DNB Bank ASA
Issuer Rating Report

SCOPE AA- STABLE

Overview

Scope Ratings assigns an Issuer Rating of AA- and a short-term debt rating of S-1+ to DNB Bank ASA, both with Stable Outlook. The ratings do not apply to unguaranteed subsidiaries of the rated parent.

The ratings were not solicited by the issuer. Both ratings and analysis are based solely on publicly available information. The issuer has participated in the process.

Highlights

- The ratings on DNB Bank ASA are based on the strength of the group, DNB ASA. DNB enjoys a strong franchise as the leading financial services provider in Norway. The group has demonstrated its ability to generate resilient earnings capable of absorbing higher-than-average loan impairments stemming from the oil-related sector while strengthening its capital position. DNB's market funding profile has also improved with the greater use of covered bonds.
- Importantly, management is clearly aware of the need to "own the customer relationship" due to increasing competition from non-bank players, more open infrastructure and lower switching costs. We see management proactively addressing these challenges to maintain the group's leading position.
- Further, we expect the operating environment to remain supportive as Norway benefits from solid economic growth, low unemployment and high wealth levels.
- The government's 34% ownership stake in the group is not a driver for DNB's rating. The group is financially sound and in line with our rating methodology we do not notch up the Issuer Rating of AA- based on the expectation of state support. Further, a sale of the government's stake would not in and of itself lead to a rating change.

Rating drivers (summary)

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

- Management's proactive approach to reinforcing DNB's leading domestic franchise.
- Strong and resilient earnings generation capabilities.
- Material reliance on market funding.
- A relatively proactive regulator mindful of previous banking crises.

Ratings & Outlook

Issuer Rating	AA-
Outlook	Stable
Senior unsecured debt	A+
Tier 2 instruments	A-
Additional Tier 1 instruments	BBB-
Short term debt rating	S-1+

Lead Analyst

Pauline Lambert
p.lambert @scoperatings.com

Associate

Alvaro Dominguez Alcalde
a.dominguez@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating change drivers

Growing imbalance in funding mix. DNB like other Norwegian banks is reliant on wholesale funding to finance part of its operations. We would view negatively a growing imbalance in the funding mix such as a higher reliance on short-term market funding.

Material deterioration in the macro environment which significantly impacts earnings. Concerns remain about the high level of personal indebtedness and property valuations in Norway. Meanwhile, the decline in oil investments appears to be levelling off. Mainland GDP is expected to grow around 2% p.a. during 2018-2020.[1]

Continued improvement in funding profile. We would view positively a further reduction in the reliance on wholesale funding as well as continued lengthening of the maturity profile of funding sources.

[1] Norges Bank, Monetary Policy Report, December 2017.

Rating drivers (details)

Management's proactive approach to reinforcing DNB's leading domestic franchise

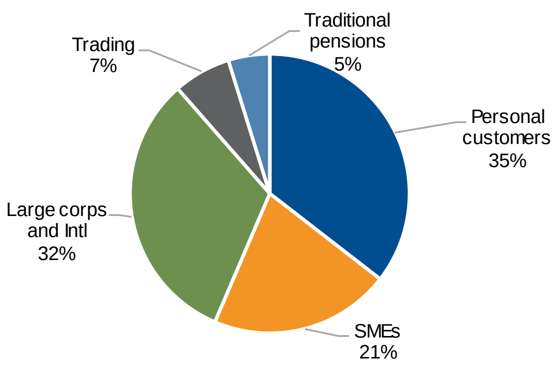
While there are a relatively large number of banks in Norway, DNB remains by far the dominant player, accounting for roughly a third of the market. Other major players include large Nordic financial groups – i.e. Nordea with 10% plus market share and Handelsbanken and Danske Bank with combined market share of about 10%. There are also over 100 savings banks which cooperate extensively, but most have very small market shares and local operations. The SpareBank 1 Alliance comprises around 15 savings banks, most of which are regional and combined account for 20% of retail lending. Meanwhile, Eika Gruppen, an alliance of around 75 smaller savings banks, accounts for 10% of retail lending.

