Sandnes Sparebank Boligkreditt AS

Residential Mortgage Covered Bonds Programme

Full Rating Report

Ratings/Outlook

Mortgage Covered Bonds	'AA'/Stable

Rating Rationale

IDR/Outlook	'BBB'/Stable
IDR uplift	NA
D-cap	4 (Moderate risk)
Tested Rating on a PD basis	'A+'
Recovery given default uplift (notches)	2
Covered Bonds Rating	'AA'
OC Fitch considers in analysis (%)	11.0
AA breakeven OC (%)	10.0

Discontinuity Risk (D-Cap of 4)

Overall assessment	Moderate
Asset segregation	Very low
Liquidity gap and systemic risk	Moderate
Systemic alternative management	Moderate
Cover pool-specific management	Low
Privileged derivatives	Low

Key Data

	Jun 15
Asset type	Residential mortgages
Cover assets (NOKbn)	7.0
Covered bonds (NOKbn)	6.4
Nominal OC (%)	13.2
WAL of assets (years)	13.8
WAL of liabilities (years)	4.2

Analysts
Andrea Gallina
+44 20 3530 1251
andrea.gallina@fitchratings.com

Stephen Kemmy
+44 20 3530 1474
stephen.kemmy@fitchratings.com

Key Rating Drivers

Rating Composition: The 'AA' rating on Sandnes Sparebank Boligkreditt AS's (SSBB) covered bonds is based on Sandnes Sparebank's Long-Term Issuer Default Rating (IDR) of 'BBB', a Discontinuity Cap (D-Cap) of 4 (moderate risk) and the publicly committed overcollateralisation (OC) of 11%, which is higher than Fitch's 'AA' breakeven OC of 10%. The Stable Outlook on the covered bonds' rating reflects that of Sandnes Sparebank's IDR.

IDR Uplift Not Applicable: The IDR uplift is not applicable to Norwegian covered bonds because bank resolution legislation in Norway remains under development.

Credit Risk Drives Breakeven OC: The credit loss component (8.0%) is the main driver of the 'AA' breakeven OC, followed by the assets disposal loss component of 6.7%, reflecting the maturity mismatches between the assets and the bonds. The cash flow valuation component stands at -3.2%, due to the excess spread available.

High Geographical Concentration: Sandnes Sparebank's home market is located in Rogaland, an oil rich county in Norway. The pool has 87.4% of the loans secured by properties in that region. Fitch has increased the expected losses compared with its base stresses in order to reflect the credit risk arising from this regional concentration. Due to the decrease in oil prices, the economy of Rogaland has been hit with higher unemployment and decreasing house prices in Stavanger. This has led to increased expected losses in a 'AA' scenario,

Moderate Discontinuity Risk Unchanged: The liquidity gap and systemic risk assessment and the systemic alternative management risk assessment are jointly the weakest of the D-Cap components. Liquidity risk is mitigated by a 12-month extendible maturity on the bonds and a public commitment by the issuer to maintain liquid assets in the pool covering interest on the bonds and senior payments for the next three months. The D-Cap measures payment interruption risk.

Programme Highlights

Stable Residential Mortgage Pool: The cover pool contains only residential loans, secured by mortgages (91.0%) or shares in housing associations (9.0%) in Norway. The majority of the loans (43.2%) are instalment loans, while 32.6% are flexible loans. The remaining 24.2% are instalment loans with a weighted average (WA) initial interest-only period of two years.

Large Maturity Mismatches: The WA life of the outstanding bonds has increased to 4.2 years from 4.0 years as of 3Q14. It compares to a WA life of 13.8 years for the assets (disregarding the substitute assets), increased from 12.7 years in 3Q14. As such, maturity mismatches between the assets and the bonds have slightly increased. SSBB plans to continue issuing covered bonds with a maturity longer than five years.

Limited Interest Rate Risks: The majority of the mortgages in the pool (95%) bear a floating rate while the rest (5%) are at a fixed rate. Outstanding bonds pay a floating rate (92% of outstanding bonds) or a fixed coupon. The interest rate risk on the bonds is hedged via swaps with external counterparties. The basis risk is not hedged, but is considered low as the issuer can adjust rates on the loans with six week notice. All assets and covered bonds are NOK-denominated.

Sensitivity Analysis

The 'AA' rating would be vulnerable to a downgrade if any of the following occurred: the reference IDR was downgraded by one notch or more; the D-Cap fell by one category to 3 (Moderate High risk); or the level of OC that Fitch takes into account in its analysis fell below Fitch's 'AA' breakeven OC of 10.0%.

If the OC that Fitch considers in its analysis drops to the legal requirement of 0%, the covered bonds rating would be downgraded to 'A-', reflecting high recoveries on the bonds and thus a two-notch rating uplift above Sandnes Sparebank's IDR.

Abbreviations

OC: Overcollateralisation

D-Cap: Discontinuity Cap

IDR: Issuer Default Rating

PD: Probability of Default

WAL: Weighted Average Life

WAFF: Weighted Average Frequency of Foreclosure

WARR: Weighted Average Recovery Rate

The Issuer

Sandnes Sparebank Boligkreditt AS (SSBB, the issuer) is a specialised covered bond issuer that was established in 2008 with the primary objective to ensure stable and long term funding. It is a fully owned subsidiary of Sandnes Sparebank (Sandnes,'BBB/Stable/F3), a small regional savings bank whose rating reflects its healthy profitability, sound asset quality, solid capitalisation and entrenched regional presence in south-west Norway.

The Boligkreditt is not rated by Fitch. The agency is using its parent's IDR as a floor for the rating of the covered bonds on a probability of default (PD) basis, as Fitch considers the subsidiary very likely to be supported by Sandnes should it get into financial difficulties.

