Nordic Credit Rating

Kredittforeningen for Sparebanker

Norway
Financial institutions

13 Feb. 2019
Rating initiation

LONG-TERM RATING

A-

OUTLOOK

Stable

SHORT-TERM RATING

N-1+

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RATING RATIONALE

Our 'A-' long-term issuer rating on Kredittforeningen for Sparebanker (KfS) reflects the company's strong capitalisation and low risk appetite. KfS is a non-profit credit institution serving Norwegian savings banks. The company has a concentrated loan portfolio but funds only investment-grade savings banks. Our average credit assessment of its loan portfolio is 'bbb+'. KfS has never experienced loan losses, and we believe that the company's default risk is lower than the average of its customers. KfS is funded by senior loans with approximately the same maturity as its individual loans. It has no obligation to refinance these loans, and the refinancing and pricing risks are therefore minimal.

The small size of the organisation creates possible implications for risk governance and operational risk factors. KfS has a rather simple business model and a relatively low transaction volume. We find that risk governance and internal risk reporting are adequate considering the company's risk profile, lack of complexity and cooperation with its owners. Changes in regulation are a risk factor for KfS' business model. The EU's upcoming bank capital and liquidity package (CRR II/CRD V) will likely have implications for KfS but may also increase the funding costs in general for banks and thus make funding through KfS more attractive.

OUTLOOK

The stable outlook reflects the strong operating environment for Norwegian banks and KfS' modest risk profile. We believe that possible challenges for the company's business model due to regulatory changes will not result in higher default risk given its high asset quality and low refinancing and liquidity risk.

POTENTIAL POSITIVE RATING DRIVERS:

- Increased loan diversification and stronger market position.
- Improved credit quality of debtors (savings banks).
- Increased profitability improving resilience.

POTENTIAL NEGATIVE RATING DRIVERS:

- Lower credit quality of debtors either due to idiosyncratic or macroeconomic stress.
- Continuing fall in business volumes or increased concentration on lower credit quality.
- Lower capitalisation.

Figure 1. KfS key credit metrics

(%)	2015	2016	2017	2018	2019e	2020e	2021e
Net interest margin	0.11	0.10	0.12	0.14	0.14	0.14	0.15
Loan losses/net loans	-	-	-	-	-	-	-
Pre-provision income/REA	0.1	0.2	0.2	0.4	0.2	0.3	0.3
Return on ordinary equity	0.4	0.8	0.8	1.2	1.1	1.0	1.2
Loan growth	(8.9)	(3.4)	(4.1)	0.8	2.3	4.0	4.0
Capital ratio	22.4	22.0	21.4	22.7	21.5	21.3	21.2

REA–Risk exposure amount. e–Estimate. All metrics are adjusted as per NCR methodology. Based on NCR estimates and company data.

COMPANY PROFILE

KfS is licensed as a credit institution and provides medium- and long-term senior loans to savings banks. It was established in 2004 by Eiendomskreditt AS, a mortgage company financing commercial real estate, and 49 savings banks to secure funding in a difficult market situation. KfS and Eiendomskreditt are based in the city of Bergen and parts of KfS' operations are outsourced to Eiendomskreditt. KfS has six part-time employees (2.6 full-year eqv.). All of them are also employed by Eiendomskreditt, which in total has 11 employees (8.3 full-year eqv.).

KfS is organized as a credit association and is operated according to cooperative principles. Its borrowers, which are solely Norwegian savings banks, become members of the association. The association's non-profit model allows member banks to achieve lower borrowing costs by diversifying their risks across KfS.

KfS is a vehicle for small savings banks with limited access to the bond market. The average lending of the member banks is NOK 3.8bn (2017), ranging from NOK 1.1bn to NOK 17.0bn. The members are spread throughout Norway with the strongest presence in the central county of Trøndelag and the weakest presence in the north of the country.

Figure 2. Member banks by county (no.), 2018

Based on NCR data and KfS annual report 2017. Map from Wikipedia.

OPERATING ENVIRONMENT–MAINLY RURAL AREAS

We assign the operating environment a score of 'a-'

NCR expects the domestic operating environment for Norwegian banks to remain benign over the next two to three years. Despite higher capital requirements, both smaller and larger Norwegian banks have outperformed their European peers in terms of earnings and efficiency and have managed a downturn in the oil and offshore segment with robust loss performances in recent years.