As the leading financial services group in Norway, DNB maintains dominant market positions in banking, asset management and insurance. In response to changing customer behaviour, the group has reduced the number of domestic branches by more than half in recent years and currently operates with less than 60 branches. At the same time, DNB's distribution model is becoming increasing digital. Keeping up with the pace of innovation and securing the ability to meet new customer needs has been identified as the most important challenge by management. In 2015, the group developed Vipps, which has become a leader in payment and identification solutions in the Nordic region. Vipps is now a joint venture with over 100 Norwegian banks, with DNB remaining the majority shareholder with nearly a 52% share.

About 80% of DNB's lending, income and deposits are derived from its domestic market. International operations stem from the group's global financing activities in the shipping, energy and seafood sectors. In addition, DNB is active in the Baltics via a 44% holding in Luminor Group AB, which was created in 4Q 2017 through the combination of DNB's and Nordea's operations in Estonia, Latvia and Lithuania.

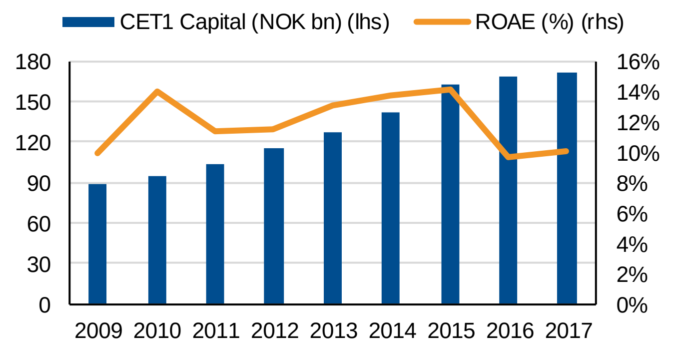
The group's earnings are well diversified by customer segment (Figure 1). DNB continues to re-balance the Large Corporates and International segment, aiming to diversify the portfolio while reducing risk concentration and capital intensity. In January 2018, a non-core division comprised of about USD 10bn in shipping and oil-related exposures was established, with the goal to reduce these exposures more quickly. While accounting for less than 10% of earnings, the Trading segment which includes the group's market-making and proprietary trading activities is a meaningful source of fee and commission income.

Figure 1: Pre-tax operating profit breakdown



Notes: Data as of YE 2017. Pre-tax operating profit of NOK 28bn excluding "Other operations and eliminations".
Source: Company data, Scope Ratings

Figure 2: Capital (NOK bn) and ROAE (%) development



Source: Company data, Scope Ratings

Strong and resilient earnings generation capabilities

Since recovering from the Norwegian banking crisis of 1988-1993, DNB has been consistently profitable. Even during the 2008-2009 financial crisis, the group remained solidly profitable despite loan loss charges peaking at almost 40% of pre-provision income. While the downturn in oil investment and oil prices began in 2013, the group's returns only began to reflect this stress in 2016 and has shown some recovery in 2017. The return on average equity was just above 10% while the group's capital position has continued to strengthen through retained earnings and active balance sheet management (Figure 2).

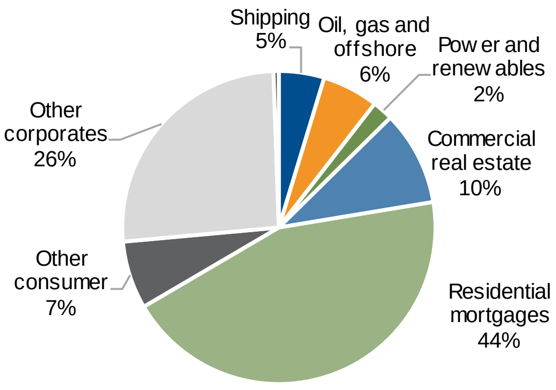
Having reached the group's CET1 capital target of around 16.1%, management is focused on achieving a ROE above 12% towards end-2019. Underpinned by a supportive macroeconomic environment, management plans on improved net interest income, higher fee and commission income, continued cost efficiency (below 40% cost/income ratio target), normalized loan loss provisions and the profitable and efficient use of capital (e.g. increasing lending to the personal customer and SME segments while rebalancing and decreasing credit exposure to the large corporates segment).