No IDR Uplift

In bank resolution frameworks where covered bonds are favourably treated, such as under the Bank Recovery and Resolution Directive (BRRD) for EU countries, Fitch's analysis starts with an uplift over the IDR of up to two notches for programmes of issuers rated in the 'BB' category and above.

As is the case for all covered bonds' programmes in Norway, the covered bonds' rating is not eligible for IDR uplift since bank resolution legislation remains under development in the country at the moment.

D-Cap of 4 Notches

The potential risk that a covered bond could default if recourse shifts to the cover pool from an issuer is captured via Fitch's D-Caps, which determine the maximum uplift from the IDR (adjusted by any IDR uplift) to the tested rating on a PD basis. It reflects the highest risk assessment of the five components ranging from '8' for minimal discontinuity to '0' for full discontinuity.

Fitch has assigned this programme a D-Cap of 4 (moderate risk). Liquidity gap and systemic risk and systemic alternative management are assessed as moderate risk and are the two weak links in the analysis.

Figure 1

Summary of SSBB's Covered Bonds Discontinuity Risk Assessment

Overall assessment	4 (moderate risk)
Asset segregation	Very low risk
Liquidity gap and systemic risk	Moderate risk
Systemic alternative management	Moderate risk
Cover pool-specific alternative management	Low risk
Privileged derivatives	Low risk

Source: Fitch

The assessments for SSBB's programme are standard for its market regarding liquidity gap and systemic risk and systemic alternative management and better than its peer for privileged derivatives.

Related Criteria

Covered Bonds Rating Criteria (July 2015)

EMEA Criteria Addendum - Norway (February 2015)

Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum (May 2014)

Covered Bonds Rating Criteria - Mortgage Liquidity and Refinancing Stress Addendum (September 2015)

Asset Segregation: Very Low Risk

Fitch assessed the asset segregation risk for the covered bonds as "Very Low". The agency believes that the structural and legislative features of the programme ensure the effective segregation of the assets in the cover pool from the claims of other creditors.

Figure 2

Asset Segregation: Very Low Risk

Component driver	Fitch assessment
Asset register	The issuance of covered bonds is regulated by the Norwegian Financial Institutions Act, which states that in the event of any type of insolvency or public administration, holders of covered bonds and counterparties to eligible derivative contracts (privileged creditors) will have an exclusive, equal and proportional preferential claim over the cover pool assigned to them. The privilege is such that no other creditor of the issuer will be able to claim any rights over the cover pool until all amounts due to the covered bond holders and privileged derivative counterparties have been repaid in full. The Norwegian Financial Institutions Act requires the issuer, and the bankruptcy administrator in case of an issuer default, to maintain a register of all assets and derivatives in the cover pool, and all issued covered bonds. The registration of an asset in the register provides strong evidence that it belongs to the cover pool. Under Norwegian law, an independent inspector is appointed to monitor that the register is maintained in accordance with regulatory requirements. The independent inspector carries out reviews every three months and reports to the Norwegian Financial Services Authority any adverse findings. The independent inspector of SSBB has not reported any adverse findings to date. Fitch has also analysed the four following points that could, if not properly addressed, hinder the effectiveness of the segregation and the privilege rights to the cover pool.
Existence of other privileged creditors	Preferential claims will also be given to swap counterparties whose swaps are registered in the cover pool, and they will therefore rank pari passu with covered bond holders. The law states that other priority creditors such as employees and tax authorities will rank behind the privileged creditors. The only claims that would rank ahead of the privileged creditors would be certain court fees of the insolvency administrator and costs related to the management, operation, collection and sale of the cover pool, which Fitch has modelled in its cash flow analysis.
Asset and liability claw back risk	The Norwegian Financial Institutions Act does not provide full legal protection against claw-back risk, as all payments made within three months before the issuer's insolvency can be reversed by the bankruptcy administrator. However, Fitch has received legal advice that the claw-back risk on the asset side in the case of SSBB's covered bond programme is mitigated because all borrowers are notified upon the transfer of their mortgage loans to SSBB, and of the change of their payments to SSBB account.
Commingling risk	The statutory limitation on the issuer's activities means that its assets will primarily be the cover pool assets, various details of which must be maintained in a register. The independent inspector will check quarterly that the register is maintained correctly. Due to its limited assets and the register, Fitch believes there is little risk of the issuer's cover pool assets being commingled with its other assets. However, payments by the borrowers are currently made into SSBB's account with Sandnes, and therefore they could be temporarily commingled or lost if Sandnes were to become insolvent. Borrowers pay their respective interest and principal instalments monthly to a loan account with Sandnes under SSBB's name. The principal portion of these payments is transferred to an account under Sandnes' name daily and is used to acquire new mortgage loans. The received interest payments remain in SSBB's account until the end of the month. The accumulated interest payments are then transferred to a deposit account with Sandnes under SSBB's name and are later used to meet the quarterly payments on the covered bonds. Account provider Sandnes is rated 'BBB'/Stable/'F3', which is below the threshold level for an account bank to support covered bonds rated in the 'AA' category, according to Fitch's Counterparty Criteria for Structured Finance and Covered Bonds. The agency has therefore accounted in its cash flow analysis for the possibility that one-month collections accumulated with Sandnes could be permanently lost upon an issuer default. In addition, any liquidity risk resulting from commingling of cash flows is mitigated by the issuer holding substitute liquid assets in the form of securities to cover the interest payments on the bonds for three months (see Liquidity Gaps and Systemic Risk below).
Set-off risk	Borrowers are likely to have accounts with the originating bank, but SSBB as a specialised covered bond issuer does not take deposits. The borrowers' potential right of set-off would not apply to the mortgage loans held at SSBB if the originating bank were to become insolvent because loans are transferred from the originating bank to SSBB and all borrowers are notified at the time of the transfer.