Figure 3. Unemployment in Norway by county, December 2018 (white bars mean that KfS is not exposed to the county)

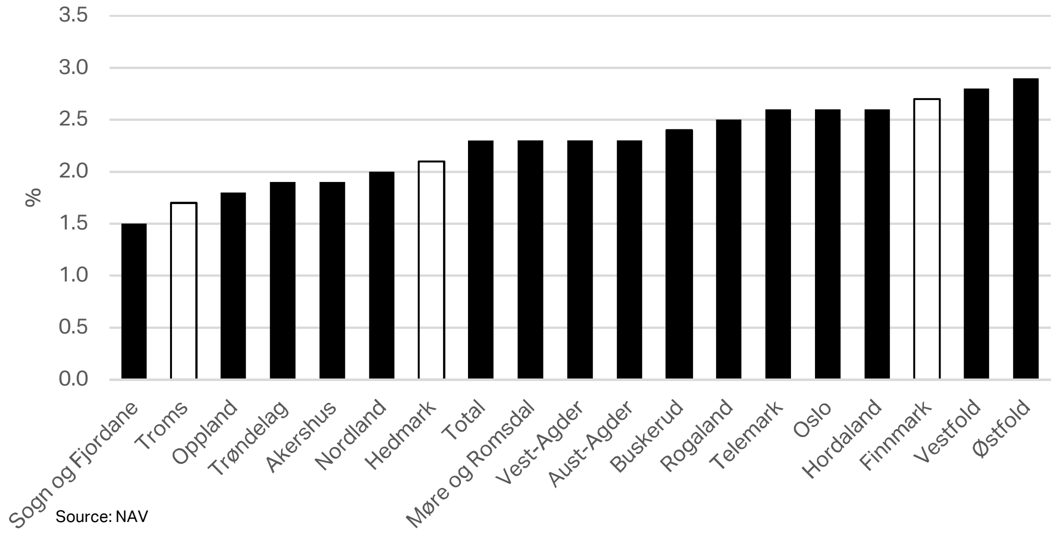
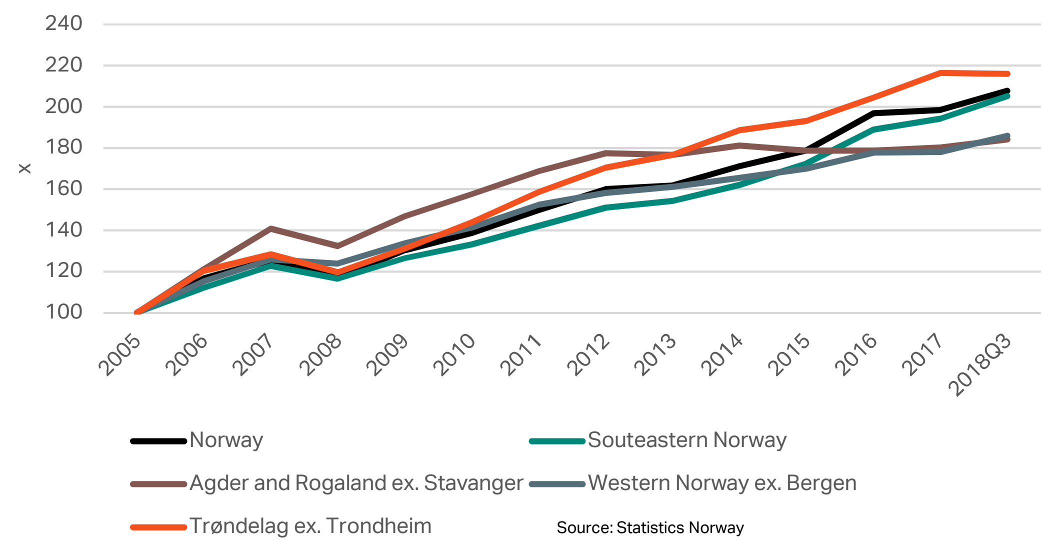


Figure 4. Norwegian regional housing prices (indexed), 2005–2018Q3. Focus on regions where KfS is more exposed



KfS' lending portfolio is geographically spread; the company's member banks have a presence in 15 of Norway's 18 counties. The member banks mostly operate in regions with low to moderate unemployment and stable or moderately increasing housing prices. However, we cut the operating environment score by one notch from the 'a' score of the national banking market due to their high level of exposure to rural areas. See 'Nordic Credit Rating - National Banking Market Assessment – Norway', dated 30 Oct. 2018.

