Note 3 - Critical estimates and assessments concerning the use of accounting principles

In the preparation of the Group accounts the management makes accounting estimates, discretionary assessments and assumptions that bear on the effect of the application of the accounting principles and hence the amounts booked for assets, liabilities, income and expenses. Estimates and discretionary assessments are evaluated continuously and are based on empirical experience and expectations of events which, as of the balance sheet date, are deemed likely to occur in the future.

Classification of financial instruments

Financial assets are classified either at fair value through other comprehensive income (OCI), at amortised cost or at fair value through profit and loss. The bank determines the classification based on characteristics of the asset's contractual cash flows and the business model under which the asset is managed.

In order to classify a financial asset the bank must determine whether the contractual cash flows from the asset are exclusively payment of interest and principal on the outstanding amount.

Principal is measured at fair value of the asset upon first-time recognition. Interest consists of payment for the time value of money, for credit risk associated with outstanding principal in a particular period, and for other loan risks and costs, in addition to a profit margin. If the bank establishes that the contractual cash flows from an asset are not exclusively payment for interest and principal, the asset shall be classified as measured at fair value through profit and loss.

When classifying financial assets, the bank establishes the business model utilised for each portfolio of assets that are managed collectively to achieve the same business objective. The business model reflects how the bank manages its financial assets and the degree to which the cash flows are generated through collection of the contractual cash flows, sale of financial assets or both. The bank establishes the business model through use of scenarios that can with reasonable likelihood be expected to occur. Establishment of the business model requires the application of discretionary judgement and an assessment of all available information at the point in time in question.

A portfolio of financial assets is classified in a "hold to collect" business model where the bank's primary aim is to hold these assets in order to collect their contractual cash flows rather than to sell them. Where the bank's objective is obtained through both collecting and selling the assets, the assets will be classified in a "hold to collect and sell" business model. In such a business model, both collection of contractual cash flows and sale of assets will be integral elements for achieving the bank's objective for the portfolio concerned.

Financial assets are measured at fair value through profit and loss if they do not fall within either a "hold to collect" business model or a "hold to collect or sell" business model.

Losses on loans and guarantees

The Bank rescores its loan portfolio monthly. Customers showing objective evidence of loss due to payment default, impaired creditworthiness or other objective criteria are subject to individual assessment and calculation of loss. Should the Bank's calculations show that the present value of the discounted cash flow based on the effective interest rate at the time of estimation is below the book value of the loan, the loan is assigned to stage 3 and a write-down is performed for the calculated loss. A high degree of discretionary judgement is required in order to assess evidence of loss, and the estimation of amounts and timing of future cash flows with a view to determining a calculated loss is affected by this judgement. Changes in these factors could affect the size of the provision for loss. In cases where collateral values are tied to specific objects or industries that are in crisis, collateral will have to be realised in illiquid markets, and in such cases assessment of collateral values may be encumbered with considerable uncertainty.

For loans in stage 1 and 2 a calculation is made of the expected credit loss using the bank's loss model based on estimates of probability of default (PD) and loss given default (LGD), as well as exposure (EAD). The bank uses the same PD model as in IRB, but with unbiased calibration, i.e. without safety margins, as a basis for assessment of increased credit risk. The PD estimate represents a 12-month probability.

Write-downs for exposures in stage 1 will be calculation of one-year's expected loss, while for exposures in stage 2, loss is calculated over lifetime.

The most important input factors in the bank's loss model that contribute to significant changes in the loss estimate and are subject to a high degree of discretionary judgement are the following:

- Use of forward-looking information and projection of macroeconomic variables for multiple scenarios on a probability-weighted basis

- Establishing what constitutes a significant increase in credit risk for a loan.

Use of forward-looking information
Measurement of expected credit loss for each stage requires both information on events and current conditions as well as expected events and future economic conditions. Estimation and use of forward-looking information requires a high degree of discretionary judgement. Each macroeconomic scenario that is utilised includes a projection for a five-year period. Our estimate of expected credit loss in stage I and 2 is a probability-weighted average of three scenarios: base case, best case and worst case. The base scenario have been developed with a starting point in observed defaults and losses over the past three years, adjusted to a forward-looking estimate of the development that is slightly above the observed defaults and losses over the past 3 years.