Source: Fitch

Liquidity Gap and Systemic Risk: Moderate Risk

As is the case for most covered bonds, the maturity of the cover assets does not match the maturities of the bonds. This can create the need for liquidity, especially if the issuer or its parent falls under administration just before the maturity of a covered bond. In this case, the administrator may not have time to raise enough liquidity against the cover pool to repay the covered bonds on time. To address this risk, the programme has some liquidity protection in place, as described below.

Fitch classified the liquidity gap and systemic risk component of the discontinuity analysis of the programme as "Moderate".

Figure 3

Liquidity Gap and Systemic Risk: Moderate risk

Component driver	Fitch assessment
Liquidity protection	Liquidity risk in the programme is mitigated in three main ways. First, SSBB has publicly committed to include liquid assets in the form of securities in line with Fitch criteria in the cover pool to cover interest payments on the bonds and senior costs for the next three months. Second, all covered bonds issued by SSBB have a soft bullet structure with a maturity extension period of one year. Third, the law requires incoming payment flows from the cover pool to be sufficient to enable the issuer to honour its payment obligations due on the covered bonds. To ensure compliance with this rule, SSBB has also publicly committed to a prudent liquidity gap policy under which it will maintain a positive payment flow for the next six months at any time. The cash-flows from cover pool, substitute assets, deposits with the parent company should cover interest payments and refinancing of the cover bonds. The mechanisms could give up to 18 months for the issuer to raise liquidity. However, there is a risk that cash held with the parent bank may be lost upon default of the bank. As a result Fitch does not give credit to the full 18-month period. There is also a risk that the 12 months' extendible maturity on the bonds can be used by the issuer without triggering an asset sale, as in all other Norwegian issuers. This could effectively reduce the time available to sell assets in a stressed environment. Fitch considers this possibility very unlikely because of the issuer's internal liquidity rules.

Source: Fitch

The moderate assessment for the liquidity gap and systemic risk of SSBB's programme is in line with all Norwegian programmes with one year principal protection in place.

Alternative Management

The risk that the transition to an alternative manager does not occur smoothly enough to ensure that all payments are made in the periods directly following the issuer's default could materialise if the alternative manager were appointed too late, if its responsibilities were unclear or if the IT systems of the issuer made it too difficult for the new manager to isolate the cover pool and covered bonds from the other assets and liabilities of the bank.

Systemic Alternative Management: Moderate Risk

Fitch determined the systemic alternative management component of the D-Cap as "Moderate". Under the legal framework, an insolvency administrator will be appointed upon issuer insolvency and will have the obligation to make timely payments on the covered bonds as they become due.

If the insolvency occurred solely at the SSBB level, a single insolvency administrator would be assigned to the estate and would therefore look after the interests of the privileged and other creditors. As non-cover pool assets and non-covered bond liabilities would be limited due to the nature of the entity, in effect the privileged creditors would have an administrator focused almost entirely on their interests, which Fitch views as positive.

In case of the insolvency of Sandnes, SSBB would fall under a wider public administration as a subsidiary of Sandnes. In this case, the public administrator would still be bound by the legal requirements, including timely payment on the covered bonds, but the legal framework does not spell out the steps the public administrators would need to take to ensure that this occurred, along with their other responsibilities. Fitch therefore views this as an area of lower certainty.

Cover Pool-Specific Alternative Management: Moderate Risk

Fitch has assessed the risk level of the cover pool-specific alternative management D-Cap component as "Low", reflecting the quality of Sandnes' IT systems and the processes in place to manage its residential mortgage portfolio.

A smooth transition to an alternative manager of the cover pool assets depends largely on the quality of the issuer's IT systems. SSBB uses an externally developed IT system, also used by most of the other Norwegian issuers, to manage its covered bond business. The quality of data received from the bank for the rating process was good, with most data delivered in line with Fitch's expectations.

Privileged Derivatives: Low Risk

Fitch has assessed the level of risk under privileged derivatives as "Low". All SSBB's derivative counterparties (DNB, Nordea and Swedbank) are external. Nordea and Swedbank are rated higher than Fitch's minimum thresholds for covered bonds rated in the 'AA' category, under Fitch's Counterparty Criteria for Structured Finance and Covered Bonds. In addition, language in the swap agreement requires the swap counterparty to post collateral, find a guarantor or a replacement if it is rated below 'A'/'F1' and replace a swap counterparty or find a guarantor if it is rated below 'BBB+/F2'.

DNB Bank acts as interest rate swap providers for the programme (nominal NOK0.5bn). As it is not rated by Fitch anymore, the agency analysed the materiality of the counterparty exposure to DNB. This was not deemed material. DNB is the largest financial institution in Norway and is partially-owned by the Norwegian government (AAA/Stable). It posts collateral under the swaps independently of its rating. The agency draws sufficient comfort from the mitigants in place to cover the counterparty risk and therefore it has not changed the assessment of this component compared to the previous annual review. Fitch will keep monitoring the programme's exposure to DNB over time. If this exposure becomes material in the future, this might have an impact on the programme's rating or the level of OC supporting the rating.