LOW CREDIT RISK AND STRONG CAPITALISATION

Please note that the remainder of the report follows the structure in the rating scorecard (figure 12).

We score risk appetite 'a'

KfS has a low-risk business model with a focus on achieving the best possible loan terms in the capital market for its members. The company has never experienced credit losses, is strongly capitalised and has ample liquidity reserves. The small size of the organisation has potential implications for risk governance as well as operational risk. We find that risk governance and internal risk reporting are adequate considering the company's risk profile and lack of complexity.

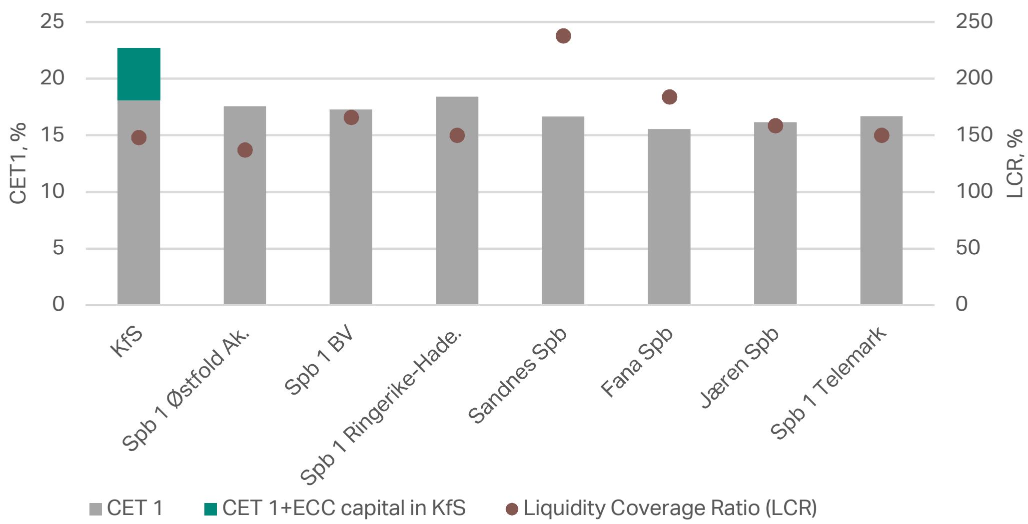
Capital

When a savings bank receives a loan from KfS, it has to place a member reserve of at least 3% of the loan with KfS (equivalent to a common equity Tier 1 [CET1] ratio of 15% for bank exposures), which is refunded after the loan is repaid. The member reserves (NOK 176m as of 31 Dec. 2018) are regarded as core equity and have lower priority than other capital, including NOK 50m in Equity Capital Certificates (ECC capital). Since the ECC capital has stronger priority, it is considered Tier 2 capital and is not included in the calculation of CET1. However, ECC capital is equity capital and NCR considers it in its assessment of KfS' capitalisation. Kfs' reported CET1 ratio was 16.9% as of end-2018 while its capital ratio (including ECC capital) was 21.6%. The company's CET1 requirement is 15.5% (16.0% from 2020).

KfS uses the standardised capital model, which implies 20% risk-weight for senior loans to unrated banks. Risk weights are expected to increase to 30% from 2022, and KfS expects that the member reserve will then increase to 4.5% to sustain the CET1 level. NCR believes that this could affect the attractiveness of KfS loans for some member banks.

KfS' leverage ratio was 3.4% in 2018; the required level is 3%. Including ECC capital, the leverage ratio is 4.3%. Increasing the member reserve to 4.5% would increase the leverage ratio to 5.1% excluding ECC capital and 6.0% including ECC capital.

Figure 5. KfS and selected Norwegian savings banks' capitalisation and liquidity, 2017