The cost of risk run rate is expected to be around 17bps of exposure at default (EAD), or approximately NOK 3bn, in 2018-2019. Loan impairments were elevated at NOK 7.4bn in FY 2016 but declined to NOK 2.4bn in FY 2017, reflecting more favorable conditions in the shipping, offshore and energy segments. There have been no spillover effects across the loan portfolio from oil-related industries, with asset quality across the retail, general corporate and commercial real estate portfolios remaining stable. There continue, however, to be some challenges with the offshore portfolio. Group net non-performing and doubtful loans remain low at 0.98% of net loans, down from 1.5% in FY 2016.

In addition to the oil-related and shipping sectors, we continue to monitor DNB's exposure to Norwegian real estate. Residential mortgages and commercial real estate account for 51% and 10%, respectively of DNB's NOK 1,877bn credit portfolio (EAD); Figure 3.

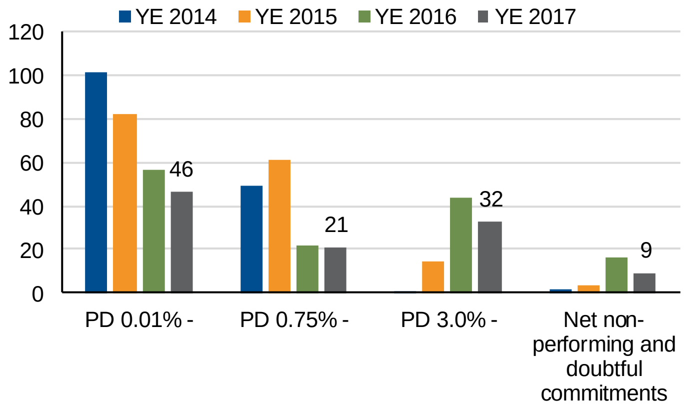
In its 2017 Financial Stability Report, the Norges Bank continues to highlight high household debt and elevated property prices as significant vulnerabilities for the Norwegian financial system. The decline in house prices last year (-3% from the peak in spring 2017) is considered a healthy correction.

Figure 3: Breakdown of EAD (NOK 1,877bn)



Notes: Data as of YE 2017. EAD = exposure at default. Public sector exposure accounts for less than 1% of the EAD shown above.
Source: Company data, Scope Ratings

Figure 4: Oil-related portfolio (NOK 109bn) risk migration



Notes: Based on DNB's risk classification system. PD = probability of default
Source: Company data, Scope Ratings

At the same time, the government has adopted regulations such as minimum equity requirements (15% for mortgages), limits on loans where the loan-to-income ratio exceeds five times and a maximum LTV of 60% on interest-only loans. Guidelines for prudent consumer lending practices have also been issued.

Positively, over the last few years, the weighted-average LTV ratio of DNB's mortgage portfolio has steadily declined. As of YE 2017, nearly 50% of the mortgage portfolio had LTVs below 60% while 6.5% had LTVs above 85%.

Material reliance on market funding

In Norway, the financial crisis of 2008–2009 was primarily a liquidity crisis, revealing the need for banks to improve their liquidity and funding structures. The group's funding profile has since improved with the share of wholesale funding declining and the maturity of long-term funding (senior debt and covered bonds) being materially extended (2017: 4 years, 2008: 2.4 years). Management aims to maintain a customer deposit to net loan ratio of at least 60%. At YE 2017, the ratio was 63% (2008: 50%), with short-term money market investments accounting for a very small component of customer deposits.