Cover Pool

Figure 4
SSBB's Cover Pool

Characteristics as of June 2015	
General	
Current principal balance (NOKbn)	6.6
Average current loan per borrower (NOK)	1,460,130
Number of loans	4,657
WA seasoning (years)	3.4
WA DTI (assumed nibor of 5.0%) (%)	36.2
Loan-to-value (LTV) (%)	
WA original LTV	66.7
WA current LTV	50.5
Property type (%)	
Detached houses	59.5
Semi-detached houses	6.4
Flats	34.1
Holiday houses	0.0
Valuation type (%)	
Automated valuation model (AVM)	99.7
Other	0.3
Amortisation type (%)[a]	
Amortising	43.2
Interest only	24.2
Flexible	32.6
Geographic distribution (%)[a]	
Rogaland	87.4
Oslo	5.1
Akershus	2.5
Hordaland	2.0
Other	3.0
Loan purpose (%)	
Owner-occupied	91.0
Shares in housing associations	9.0

[a] From SSBB's Investor Report
Source: Fitch/SSBB

Cover Pool Credit Analysis

At end-June 2015 the cover pool contained mortgage assets (95.2%) and substitute assets, which are typically made up of Norwegian covered bonds rated 'AA-' or above and deposits with financial institutions rated at least A/F1 which are available on demand. (4.8%). The mortgage pool consisted mostly of variable-rate mortgage loans totalling NOK6.3bn to 4,774 borrowers. The cover pool is well seasoned (3.4 years) with a WA current LTV of 50.5%. The cover pool has a large geographical concentration in and around the city of Sandnes in the Rogaland region (87.4%), which is Sandnes' main operational area, and a significant, but decreasing proportion of flexible loans (32.6%).

Credit Analysis

Fitch has analysed the cover pool according to its main criteria and *EMEA Criteria Addendum – Norway*.

Fitch performed the cover pool asset analysis using line-by-line data for the whole cover pool. Employment information was not available loan by loan for operational reasons. However, the issuer previously provided full information for a sample of 200 loans, which were then used to test Fitch's assumptions with regards to the borrower type.

According to Fitch's methodology, the two key components of the default probability on the residential loans are the willingness and ability of a borrower to make payments on the loan. Willingness to pay is usually measured by the original LTV (OLTV): higher default probability is assigned to high OLTV loans. The ability to pay is measured by the ratio of the borrower's income to the mortgage payments: the debt to income ratio (DTI).

Fitch further adjusts the default probabilities to account for borrower- and asset-specific characteristics. The sections below detail the drivers of the expected loss of the cover assets. The recovery rates are mainly driven by market value decline (MVD) assumptions.

Figure 5

Fitch Default Model Output

(%)	WAFF	WARR	WAMVD	Expected loss
AAA	22.03	49.10	68.67	11.21
AA	17.61	57.99	62.27	7.40
B	4.02	73.69	26.31	1.06

WAFF = Weighted Average Frequency of Foreclosure
WARR = Weighted Average Recovery Rates
WAMVD = Weighted Average Market-Value Decline
Source: Fitch

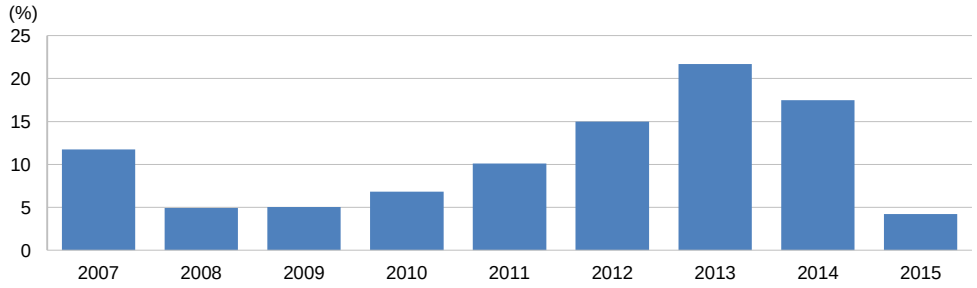
OLTV and DTI

Most of the portfolio was originated between 2011 and 2015. The WA OLTV of the portfolio is 66.7% and about 18% of loans had LTVs above 80% at origination. The WA debt-to-income ratio (DTI) is 36.5%.

Figure 6

Distribution by the Year of Origination

Cover pool

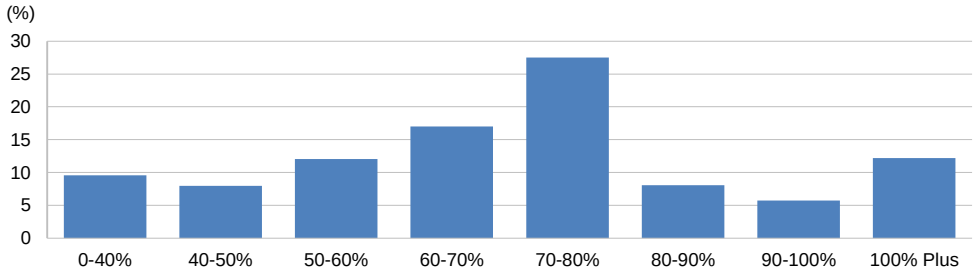


Source: SSBB

Figure 7

Original LTV Distribution

Cover pool

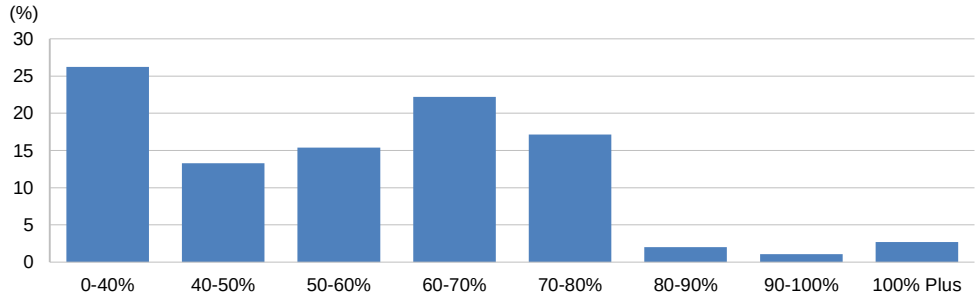


Source: SSBB

Figure 8

Current LTV Distribution

Cover pool



Source: SSBB

Borrower Profile

Based on a sample analysis of the borrowers, Fitch made a conservative assumption that 10% of the borrowers in the pool are self-employed. This implies a 20% increase in default probability under our criteria. The rest of the borrowers are assumed to be employed.