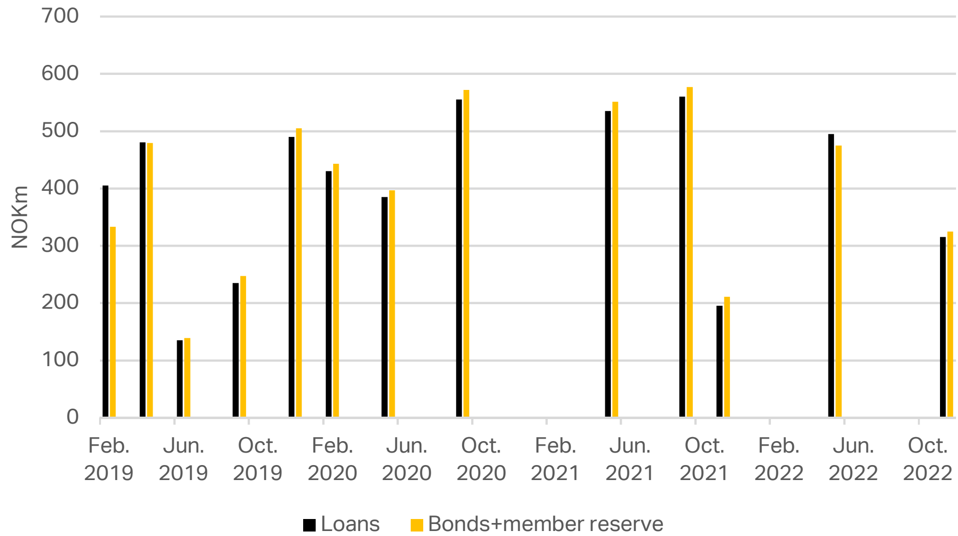


Source: Company data, NCR

Funding and liquidity

KfS is funded by senior loans which are virtually matched with loan maturity. See Figure 6 for a snapshot of maturity profiles as of 31 Dec. 2018. Note that individual loans are bundled and that several individual loans can mature on the same date. The company has no obligation to refinance the loans and refinancing and pricing risk are therefore minimal. What remains is the risk that one or more banks might be unable to repay debt at maturity, which would put stress on KfS' liquidity. We believe that KfS has ample procedures in place to handle this risk factor should it arise. For example, individual loans that fall due on a certain date cannot constitute more than 1/3 of KfS' capital base. KfS must hold minimum liquidity of 100% of total bonds maturing in the next 30 days. In addition, the company must hold a liquidity buffer of at least 25% of expected loans due over the next 30 days. As of end-2018, KfS held NOK 136m in liquid interest-bearing paper which, together with the member reserve from maturing loans, would have covered 87% of maximum individual loans due.

Figure 6. Maturity profiles of KfS' loans and bonds as of 31 Dec. 2018



Source: NCR based on company data

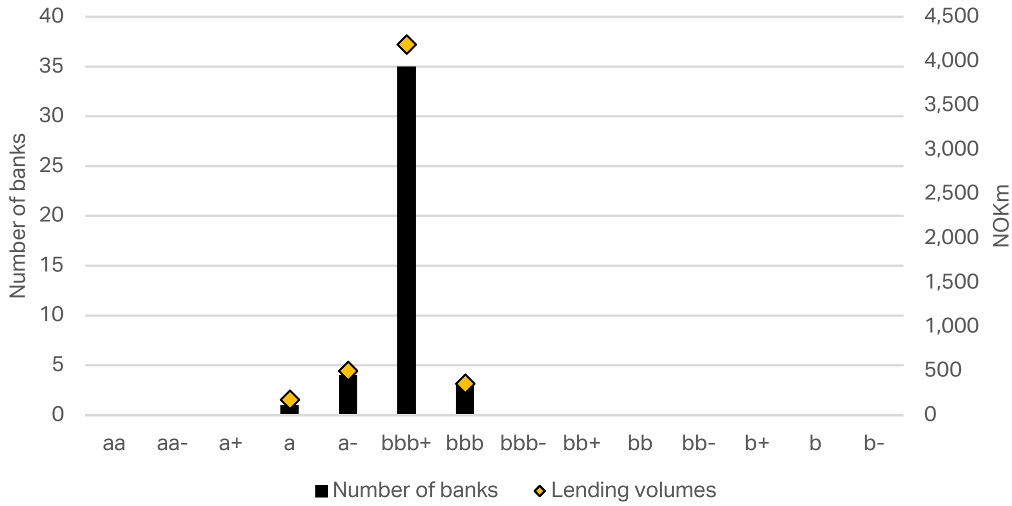
Risk governance

KfS has a somewhat simple business model and a relatively low transaction volume. The organisation has adequate risk competence, a competent Board of Directors and its cooperation with Eiendomskreditt provides access to additional and flexible resources. As such, we believe that risk resources are proportionate and adequate given the company's risk profile. KfS has few employees and key-person risk is not insignificant. However, KfS has access to support from Eiendomskreditt and access to financial competence in Bergen, if necessary.