The group is an established international borrower with short-and-long-term debt programs in EUR and USD. Of the NOK 780bn in debt securities issued as of YE 2017, 90% was in foreign currency and 20% was in foreign-currency denominated commercial paper. DNB is considered by investors as a relative "safe-haven", along with other Nordic banks, although recent history has shown that investor perceptions can change quickly and be unpredictable.

Covered bonds have proven to be a stable source of long-term funding. While not as large as some, we note that the covered bond market in Norway has become firmly established since the legislative framework entered into force in June 2007. Covered bonds are issued primarily by DNB Boligkreditt AS, a fully-owned subsidiary of the group. As of YE 2017, covered bonds with a nominal value of NOK 437bn accounted for over 20% of the group's funding.

Norway's relatively small sovereign bond market acts a constraint on the availability of liquid assets in NOK and therefore, banks meet their liquidity needs in other currencies such as USD and EUR where the supply of liquid assets is far greater. Since January 2016, the Norwegian FSA has required larger Norwegian banks such as DNB to have a LCR of at least 100%. Acknowledging the limited supply of NOK assets, the currency distribution for individual banks is reviewed as part of the supervisory process. At YE 2017, the group's total LCR was a solid 117%, with the LCR in other currencies also at reassuring levels (NOK at 93%, USD at 137% and EUR at 191%).

Relatively proactive regulator mindful of previous banking crises

During the Norwegian banking crisis of the early 1990s, authorities rescued about half of banking system assets. The government ended up taking stakes in three banks and today still maintains a 34% ownership stake in DNB.

The stake is held to ensure that the group remains in Norway and continues to support Norwegian businesses. Consequently, authorities remain diligent about risks in the banking system, recognizing that Norwegian banks rely heavily on foreign funding and that turbulence in international financial markets can quickly impact the banking sector and the domestic economy.

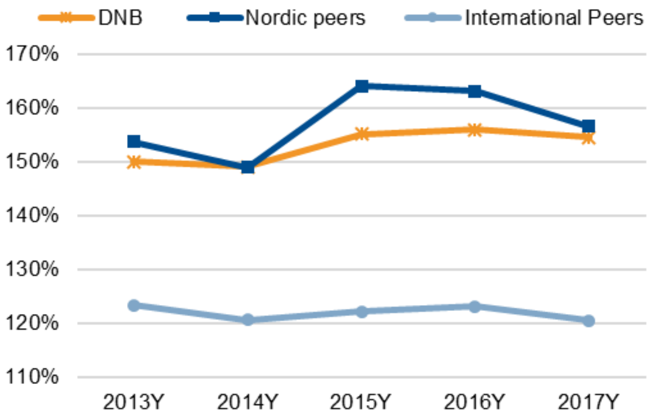
DNB is supervised by Finanstilsynet (Norwegian FSA). However, as a part of the EAA, Norway adheres to the EU's single rulebook and its banks follow EU regulatory norms. DNB remains subject to relatively stringent solvency requirements. For 2018, the group is subject to a SREP CET1 capital requirement of 15.2% which we consider to be conservative for its risk profile compared to European peer standards. It is comprised of the 4.5% minimum, a 1.6% Pillar 2 add-on, a 2.5% capital conservation buffer, a 3% systemic risk buffer, a 2% systemically important financial institutions buffer and a 1.6% countercyclical buffer. As well, the regulator expects DNB to hold a management buffer of around 1%. Consequently, management targets a CET1 capital ratio of around 16.1%. As of YE 2017, the group's CET1 ratio on a Basel I transitional basis was 16.4% (16.7% on Basel III basis), including the impact of a NOK 1.7bn share buy-back.

Banks in Norway have been subject to transitional arrangements (also known as the Basel I floor) such that RWAs cannot be less than 80% of risk-weighted volume calculated according to Basel I regulations. Considering the Basel Committee's proposed new standardized approach, the Norwegian FSA has been given until mid-April 2018 to present its recommendations on how the Basel 1 floor may be replaced.