Mortgage Loans

About 95% of the loans bear variable rates. The rest are fixed-rate mortgage loans. The WA interest rate on the cover pool assets was 3.15%.

The portfolio contains amortising (repayment) and flexible mortgage loans. Sandnes has decreased the origination of flexible loans since the beginning of 2013. Accordingly it is lowering the amount of flexible loans in the pool. The proportion of flexible mortgage loans in the pool had decreased to 32.6% in June 2015 from 37.2% in September 2014 (see Figure 9). The issuer is intending to stabilise the proportion of flexible loans in the pool around this figure within the next 12 months.

Flexible loans were introduced to the Norwegian market in 2007, and have become one of the most used mortgage products on the market. A flexible mortgage loan can act as an interest-only loan or an overdraft facility. Borrowers with flexible loans are only required to pay interest payments monthly on the drawn portion of the loan; principal can be repaid at the borrower's discretion. Furthermore, the flexible loan has no limits on re-drawing up to a pre-agreed maximum limit.

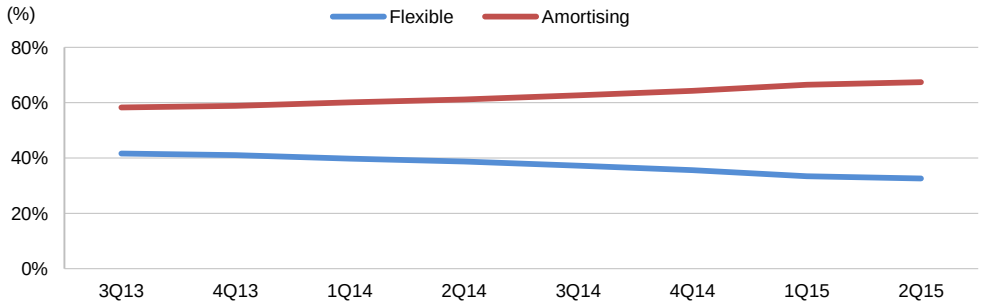
The issuer would not consider a flexible loan as in arrears until the borrower had drawn the maximum amount permissible (up to a limit of 75% of the property value at loan origination) and then missed a payment. The originating banks may monitor if quick drawings are made, for example where the borrower has cash flow difficulties. However, they cannot stop borrowers from drawing up to their permissible amounts.

In its asset and cash flow analysis Fitch has assumed that all flexible loans are drawn to their maximum drawable allowance. Fitch has increased the default probability for these loans according to their maturity. Nearly all flexible loans have a term of 10-15 years and hence a hit of 20% have been applied to reflect the higher risk posed by the interest-only feature of the loans and the payment shock at maturity.

Figure 9

Amortisation type

Cover pool



Source: SSBB

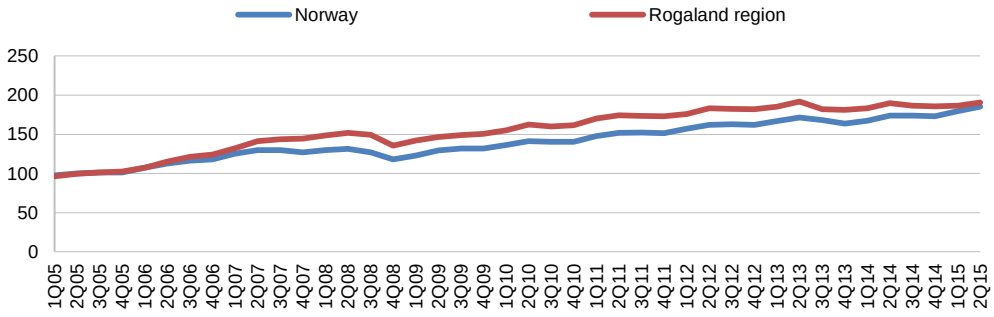
Geographical Concentration

Sandnes' business activities are concentrated in and around the city of Sandnes in the Rogaland region, an economically strong, oil producing area of Norway that has about 9% of the national population. About 89% of mortgage loans are secured by properties located around Sandnes, reflecting the bank's business model.

Rogaland has a diversified high-value economy but its growth depends on the oil and gas markets. Apart from a possible external shock affecting the oil industry, the main source of risk to economic stability is the housing market. According to Statistics Norway, house prices in the Rogaland region, particularly in its key cities Stavanger and Sandnes, have risen above the national average since 2005, as can be seen in the graph below. The significant drop in oil price observed since mid-2014 has impacted the regional economy, increasing unemployment to 4.3% from 3.8% in 2014. The housing market has also been impacted, with prices in Rogaland outperforming the rest of the country and decreasing in Stavanger.

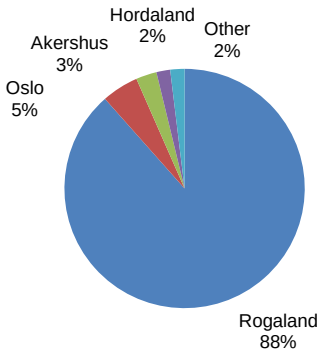
Figure 10

House Price Index



Source: Statistics' Norway

Figure 11
Geographical Distribution
Cover pool



Source: SSBB

Fitch considers unlikely a sharp increase in defaults resulting from an economic or oil industry downturn given a strong social security system and diversification among borrowers. To reflect the concentration risk and hence strong dependency on one industry, Fitch increased the default probability for the loans secured by properties in Rogaland region by 25%. In the latest *EMEA Criteria Addendum – Norway* published on February 2015 the agency also increased the MVDs for Hordaland and Rogaland regions in all rating scenarios due to high property price sensitivity to the economic developments in these counties and the small size of the market where Sandnes operates.