The development in the Upside and Downside scenario is prepared with the help of adjustment factors where the development in economic situation is projected with the help of assumptions regarding how much the probability of default (PD) or loss given default (LGD) will increase or be reduced compared with the baseline scenario over a five-year period. A basis is taken in observations over the past 15 years, where Downside reflects the expected default and loss level in a crisis situation with PD and LGD levels that are applied in conservative stressed scenarios for other purposes in the bank’s credit management.

In 2020 and 2021, the bank changed the model assumptions due to increased uncertainty related to the pandemic. The change consisted of increased loss expectations in the base scenario both for retail and corporate portfolio. These changes were reversed in 2021 for retail customers and in first quarter of 2022 for corporate market portfolio. In addition, the bank's exposure to hotels and tourism in stage 1 was included in stage 2 and this change was reversed in fourth quarter of 2022.

In 2022, increased macroeconomic uncertainty as a result of the war in Ukraine, strong increases in energy and raw material prices, challenges in the supply chains and the prospect of permanently higher inflation and interest rates have led to an increased probability of a low scenario for the corporate market excl. offshore. Future loss expectations have been increased by increased PD and LGD for both the personal market and the corporate market, excl. offshore in the base scenario. The bank has focused on the expected long-term effects of the crisis. For the offshore portfolio, during 2022, as a result of significant improvement in the market and market prospects, increased earnings assumptions have been used in the simulations and the weight for low scenarios has been reduced for supply and subsea.

The development in the base scenario is prepared using adjustment factors where the development in the business cycle is projected by assumptions about how much the probability of default (PD) or loss of default (LGD) will increase or decrease compared to the base scenario in a five-year period. We expect increased losses related to debtors that have a demanding starting point before the crisis - typically debtors in stage 2. We have therefore chosen to increase the trajectories for PD and LGD as well as reduce expected repayments in the base scenario, especially from year 2 onwards, since this will affect expected losses mainly for debtors in stage 2. To adjust for migration into stage 2, PD and LGD estimates are also increased in the first year. No first year repayments are assumed for all portfolios in the downside scenario.

The scenarios are weighted with a basis in our best estimate of the probability of the various outcomes represented. The estimates are updated quarterly and were as follows as per the estimates at 31 December:

Portfolio		**2022**			**2021**	
	Base Case	**Worst Case**	**Best Case**	**Base Case**	**Worst Case**	**Best Case**
Retail Market	70 %	15 %	15 %	70 %	15 %	15 %
Corporate excl. Agriculture and offshore	60 %	25 %	15 %	65 %	20 %	15 %
Agriculture	60 %	25 %	15 %	65 %	20 %	15 %
Offshore	65 %	20 %	15 %	65 %	20 %	15 %
Tourism	60 %	30 %	10 %	60 %	30 %	10 %

For the offshore portfolio, separate assessments are made with regard to probability of default under various scenarios and associated realisation values. In these assessments the various offshore segments – supply, subsea and seismic – have different scenario weights. Consistent assumptions are used with regard to expected developments in rates, utilisation levels and realisation values for vessels in the various scenarios where the vessels’ current and expected contractual situation is assessed.

Sensitivities
The first part of the table below show total calculated expected credit loss as of 31 December 2021 in each of the three scenarios, distributed in the portfolios retail market (RM) corporate market (CM), and offshore, travel and agriculture which adds up to parent bank. In addition the subsidiary SB 1 Finans Midt-norge is included. ECL for the parent bank and the subsidiary is summed up in th coloumn "Group".

The second part of the table show the ECL distributed by portfolio using the scenario weight applied, in addition to a alternative weighting where worst case have been doubled.

If the downside scenario's probability were doubled at the expense of the baseline scenario at the end of December 2022, this would have entailed an increase in loss provisions of NOK 315 million for the parent bank and NOK 346 million for the group.

