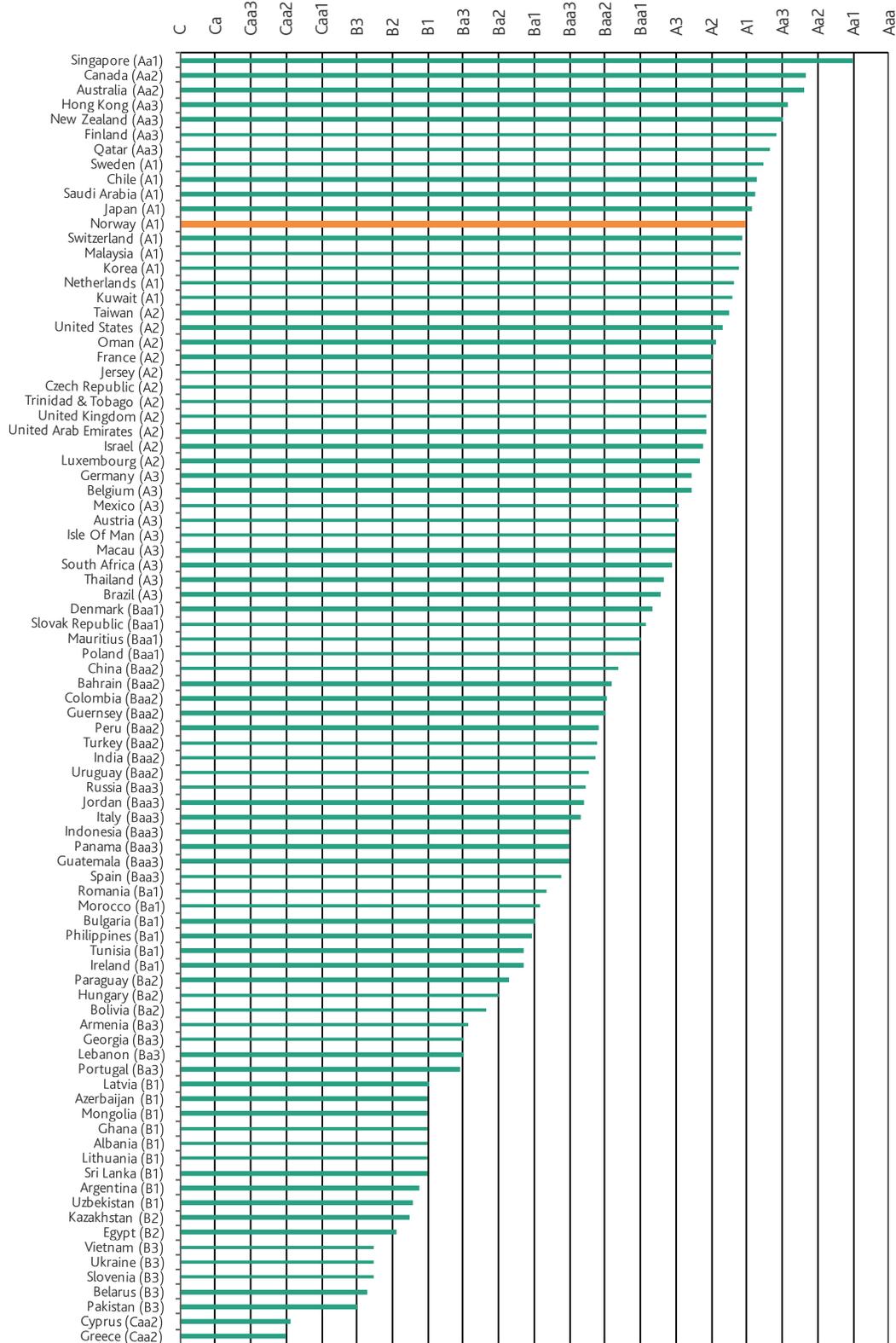
Appendix 1

Global Comparison Charts

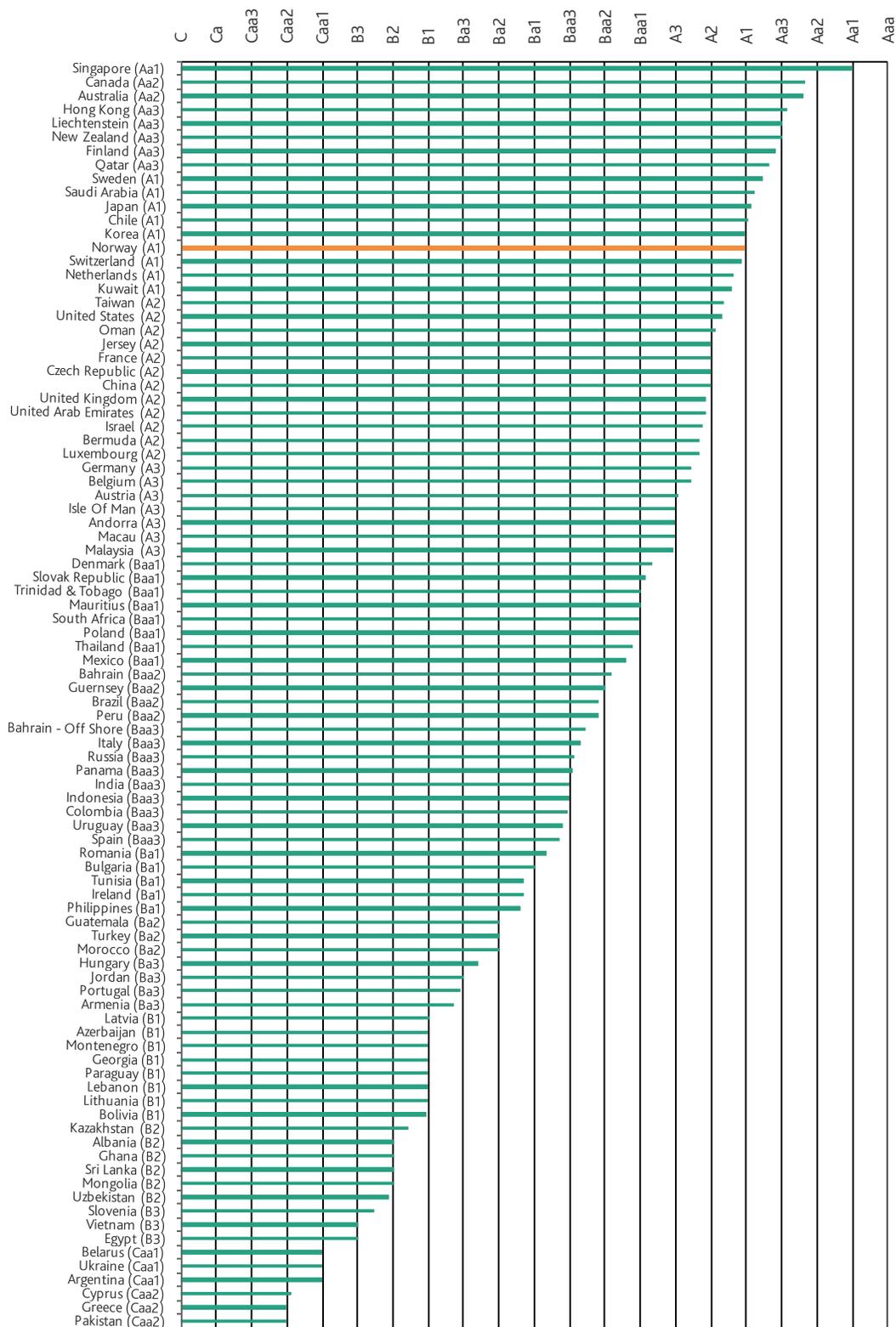
Asset-Weighted Average Bank Financial Strength Ratings (as of 5 February 2013)



Asset-Weighted Average Local Currency Long-Term Bank Deposit Ratings (as of 5 February 2013)



Asset-Weighted Average Foreign Currency Long-Term Bank Deposit Ratings (as of 5 February 2013)



Appendix 2

BFSR / BCA Mapping Table

BFSR/Baseline Credit Assessment Mapping

BFSR	Baseline Credit Assessment (BCA)
A	aaa
A-	aa1
B+	aa2
B	aa3
B-	a1
C+	a2
C	a3
C-	baa1
C-	baa2
D+	baa3
D+	ba1
D	ba2
D-	ba3
E+	b1
E+	b2
E+	b3
E	caa1
E	caa2
E	caa3

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