In our view, market risk is negligible given that KfS does not trade financial instruments, matches the financing and floating rates on both loans and funding (thereby eliminating interest rate risk), maintains low risk limits, and has no currency exposure.

Credit risk

Figure 7. NCR's credit assessments of KfS' member banks as of end 2018



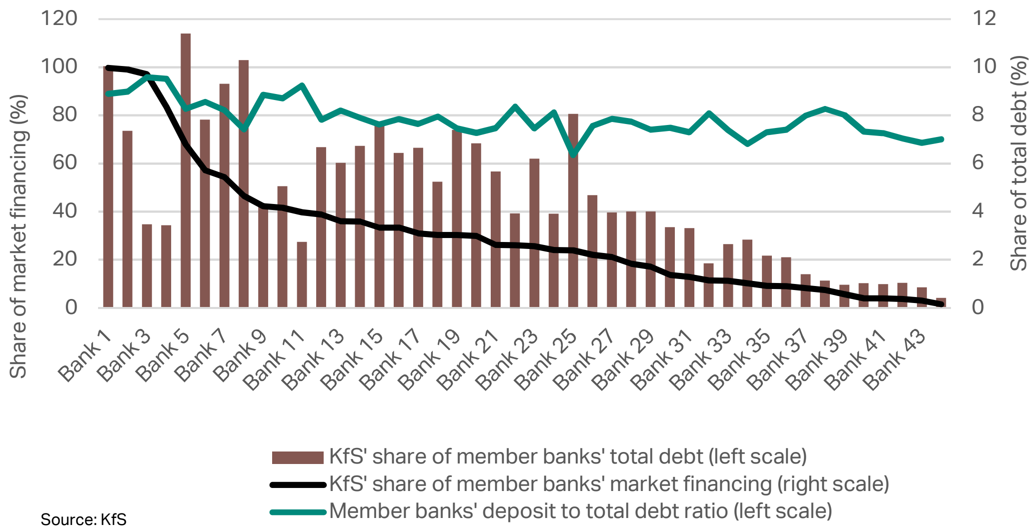
Based on KfS data and NCR assessments

Despite the small number of KfS' member banks, NCR finds the company has low credit risk appetite. KfS lends only to Norwegian savings banks, which are heavily regulated and supervised by the Norwegian financial supervisory authority. KfS uses official ratings or credit scores from up to four brokers to risk classify its member banks. A bank needs to have a rating or equivalent credit score of BBB- or higher to qualify for a loan from KfS. NCR has carried out confidential credit assessments of the banks on the company's loan book and finds that the credit assessments range from 'bbb' to 'a', with an average score of 'bbb+'. We believe that our credit assessments are likely to lie within +/- 1 notch of an actual credit rating in most instances.

We believe that the main credit risk factor for KfS is concentration risk and, as such, we cap our credit risk sub-score at 'a'. With only 43 members, the company's average loan was NOK 121m as at end-2018, or 52% of the capital base. KfS' maximum exposure to an individual bank is 100% of the lower of the respective bank's or KfS' capital base. The largest loan was NOK 225m as of end-2018, or close to 100% of the capital base. The number of savings banks in Norway is slowly declining and there is a risk that, over time, consolidation will create larger banks of presumably higher credit quality which will have better access to the capital markets directly or larger funding needs than KfS can satisfy. This might lead to a gradual reduction in KfS' credit quality if only smaller or less creditworthy banks choose KfS financing.

Market funding is important for Norwegian banks, in part because most domestic household pension savings are channelled through public and collective pension schemes. However, deposits remain the main source of funding for the country's banks. As shown in Figure 8, KfS funds only a small part of its member banks' balance sheets, but accounts for up to 100% of their market funding in some cases. Nevertheless, we do not see systemic risk as significant for KfS.

Figure 8. Member banks' funding structure ranked by KfS' share of market financing (2017)



Source: KfS

Other risks

Changes in regulation are the main risk factor for KfS' business model. These changes are discussed in the next section. We believe that due to the almost complete match between KfS' funding and lending maturity profile, the member reserve system securing capital adequacy, and the company's low and flexible cost base, a run-off of KfS would be unlikely to lead to default.

WEAK COMPETITIVE POSITION

Competitive position scored 'bb'

KfS is a small player in the Norwegian credit market and its only product is senior loans to savings banks. The viability of the company's business model could change for the better or worse depending on market and structural factors. However, the business model would also simplify an orderly run-off without significant deterioration of credit quality or liquidity risk.