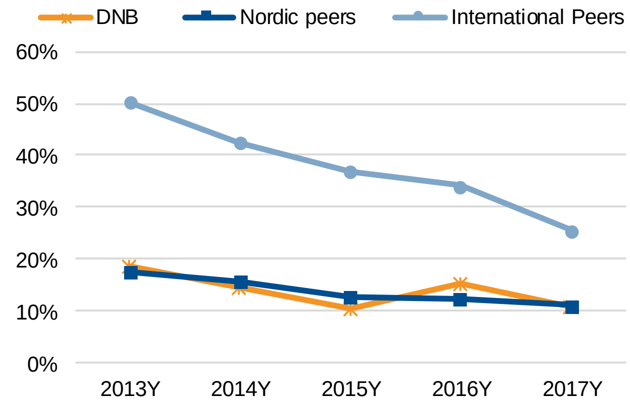
In addition, DNB is subject to a leverage ratio requirement of 6%, comprised of the minimum 3%, a minimum buffer of 2% for all Norwegian banks and a minimum buffer of 1% for systemically important banks in Norway. As of YE 2017, DNB's leverage ratio was 7.2%, which compares well to global peers.

I. Appendix: Peer comparison

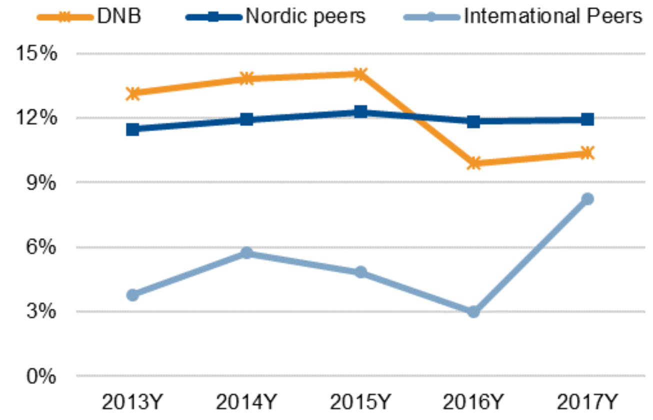
Net loans / deposits (%)



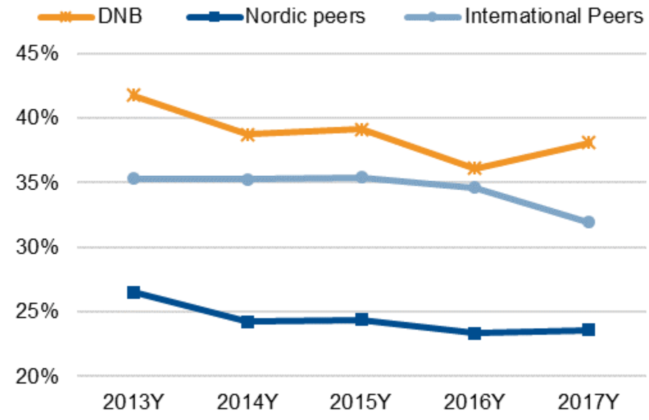
Impaired loans / Tangible equity and reserves (%)



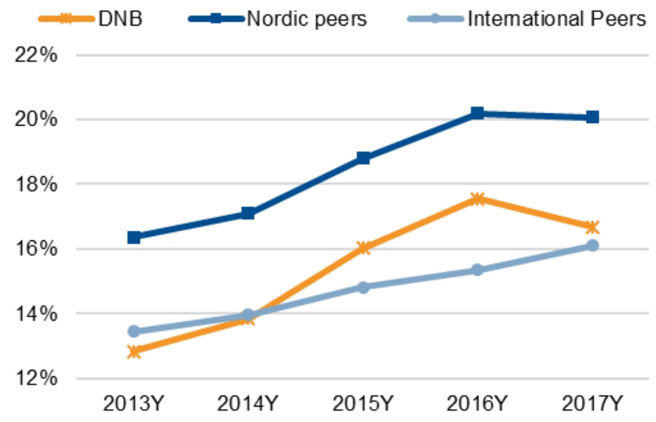
Return on average equity (ROAE) (%)