	CM (excl offshore and agriculture)	RM	Offshore	Tourism	Agriculture	Total parent	SB 1 Finans MN, CM	SB 1 Finans MN, RM	Group
ECL base case	465	80	236	10	47	839	42	22	903
ECL worst case	1,240	268	482	32	191	2,214	89	78	2,381
ECL best case	353	30	195	6	28	612	29	14	654
ECL with scenario weights used 60/25/15	642	-	-	-	81	723	44	-	767
ECL with scenario weights used 65/20/15	-	-	279	-	-	279	-	-	279
ECL with scenario weights used 60/30/10	-	-	-	15	-	15	-	-	15
ECL with scenario weights used 70/15/15	-	100	-	-	-	100	-	29	129
Total ECL used	**642**	**100**	**279**	**15**	**81**	**1,117**	**44**	**29**	**1,190**
ECL alternative scenario weights 35/50/15	836	-	-	-	117	952	64	-	1,016
ECL alternative scenario weights 45/40/15	-	-	328	-	-	328	-	-	328
ECL alternative scenario weights 30/60/10	-	-	-	23	-	23	-	-	23
ECL alternative scenario weights 55/30/15	-	129	-	-	-	129	-	37	166
Total ECL alternative weights	**836**	**129**	**328**	**23**	**117**	**1,432**	**64**	**37**	**1,533**
Change in ECL if alternative weights were used	**194**	**28**	**49**	**8**	**36**	**315**	**20**	**8**	**343**

The Tourism portfolio includes commercial real estate with more than 50% of the income from hotels and tourism companies.

The table reflects that there are some significant differences in underlying PD and LGD estimates in the different scenarios and that there are differentiated levels and level differences between the portfolios. At group level, the ECL in the upside scenario, which largely reflects the loss and default picture in recent years, is about 80 per cent of the ECL in the expected scenario. The downside scenario gives about double the ECL than in the expected scenario. Applied scenario weighting gives about 30 percent higher ECL than in the expected scenario.

Determination of significant increase in credit risk:
The assessment of what constitutes a significant increase in credit risk requires a large degree of discretionary judgement. Movements between stage 1 and stage 2 are based on whether the instrument's credit risk on the balance sheet date has increased significantly relative to the date of first-time recognition. This assessment is done with a basis in the instrument's lifetime PD, and not expected losses.

The assessment is done for each individual instrument. Our assessment is performed at least quarterly, based on three factors:

- The bank uses both absolute and relative changes in PD as criteria for removal to stage 2. A change of more than 150% in PD is considered to be a significant change in credit risk. In addition, the PD must at minimum be more than 0.6 percentage points.
- An additional quantitative assessment is made based on whether the exposure has a significantly increased credit risk if it is subject to special monitoring or forbearance.
- In addition, customers with payments between 30-90 days overdue will in all cases be moved to stage 2.

If any of the above factors indicate that a significant increase in credit risk has occurred, the instrument is moved from stage 1 to stage 2.

See also note 2 on accounting principles and note 6 on risk factors.

Fair value of equity interests
Assets recognised at fair value through profit and loss will mainly be securities traded in an active market. An active market is defined as a market where homogeneous products are traded, where willing buyers and sellers are normally present at all times, and where prices are accessible to the general public. Shares quoted in a regulated market place fit in with the definition of an active market. A market with a large spread between bid and ask prices and where trading is quiet may pose a challenge. Some key shares will be based on in-house valuations, transaction prices or external analyses of the company. Such shares are valued using acknowledged valuation techniques. These include the use of discounted cash flows or comparative pricing where similar, listed, companies are used (multiple pricing) to determine the value of the unlisted company. Such valuations may be encumbered with uncertainty.

Any changes in assumptions may affect recognised values. Investments in private equity funds made in the subsidiary SpareBank 1 SMN Invest are valued based on net asset value (NAV) reported from the funds. The group uses the «fair value option» for investments in private equity funds. Fair value is calculated based on valuation principles set out in IFRS 13 and guidelines for valuation in accordance with International Private Equity and Venture Capital (IPEV), see www.privateequityvaluation.com.