Shares in Housing Associations

Loans secured by SHAs represent about 8.4% of the cover pool. SHA loans are granted to borrowers for buying a share in a housing association, giving them the right to live in one of the housing units belonging to the association. This is fairly common practice in large cities. All borrowers in the housing associations share the debt of the housing association.

Usually, this common debt is a loan taken by the housing association either at the time the association was set up, to finance part of the building, or later for renovation purposes. The common debt usually has a low LTV. It always has first ranking over the borrower's housing loan.

Fitch takes into account the added risk for the borrower that the housing association defaults on its common debt. This is mainly a risk where the common debt LTV is high. In line with its criteria, Fitch typically treats SHA loans where the common debt LTV is below 20% similarly to standard residential loans, as it considers the risk of default of the corresponding housing associations very low. Conversely, the agency assigned 100% default rate and 20% recovery rate to SHA loans with common debt LTV above 20%. These represent about 1.0% of the cover pool. See *EMEA Criteria Addendum - Norway* for further details.

Loan in Arrears

None of the loans were in arrears at the cut-off date. Loans in arrears will generally be removed from the cover pool, as those more than 90 days in arrears cannot be counted towards its value for the purposes of the over-collateralisation calculations under Norwegian legislation. However, such loans would still be pledged to the covered bond holders if they remain in the cover pool. Fitch will apply its standard default probability assumptions to loans in arrears, should there be any in the portfolio.

Portfolio Changes Over Time

The portfolio composition may rapidly change for a number of reasons, including the fast amortisation rate and potential cover pool increases in the course of new bond issuances. Fitch will monitor the portfolio and may change its loss assumption for the pool if deemed appropriate.

Cash Flow Analysis

To assign a rating to the covered bonds above the Reference IDR, Fitch compares the cash flows from the cover pool with the cash flows due on the covered bonds after an issuer event of default. The agency assumes that no new assets enter the cover pool to replace maturing or non-performing assets, that there is no issuance of further covered bonds and that some assets are sold at a discount (factoring in refinancing spread assumptions) when needed in order to meet the payments on the bonds.

The cash flows expected from the assets were modified to reflect prepayment, margin, delinquency, default and recovery assumptions in different stress scenarios. In addition, the cost of servicing the portfolio was modelled above contractual values, to simulate a substitute servicer at increased costs.

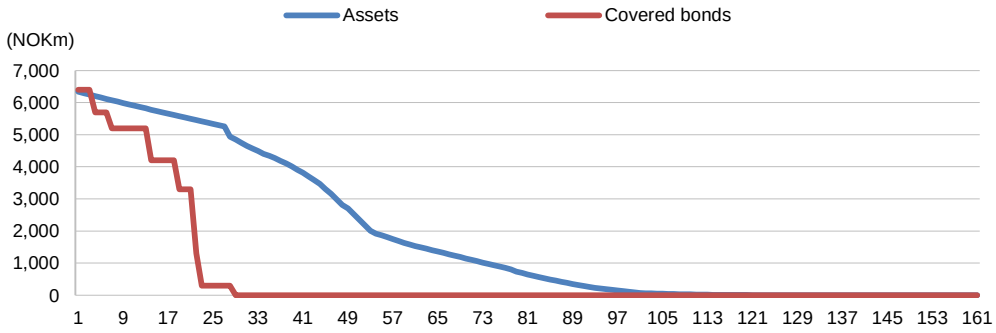
Maturity Mismatches

The redemption profile of the covered bonds does not match the amortisation of the cover assets. As a result, temporary liquidity surpluses or shortfalls may arise, which could strain available resources. Fitch has considered in its analysis that the assets may be sold at a discount to meet the payments on the bonds.

At present, SSBB's covered bond programme has significant maturity mismatches, which are the key driver of the breakeven OC. The agency calculated a WA life of 13.8 years for the cover assets, while the covered bonds had a WA life of 4.2 years (disregarding the extension feature of the bonds) at end-September 2015. Fitch calculated the amortisation profile and WA life of the flexible loans assuming that these are fully drawn.

Figure 12

Amortisation Profile



Source: Fitch, SSBB

Extendible Maturities

The issued covered bonds are soft bullet bonds with an extension period of up to one year, whose terms will be defined in the relevant pricing supplement for each issue. If the issuer fails to pay all amounts due on the maturity date, the maturity will automatically be extended each month up to the extended maturity date.

Interest will continue to be payable under the covered bonds during the extension period and the issuer will be allowed to redeem all or part of the then-outstanding principal on any of the monthly payment dates. This increases the time for the administrator to find alternative solutions to repay the covered bonds as they become due and minimises the risk of the covered bonds defaulting after an issuer default.

Hedging

About 95% of all loans in the cover pool are floating rate. The rate is set at the discretion of the issuer and is typically based on the internal funding rate (plus a margin), which largely mirrors three-month NIBOR. The issuer can change the interest rate on the loans by giving six weeks' notice to the borrowers. Only the fixed-rate loans are swapped into three-month NIBOR from time to time based on internal risk management requirements. These swaps have no material impact on the breakeven OC for the rating because of the small amount of the fixed rate assets in the pool.

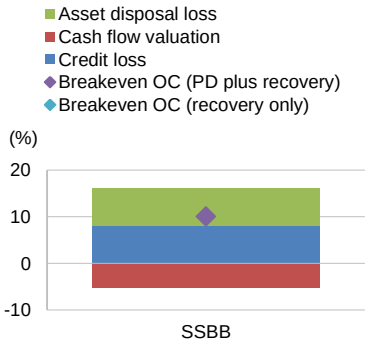
All outstanding covered bonds are denominated in Norwegian kroner and bear floating interest rate, except for one issuance. The interest rate risk on the bond is hedged via an interest rate swap where the fixed interest rate payment on the bonds is swapped for three-month NIBOR plus a margin.