KfS' member banks have a total market share of 7% of total bank lending in Norway. The company's lending equals 3% of member banks' total lending and 22% of their total capital base (2017 figures). KfS' lending declined from 2013 to 2017, probably due to falling funding costs for members, particularly the larger ones. KfS returned to growth in 2018 and increasing bond spreads and higher funding costs for banks could make it more competitive in future. In this manner, KfS provides its member banks a counter-cyclical funding alternative, as was the case when KfS' was founded in the wake of market stress in the early 2000s. The company can grow both through increased penetration of its existing customer base and by attracting new customers, as only 43 of Norway's 99 savings banks are currently members.

However, new regulation represents a challenge for KfS' business model. In general, CRR II/CRD V could have negative implications for KfS attractiveness as a funding source by increasing capital requirements for loans to financial institutions. While this will increase capital requirements for banks in general, we are not certain that the member banks would accept a higher member reserve without compensation, especially those with higher creditworthiness or access to capital market funding. So far, however, member banks have demonstrated loyalty to maintaining KfS as a funding vehicle which reflects a historical tendency for savings banks to cooperate for the benefit of the collective group.

The European Commission has proposed changes in the regulation of large exposures, which would be measured against core capital and not total capital. While KfS could conceivably convert its existing

ECC capital to another form, large exposure rules could reduce maximum loan size by 20%, which would be significant due to KfS' loan structure.

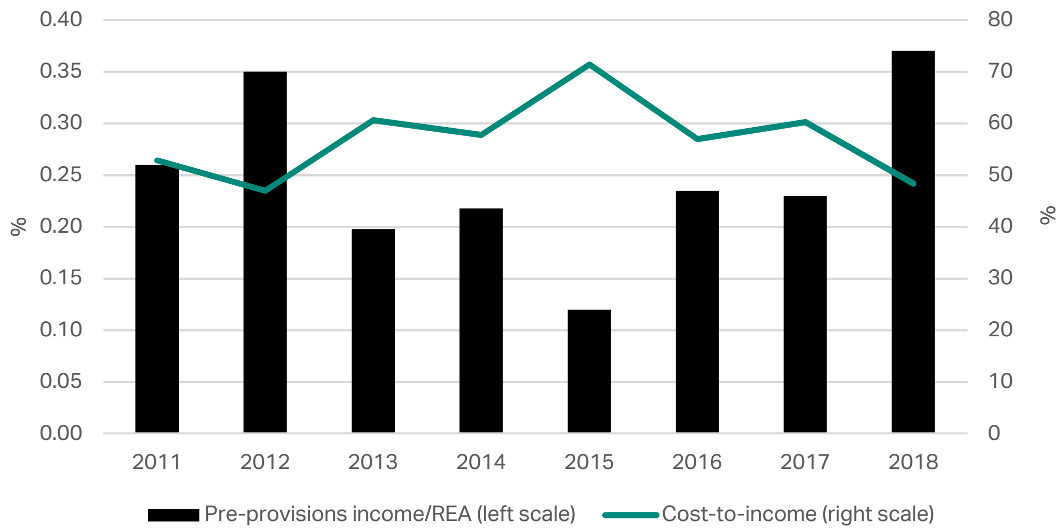
PERFORMANCE INDICATORS

We assess performance indicators at 'a-'

KfS defines itself as a non-profit company, and the lending margin is set at a level that covers costs, dividends on the Equity Capital Certificates and tax. This means that profitability has limited loss-absorbing capacity. Conversely, KfS has a record of stable performance, and has never experienced loan losses or nonperforming loans. The last default by a Norwegian savings bank occurred in the early 1930s, and increasing capital requirements of the sector and continuing consolidation are resulting in increased stability for the remaining banks.

KfS has a strong cost focus and benefits from its shared location and co-operation with Eiendomskreditt. However, low margins mean that the company's cost/income ratio is relatively high with an average of 59% over the past five years. Increased business volume would increase cost efficiency, as we saw in 2018. Conversely, a new deposit guarantee scheme will most likely increase operational costs by NOK 0.5m annually, or about 13% of the current cost base.

Figure 9. KfS earnings performance indicators, 2011-2018



Source: Company data, NCR

ADJUSTMENT FACTORS

PEER COMPARISON

We believe that KfS' relative strengths are reflected in the 'a-' initial credit assessment and do not adjust this assessment based on a peer assessment or any other factors. NCR has confidential credit assessments (not full credit ratings) of 302 Nordic banks, of which 117 are Norwegian banks. The average score is 'bbb+', the same as the average score for KfS' member banks.