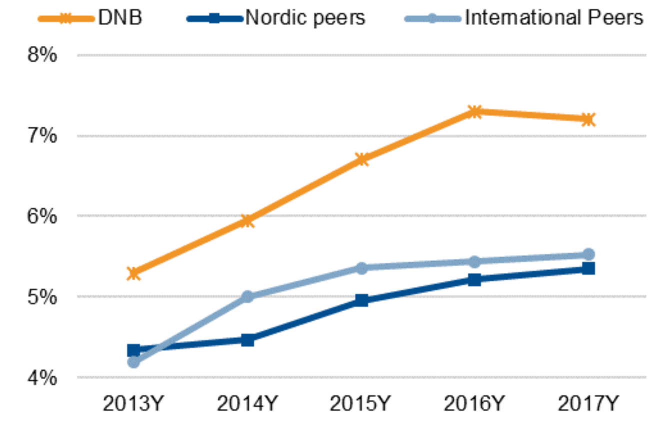
Asset risk intensity (RWAs / total assets, %)



Common equity tier 1 ratio (Basel III transitional, %)



Tier 1 leverage ratio (%)



Nordic peers: Danske, DNB, Handelsbanken, SEB, Swedbank, Nordea.
International peers: Credit Agricole, BPCE, Credit Mutuel, La Banque Postale, Lloyds, RBS, Intesa, UBI Banca, Commerzbank, Danske, DZ Bank, ABN AMRO, Rabobank, Caixabank, Caixa Geral, Sabadell, Handelsbanken, SEB, Swedbank, Bank of Ireland, AIB, National Bank of Greece.
Source: SNL

II. Appendix: Selected Financial Information – DNB Group

	2013Y	2014Y	2015Y	2016Y	2017Y
Balance sheet summary (NOK m)					
Assets					
Cash and interbank assets	348,053	431,914	320,533	384,705	390,923
Total securities	591,412	649,575	617,289	571,102	583,176
of which, derivatives	130,939	235,736	203,029	157,940	132,349
Net loans to customers	1,340,831	1,438,839	1,542,744	1,509,078	1,545,415
Other assets	109,142	129,013	117,964	188,316	178,754
Total assets	**2,389,438**	**2,649,341**	**2,598,530**	**2,653,201**	**2,698,268**
Liabilities					
Interbank liabilities	234,219	214,214	161,537	212,882	224,107
Senior debt	711,555	812,025	804,928	765,869	780,247
Derivatives	111,310	184,971	154,663	130,161	110,262
Deposits from customers	867,904	941,534	944,428	934,897	971,137
Subordinated debt	26,276	29,319	30,953	29,347	29,538
Other liabilities	295,947	308,219	311,596	373,623	366,080
Total liabilities	**2,247,211**	**2,490,282**	**2,408,105**	**2,446,779**	**2,481,371**
Ordinary equity	142,227	159,059	182,072	190,471	200,738
Equity hybrids	0	0	8,353	15,952	16,159
Minority interests	0	0	0	0	0
Total liabilities and equity	**2,389,438**	**2,649,341**	**2,598,530**	**2,653,201**	**2,698,268**
Core tier 1/Common equity tier 1 capital	128,072	142,108	162,906	168,214	171,346
Income statement summary (NOK m)					
Net interest income	30,192	32,487	35,358	34,110	35,422
Net fee & commission income	7,393	8,968	8,862	8,280	8,448
Net trading income	4,621	4,897	8,525	6,373	4,464
Other income	4,564	3,063	1,306	2,253	3,544
Operating income	**46,770**	**49,415**	**54,051**	**51,016**	**51,878**
Operating expense	20,179	20,344	20,843	20,521	20,815
Pre-provision income	**26,591**	**29,071**	**33,208**	**30,495**	**31,063**
Credit and other financial impairments	2,185	1,639	2,270	7,424	2,428
Other impairments	564	108	224	173	NA
Non-recurring items	NA	NA	NA	NA	NA
Pre-tax profit	**22,709**	**27,102**	**31,871**	**23,387**	**26,858**
Discontinued operations	4	-22	-51	4	-1
Other after-tax Items	0	0	0	0	0
Income tax expense	5,188	6,463	7,048	4,140	5,054
Net profit attributable to minority interests	0	0	0	0	0
Net profit attributable to parent	**17,526**	**20,617**	**24,772**	**19,251**	**21,803**