The basis risk rising from the difference between the funding rate (mortgage assets) and three-month NIBOR (covered bonds) is not hedged. However, the risk is not material taking into account the fact that the funding rate tracks three-month NIBOR and the rates on the loans can be adjusted with six weeks' notice.

All swap agreements are with external counterparties such as DNB (please see the detailed explanation in the D-Cap Appendix), Nordea and Swedbank.

Figure 13

Breakeven OC Components



Source: Fitch

Breakeven OC

The 'AA' break-even OC is 10.0%. This level supports 'A+' stresses on a PD basis in Fitch's cash flow model. In addition, modelled recoveries under 'AA' stresses enable the agency to grant a two-notch recovery uplift to 'AA'. The credit loss component (8.0%) is the main driver of the 'AA' breakeven OC, followed by the assets disposal loss component of 6.7%, reflecting the maturity mismatches between the assets and the bonds.. The worst-case scenario is low prepayments and low interest rates.

The Norwegian covered bond legislation does not require the issuers to maintain a specific minimum amount of OC. As the Reference IDR is 'BBB'/'F3', the agency relies on the publicly committed OC of the issuer of 11.0% rather than the minimum level of OC maintained over the last 12 months.

The composition and credit quality of the cover pool may change over time because of the dynamic nature of the programme. The Fitch breakeven OC for the covered bond rating will be affected, among other things, by the profile of the cover assets relative to outstanding covered bonds, which can change over time, even in the absence of new issuances. Therefore, it cannot be assumed to remain stable over time.

On-Going Programme Review

Fitch will periodically review the credit quality of the cover pool and perform a cash flow analysis to assess whether the OC taken into account by the agency provides protection against identified risks commensurate with the rating of the covered bonds issued by SSBB under this programme. Cover pool and covered bonds information will be updated regularly and displayed on Fitch's covered bond surveillance tool (available at www.fitchratings.com) and in the quarterly Covered Bonds Surveillance Snapshot (July 2015).

Appendix 1: Programme Summary

This is a legislative covered bond programme supervised by the Norwegian Financial Services Authority. The programme conditions allow for the issuance of bonds with different characteristics in currency, term, payment frequency or interest rate type (fixed or floating). At end-September 2015, seven covered bonds totalling NOK6.4bn were outstanding, all denominated in Norwegian krone. All bonds benefit from a 12-month extendible maturity.

The purchase of cover pool assets by SSBB is financed by a funding loan provided by Sandnes. All cover assets including substitute assets are registered in the cover pool register (the Register). According to Norwegian legislation:

The cover pool may consist of residential mortgage loans with maximum LTV of 75% at the time of inclusion in the cover pool, based on a valuation not more than 3 months old. If the property value falls and as a result LTV increases above the 75% threshold, only the part of the loan up to 75% will be counted as an asset in the cover pool for the purpose of calculating the overcollateralisation.

Substitute assets (securities with a rating at least AA-) can form part of but cannot exceed 20% of the cover pool.

If the issuer is declared bankrupt, the bankruptcy administrator, who would be appointed by the court to run the cover pool, would have to ensure that the bond holders receive timely payments, which might require a sale of the cover assets.

No acceleration of payments is provisioned by law. If payments cannot be made to the bond holders in a timely manner, the bankruptcy administrator will halt all the payments and notify all bond holders of the insolvency. After the halt of the payments, further administration of the cover pool will follow the general Norwegian rules of bankruptcy.

There is no time subordination of payments to long-dated covered bondholders. All payments and recoveries from the cover pool will be allocated pro rata among the bond holders. Payments to the swap counterparty and the swap termination payments rank pari passu with payments to the covered bond holders.

Figure 14

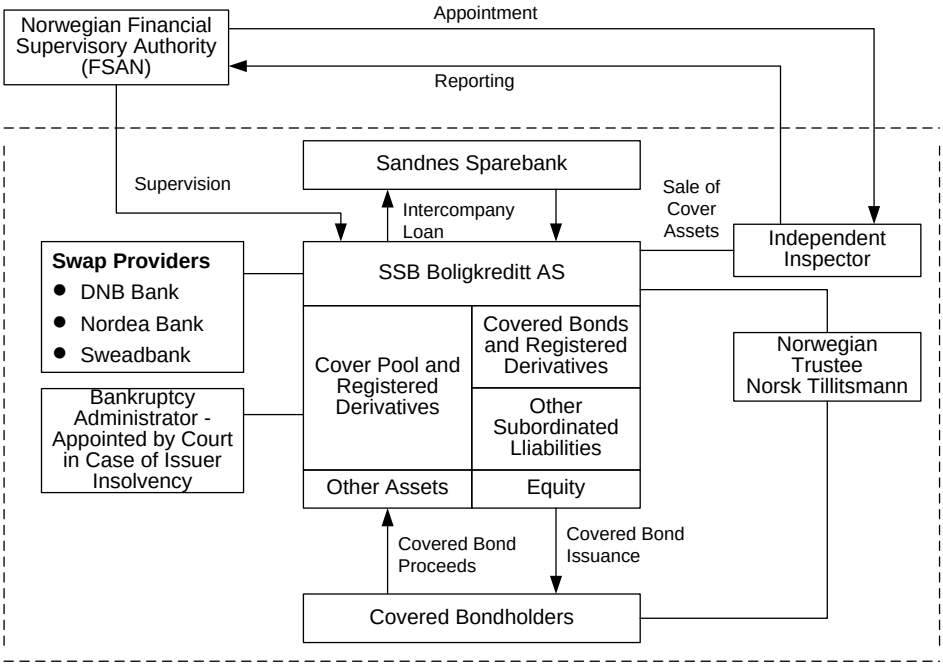
Main Parties

Sandnes Sparebank	Originator Account bank Servicer
Sandnes Sparebank Boligkreditt	Issuer
DNB Bank (NR) Nordea (AA-/Stable/F1+) Swedbank (A+/Positive/F1)	Swap providers

Source: Programme documents

Figure 15

Structural Diagram



Source: Fitch

Appendix 2: Origination and Servicing

Fitch conducted an operational review at Sandnes and SSBB in May 2015 to assess the processes of loan underwriting and servicing procedures, and its risk strategy.