SUPPORT ANALYSIS

We view KfS' ownership as supportive of our standalone credit assessment, but do not provide additional notches to reflect support. The company's capital consists mainly of member reserves and we have taken this structure into account in our capital score.

Figure 10. KfS ECC ownership structure

Owner	Share of ECC
Eiendomskreditt	10.0%
Sparebanken Vest	8.3%
Sparebanken Sogn og Fjordane	6.4%
Sparebanken Øst	5.5%
Helgeland Sparebank	3.7%
SpareBank 1 BV	3.7%
Voss Sparebank	3.7%
SpareBank 1Nordvest	2.8%
SpareBank 1 Østfold Akershus	2.8%
Other	53.1%
Total	100.0%

ISSUE RATINGS

Our rating on KfS' unsecured senior debt is in line with the issuer rating, i.e. 'A-'.

Figure 11. KfS issue rating indications

Issue rating indications	Starting point	Issue rating
Senior unsecured	Indicative credit rating	A-

Figure 12. KfS-Rating scorecard

Subfactors	Impact	Score
National factors	10.0%	a
Regional, cross border, sector	10.0%	bbb+
Operating environment	20.0%	a-
Capital	17.5%	a+
Funding & liquidity	15.0%	a+
Risk governance	5.0%	bbb
Credit risk	10.0%	a
Market risk	0.0%	N/A
Other risk	2.5%	a-
Risk appetite	50.0%	a
Market position	15.0%	bb
Earnings	7.5%	bbb-
Loss performance	7.5%	aa
Performance indicators	15.0%	a-
Indicative credit assessment		a-
Peer comparisons		0
Transitions		0
Borderline assessments		0
Adjustment factors		0
Standalone credit assessment		A-
Ownership		0
Material credit enhancement		0
Rating caps		0
Support		0
Issuer rating		A-
Short-term rating		N-1+

Figure 13. KfS-Instrument ratings

ISIN	Seniority	Disbursment	Maturity	Rating	Currency	Amount
NO0010725286	Senior unsecured	2014-12-09	2019-12-09	A-	NOK	490,000,000
NO0010755234	Senior unsecured	2016-01-14	2019-04-03	A-	NOK	465,000,000
NO0010767866	Senior unsecured	2016-06-17	2019-06-17	A-	NOK	135,000,000
NO0010768401	Senior unsecured	2016-06-24	2019-09-17	A-	NOK	240,000,000
NO0010775216	Senior unsecured	2016-09-23	2020-09-17	A-	NOK	555,000,000
NO0010782923	Senior unsecured	2017-01-25	2020-02-10	A-	NOK	430,000,000
NO0010791114	Senior unsecured	2017-04-11	2020-05-11	A-	NOK	385,000,000
NO0010792963	Senior unsecured	2017-05-11	2021-05-11	A-	NOK	535,000,000
NO0010806011	Senior unsecured	2017-09-18	2021-09-17	A-	NOK	560,000,000
NO0010812183	Senior unsecured	2017-12-11	2022-11-11	A-	NOK	315,000,000
N00010820996	Senior unsecured	2018-04-11	2022-05-11	A-	NOK	460,000,000
NO0010835267	Senior unsecured	2018-10-29	2021-11-29	A-	NOK	205,000,000
NO0010842362	Senior unsecured	2019-02-01	2023-02-10	A-	NOK	100,000,000
NO0010842891	Senior unsecured	2019-02-07	2023-11-29	A-	NOK	50,000,000

Figure 14. KfS-Key credit metrics and financials

Key credit metrics (%)	2014	2015	2016	2017	2018
Income composition					
Net interest income/op. revenue	100.2	112.3	87.1	100.3	98.4
Net fee income/op. revenue	(0.2)	(0.2)	(0.1)	(0.3)	(0.3)
Net trading income/op. revenue	0.0	(12.2)	13.0	-	0.8
Net other income/op. revenue	-	-	-	-	1.1
Earnings					
Net interest margin	0.1	0.1	0.1	0.1	0.1
Pre-provision income/REA	0.2	0.1	0.2	0.2	0.4
Return on ordinary equity	1.5	0.4	0.8	0.8	1.2
Return on assets	0.0	0.0	0.0	0.0	0.1
Cost-to-income ratio	57.8	71.4	57.0	60.2	48.4
Capital					
CET1 ratio	19.0	18.1	17.2	18.1	16.9
Tier 1 ratio	19.0	18.1	17.2	18.1	16.9
Capital ratio	22.4	22.0	21.4	22.7	21.5
REA/assets	23.3	22.4	21.2	20.3	20.2
Growth					
Asset growth	(7.1)	(8.6)	(5.0)	(3.8)	0.5
Loan growth	(7.7)	(8.9)	(3.4)	(4.1)	0.8