Management has based its assessments on the information available in the market combined with best judgment. No new information has emerged on significant matters that had occurred or already existed on the balance sheet date as of 31.12.2022 and up to the Board's consideration of the accounts on 1 March 2023. See also note 30 for specification of shares and equity interests.

Fair value of financial derivatives and other financial instruments
Fair value of derivatives is usually determined using valuation models where the price of the underlying, for example interest rates or exchange rates, is obtained in the market. When measuring financial instruments for which observable market data are not available, the Group makes assumptions regarding what market participants would use as the basis for valuing similar financial instruments. The valuations require extensive use of discretionary judgement inter alia when calculating liquidity risk, credit risk and volatility. Changes in these factors will affect the estimated fair value of the Group's financial instruments. For further information, see note 27 Measurement of fair value of financial instruments.

For options, volatilities will either be observed implicit volatilities or estimated volatilities based on historical movements in the price of the underlying instrument. In cases where the Bank's risk position is approximately neutral, middle rates will be used. "Neutral risk position" means for example that interest rate risk within a maturity band is virtually zero. Where market prices that are obtained are based on transactions with lower credit risk, this will be taken into account by amortising the original price difference measured against such transactions over the period to maturity.

Goodwill
The Group conducts tests to assess possible impairment of goodwill annually or in the event of indications of impairment. Assessment is based on the Group's value in use. The recoverable amount from cash-flow-generating units is determined by calculating discounted future cash flows. The cash flows are based on historical earnings and expectations of future factors and include suppositions and estimates of uncertain factors. The outcome of the impairment tests depends on estimates of discount rates which are set discretionarily based on information available on the balance sheet date.

Regarding goodwill related to Romsdals Fellesbank, the portfolio is regarded as integrated in the Bank's other lending and deposit operations, and, the lowest level for the cash generating unit is the segments Retail Market and Corporate Market. Goodwill has been allocated to the segments based on their share of the loan portfolio. A net cash flow is estimated based on earnings in the Bank's loan and deposit portfolio. A five-year cash flow prognosis have been developed using expected growth, and a terminal value without growth thereafter. Cash flows are discounted with a discount rate (before tax rate) of 1.3 per cent.

Calculations show that the value of discounted cash flows exceeds recognised goodwill by an ample margin.

Other goodwill in the Group is calculated based on average earnings in the market area and is discounted at the risk-free interest rate + the risk premium for similar businesses (12-14 per cent).

Acquisitions
Acquisition of another company is accounted for by the acquisition method. This method requires a full purchase price allocation (PPA) in which the purchase price is allocated to identified assets and liabilities in the acquired company. Excess values beyond those allocated to identified assets and liabilities are booked as goodwill. Any deficit values are, after careful assessment, recognised as income through profit/loss in the year of the acquisition (badwill). The analyses contain both concrete calculations and use of best judgement in arriving at the fairest possible value of the acquired companies at the time of acquisition. While some uncertainty invariably attends estimation items, they are supported by determinations of expected cash flows, comparable transactions in previous periods etc. See also note 40 on business acquisitions/business combinations.

Companies held for sale
SpareBank 1 SMN's strategy is that ownership resulting from defaulted exposures should at the outset be of brief duration, normally not longer than one year. Work on selling such companies is continuously ongoing, and for accounting purposes they are classified as held for sale. See also note 39 on investments in owner interests.

Sale of loan portfolios
In the sale of loan portfolios to Eksportfinans, SpareBank 1 Boligkreditt and SpareBank 1 Næringskreditt, the Group considers whether the criteria for derecognition under IAS 39 are met. At the end of the accounting year all transferred portfolios were derecognised from the parent bank's balance sheet. See also note 9 on derecognition of financial assets.

Classification of hybrid capital

Sparebank 1 SMN has issued two hybrid capital instruments where the terms satisfy the requirements of CRD IV for inclusion in common equity tier 1 capital. As from 2017 these instruments are classified as equity in the financial statements since they do not meet the definition of financial liabilities under IAS 32. The instruments are perpetual and SpareBank 1 SMN is entitled not to pay interest to the investors. The interest is not presented as an expense in the income statement, but as a reduction in equity.