Source: SNL

III. Appendix: Ratios – DNB Group

	2013Y	2014Y	2015Y	2016Y	2017Y
Funding and liquidity					
Net loans/deposits (%)	149.9%	149.1%	155.1%	155.9%	154.5%
Liquidity coverage ratio (%)	106.9%	135.0%	133.0%	138.0%	117.0%
Net stable funding ratio (%)	NA	97.6%	100.0%	104.0%	103.0%
Asset mix, quality and growth					
Net loans/assets (%)	56.1%	54.3%	59.4%	56.9%	57.3%
Impaired & delinquent loans/loans (%)	2.4%	1.9%	1.6%	2.4%	1.8%
Loan-loss reserves/impaired loans (%)	46.2%	52.5%	57.8%	41.7%	50.2%
Net loan growth (%)	3.3%	7.3%	7.2%	-2.2%	2.4%
Impaired loans/tangible equity & reserves (%)	18.6%	14.4%	10.3%	15.2%	10.6%
Asset growth (%)	3.0%	10.1%	-1.9%	2.1%	1.7%
Earnings and profitability					
Net interest margin (%)	1.3%	1.4%	1.4%	1.4%	1.4%
Net interest income/average RWAs (%)	2.9%	3.3%	3.3%	3.5%	3.5%
Net interest income/operating income (%)	64.6%	65.7%	65.4%	66.9%	68.3%
Net fees & commissions/operating income (%)	15.8%	18.1%	16.4%	16.2%	16.3%
Cost/income ratio (%)	43.1%	41.2%	38.6%	40.2%	40.1%
Operating expenses/average RWAs (%)	2.0%	2.1%	2.0%	2.1%	2.0%
Pre-impairment operating profit/average RWAs (%)	2.6%	3.0%	3.1%	3.2%	3.1%
Impairment on financial assets /pre-impairment income (%)	8.2%	5.6%	6.8%	24.3%	7.8%
Loan-loss provision charges/net loans (%)	0.2%	0.1%	0.2%	0.5%	0.2%
Pre-tax profit/average RWAs (%)	2.2%	2.8%	3.0%	2.4%	2.6%
Return on average assets (%)	0.7%	0.8%	0.8%	0.7%	0.8%
Return on average RWAs (%)	1.7%	2.1%	2.3%	2.0%	2.1%
Return on average equity (%)	13.1%	13.8%	14.0%	9.9%	10.4%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	12.8%	13.8%	16.0%	17.6%	16.7%
Tier 1 capital ratio (%, transitional)	13.2%	14.2%	17.0%	19.4%	18.2%
Total capital ratio (%, transitional)	15.3%	16.6%	19.8%	21.4%	20.3%
Leverage ratio (%)	5.3%	6.0%	6.7%	7.3%	7.2%
Asset risk intensity (RWAs/total assets, %)	41.8%	38.7%	39.1%	36.1%	38.1%
Market indicators					
Price/book (x)	1.2x	1.1x	1.0x	1.1x	1.2x
Price/tangible book (x)	1.3x	1.2x	1.0x	1.1x	1.3x
Dividend payout ratio (%)	25.1%	30.0%	30.0%	49.8%	55.3%

Note: Capital ratios are on a Basel III basis.
Source: SNL

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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