Sandnes' residential mortgage market share in Rogaland is about 10% and has remained fairly stable in recent years. It offers fixed and variable interest rate mortgage loans with amortising (annuity and linear) and flexible amortisation profile and maturity up to 30 years.

The amortising flexible loans that Sandnes currently offers are standard for the Norwegian market. However, until August 2013 the offered flexible mortgage loans had non-standard features. Notably, mortgage loan contracts did not have maturity dates, while the collateral was registered as security usually for 30 years. In August 2013 Sandnes discontinued offering flexible mortgage loans without maturity and a month later amended all existing flexible loan contracts to include maturity dates (mostly 15 years since loan origination).

Origination and Underwriting

Origination Channels

At present, all originations are done in-house. Customers can only apply for a loan directly in one of the bank's three branches (in Sandnes, Stavanger and Oslo). Sandnes also used internet banking as an origination source until 2010. Origination volumes have remained stable in recent years.

Underwriting

Sandnes Sparebank uses an internally developed scorecard to assess the risk of the borrowers and for pricing the loans. The scorecard takes into account the following risk parameters of individual loans: collateral, debt service capacity, credit history in general and with the bank. Credit approval is done at different management levels, depending on the loan amount and credit score of the borrower.

Underwriting Criteria

Sandnes criteria have tightened over time. Until 2010, there was no formal cap on the LTV and lenders granted mortgage loans up to 100% LTV. In 2010 the Norwegian Financial Services Authority introduced a maximum LTV of 90% for the amortising loans and 75% for flexible loans. These limits were lowered to 85% and 70%, respectively at the start of 2012. In addition, an affordability test factoring in an increase in rates of 5 percentage points has to be performed.

The current underwriting criteria, determined by the external guidelines established by the Norwegian Financial Services Authority, are as follows:

- maximum LTV limit of 85% for amortising loans (in comparison, only loans with LTV of up to 75% are eligible for the cover pool);
- maximum LTV limit of 70% for flexible loans;
- debt-to-income ratio of 3x;
- affordability stress testing.

The Financial Services Authority allows financial institutions to deviate from these requirements but deviations need to be reported to the authority quarterly. According to Sandnes' internal guidelines, deviations from official guidelines can be approved only by a director and are reported to the board.

Affordability Test

In line with Norwegian Financial Services Authority requirements, credit approval cannot be made without testing the borrower's ability to repay a mortgage loan. The bank's cash flow analysis is based on standard living expenses, assumes an amortising repayment type (also for flexible and interest-only loans) and takes into account a 5 percentage points increase in the interest rate.

Borrower Income Verification

The borrower's income is always verified by an employee of the bank. The most recent payslip is taken into account for employed borrowers, while for self-employed borrowers one year's income is taken into consideration.

Property Valuation

The property valuation can be carried out only by a qualified external third party. It is not permitted for the bank's employees or the customer to provide a property valuation. Sources of property valuation information include:

- contract-market price where the property has been sold in the preceding 24 months.
- valuation from a real estate agent authorised by the Financial Services Authority.
- Eindomsverdi AVM valuation, always the second valuation for the new originations, and can also be used as the first property valuation for existing customers (refinancing).

The cover pool does not include any new-build loans, but it can include refurbishment loans. The property value upon origination of a refurbishment loan is not adjusted for the possible increase in its value upon the completion of the refurbishment works.

Adverse Credit History

The originator checks borrowers' credit history. Borrowers with an adverse credit history are not accepted.

Shares in Housing Associations

About 9% of the portfolio is loans for SHAs. SHA loans are granted to borrowers for the purpose of buying a share in a housing association, which gives them the right to live in a residential unit of the housing association. The share is valued at the market price of the property less the proportional share of the housing association's common debt. There is no difference in origination or underwriting of loans secured by SHA and by owner occupied properties.

Servicing

Primary servicing is done in-house, while special servicing is performed by Lindorff, the special servicing market leader in Norway. Lindorff takes over mortgage loans in arrears after 90 days or when a loan is considered to be in default, and carries out credit evaluation, foreclosure and debt collection.

IT systems

EVRY is the main IT-provider at the moment, but it will convert to SDC in October 2015. SDC is chosen as the main IT-provider by 124 banks throughout Denmark (34), Norway (82), Sweden (4) and Farao Island (4); the main reason to substitute the IT-system is to improve the core structure of programme management.

The loans are transferred in mass on a quarterly basis, but this can be easily done more often or on an individual basis loan by loan (timing for the transfer is overnight).

Appendix 3: Outstanding Liabilities

Figure 16

List of Outstanding Public Covered Bonds

Series	Currency	(Size/bn)	Coupon type	Rate	Scheduled maturity	ISIN
SSBB02	NOK	0.7	Floating	Nibor + 65bp	15 Apr 16	NO0010577166
SSBB06	NOK	0.5	Floating	Nibor + 102bp	08 Feb 17	NO0010636335
SSBB07	NOK	1.0	Floating	Nibor + 50bp	20 Sep 18	NO0010689664
SSBB08	NOK	0.9	Floating	Nibor + 48bp	04 Dec 19	NO0010697691
SSBB09	NOK	1.0	Fixed	310bp	25 Feb 21	NO0010704232
SSBB10	NOK	2.0	Floating	Nibor + 29bp	03 Sep 20	NO0010718331
SSBB11	NOK	0.3	Floating	Nibor + 34bp	15 Jun 22	NO0010731938

Source: Bloomberg, Sandnes Sparebank

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.