Key financials (NOKm)	2014	2015	2016	2017	2018
Balance sheet					
Total assets	6,409	5,859	5,563	5,350	5,377
Total financial assets	6,357	5,824	5,547	5,339	5,335
Net loans and advances to customers	6,123	5,579	5,391	5,172	5,215
Total securities	136	196	146	112	89
Issued securities	6,018	5,533	5,292	5,090	5,128
of which other senior	6,018	5,533	5,292	5,090	5,128
Total equity	335	288	253	246	234
Total ordinary equity	335	288	253	246	234
Capital					
CET1	284	238	203	196	184
Tier 1	284	238	203	196	184
Total capital	334	288	253	246	234
REA	1,491	1,310	1,179	1,084	1,086
Income statement					
Operating revenues	8	6	7	7	8
Pre-provision operating profit	3	2	3	3	4
Net income	2	1	2	2	3

Figure 15. Norway-Key national metrics

	2014	2015	2016	2017	2018e	2019e	2020e
Real GDP* growth (%)	2.2	1.4	1.0	1.9	2.4	2.3	2.0
CPI growth (%)	2.4	2.7	3.0	1.4	1.4	1.6	1.7
Unemployment rate (%)	3.6	4.5	4.7	4.1	3.7	3.5	3.3
Current account balance/ GDP (%)	11.0	8.0	3.9	5.7	8.1	7.8	8.3
Central bank policy rates	1.3	0.8	0.5	0.5	0.8	1.3	1.7

*Mainland
Source: Economist Intelligence Unit, NCR consensus estimates, Central bank. e–Estimate.

Type of credit rating:	Long-term issuer credit rating Short-term issuer credit rating Issue credit rating The rating is an initial credit rating.
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Office responsible for the credit rating:	Nordic Credit Rating AS, Oslo, Norway. NCR is a registered credit rating agency under Regulation (EC) No 1060/2009.
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Methodology used when determining the credit rating:	'Nordic Credit Rating - Financial Institutions Rating Methodology' published 14 Aug. 2018 'Nordic Credit Rating – Rating Principles' published 14 Aug. 2018 The methodology and principles documents provide analytical guidance to NCR's rating activities including but not limited to, assumptions, parameters, cash flow analysis, and stress-testing. NCR's methodologies and principles can be found on our website: www.nordiccreditrating.com The historical default rates of entities and securities rated by NCR will be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.
Materials used when determining the credit rating:	Annual/quarterly reports of the rated entity Company presentations Bond prospectuses Meetings with management of the rated entity Website of rated entity Non-public information Press reports/public information Data provided by external data providers External market reports NCR considers the data it has analysed to be satisfactory and, to the best of its knowledge, believes the information to be reliable. However, NCR does not guarantee that the information used is fully adequate, accurate or complete.
Conflicts of interest:	The rating is NCR's independent opinion of the rated entity's relative creditworthiness. The rating is solicited, i.e. it is prepared for a fee paid by the rated entity. At the time of analysis and publication neither NCR nor any of the analysts or persons involved in the rating process held any interest, ownership interest or securities in the rated entity. Sparebanken Vest is both owner of Equity Capital Certificates (ECCs) in Kredittforeningen for Sparebanker (KfS) and in NCR. Other owners of ECC's in KfS are indirect owners in NCR through ownerships in SpareBank 1 Gruppen AS or Eika Gruppen AS.
Additional information:	Prior to publication, the rating was disclosed to the rated entity. The issuer was given 24 hours (of which 8 business hours) to remark on factual errors and/or the inadvertent inclusion of confidential information, if applicable. The rating was not amended after the review by the issuer. NCR's rating is an opinion regarding the relative creditworthiness of an entity or an instrument. It is not a prediction, guarantee or recommendation to buy, hold or sell securities. NCR assigns outlooks to issuer ratings to indicate where they could move in the near term, normally 12–18 months. Further information on the rating process, rating definitions and limitations is available on our website: nordiccreditrating.com.
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