

## Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-2
Bank Financial Strength	C-

## Contacts

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## Key Indicators

### Sparebanken Sør (Consolidated Financials)[1]

	[2]12-10	[2]12-09	[2]12-08	[3]12-07	Avg.
Total Assets (NOK billion)	37.7	35.3	33.7	30.2	[4]7.7
Total Assets (EUR million)	4,839.1	4,263.9	3,459.8	3,801.4	[4]8.4
Total Assets (USD million)	6,491.9	6,117.6	4,809.3	5,557.8	[4]5.3
Tangible Common Equity (NOK billion)	2.7	2.6	2.1	2.2	[4]7.0
Tangible Common Equity (EUR million)	351.8	308.8	217.4	282.2	[4]7.6
Tangible Common Equity (USD million)	471.9	443.0	302.2	412.5	[4]4.6
PPI / Avg RWA (%)	2.9	1.7	0.8	1.6	[5]1.8
Net Income / Avg RWA (%)	1.8	0.8	-0.2	1.1	[5]0.8
(Market Funds - Liquid Assets) / Total Assets (%)	44.5	35.2	38.9	34.1	[6]38.2
Core Deposits / Average Gross Loans (%)	57.0	58.6	59.0	60.5	[6]58.8
Tier 1 Ratio (%)	14.0	14.1	11.2	10.6	[5]13.1
Tangible Common Equity / RWA (%)	13.1	13.0	10.8	10.6	[5]12.3
Cost / Income Ratio (%)	43.8	58.6	77.3	57.9	[6]59.4
Problem Loans / Gross Loans (%)	1.8	1.3	1.2	0.9	[6]1.3
Problem Loans / (Equity + Loan Loss Reserves) (%)	18.9	13.1	14.4	10.0	[6]14.1

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] Basel II & IFRS reporting periods have been used for average calculation [6] IFRS reporting periods have been used for average calculation

## Opinion

### SUMMARY RATING RATIONALE

Moody's rates Sparebanken Sør A3/C-/P-2.

The C- bank financial strength rating (BFSR), which translates into a baseline credit assessment (BCA) of Baa2, reflects Sparebanken Sør's sound local franchise, solid retail business and sound capital levels. However, the rating is constrained by the bank's large exposure to the real estate sector, its high borrower concentration and its less sophisticated risk management procedures.

The global local currency (GLC) deposit rating of A3 assigned to Sparebanken Sør is supported by the bank's Baa2 BCA and the Aaa local currency deposit ceiling of Norway, which is deemed the underlying support provider. Given the bank's importance to its region, and the region's importance to the national economy of Norway, Moody's assesses a high probability of systemic support in the event of a stress situation. Consequently, Sparebanken Sør's GLC deposit rating benefits from a two-notch uplift from its BCA.

### Credit Strengths

- Sound market position in southern Norway

- Resilient earnings from retail banking operations
- Good capitalisation, strengthened in 2009

#### **Credit Challenges**

- Growing revenue in the highly competitive Norwegian market
- Reducing credit risk concentrations, especially to the real estate sector and by single-name borrower
- Further developing risk management practices
- Maintaining asset quality across the economic cycle

#### **Rating Outlook**

The outlook on all ratings is stable.

#### **What Could Change the Rating - Up**

An upgrade of the BFSR or the GLC deposit rating could be triggered by: (i) an improvement in the bank's profitability metrics; or (ii) a reduction in the loan book concentration.

#### **What Could Change the Rating - Down**

The BFSR could be downgraded if there is: (i) any deterioration in asset quality or capitalisation that exceeds Moody's expectations; any change in the risk profile of the bank; or (iii) any sign that the bank is unable to sustain its market positions.

The GLC deposit rating could be downgraded if: (i) the BFSR deteriorates; or (ii) Moody's current assessment of the probability of systemic support for the bank declines.

#### **DETAILED RATING CONSIDERATIONS**

Detailed considerations for Sparebanken Sør's currently assigned ratings are:

##### **Bank Financial Strength Rating**

The assigned BFSR is one notch below the C outcome of Moody's bank financial strength scorecard. Based on Moody's scenario analysis (see Special Comment entitled "Moody's Approach to Estimating Nordic Banks' Credit Losses" published in July 2009), we believe that Sparebanken Sør's sizeable exposure to the real estate sector and its high loan book concentration could exert adverse pressure on its capitalisation. As a result, we believe that the bank's financial strength is more consistent with a C- BFSR.

Qualitative Factors (50% weighting)

Factor 1: Franchise Value

Trend: Neutral

Sparebanken Sør is a regional savings bank with a sound market position in southern Norway in the counties of Vest-Agder, Aust-Agder and Telemark, where Moody's estimates it commands market shares of almost 15% for lending and close to 20% for deposits. However, its national market share is limited, at around 1%.

The bank operates as an independent savings bank, using an open-architecture business model to offer financial services including life and non-life insurance (Frende Forsikring, 10% ownership) and investment (Norne Securities, 14.8% ownership) products. Both Frende Forsikring and Norne Securities are product companies jointly owned by several independent savings banks in Norway. In addition, Sparebanken Sør owns a real estate brokerage subsidiary (ABCcenter) and established its own covered bond company, Sør Boligkreditt AS, in Q4 2008 for funding purposes.

In the region where it operates, Sparebanken Sør faces competition from larger players such as Nordea and DnB NOR, as well as from other local and regional savings banks. As a result, one of the bank's main challenges is maintaining and improving its market share.

Although we acknowledge Sparebanken Sør's strong presence in the region in which it operates, we note that the Norwegian banking market is highly competitive and that savings banks generally lack pricing power against the two national market leaders. In addition, the D+ score for franchise value is constrained by the bank's low geographic diversification.

Factor 2: Risk Positioning

Trend: Neutral

Sparebanken Sør is organised as independent entity without external owners. The highest body, the Committee of Representatives, is comprised of 28 depositors, employees and public appointees and is responsible for electing the Board of Directors members. The CEO is not a member of the Board of Directors, which consists of 9 members. Sparebanken Sør's corporate governance principles are based on the Norwegian Code of Practice and the rules from the Committee of European Banking Supervisors (CEBS).

However Sparebanken Sør has been criticised for its involvement in the local football club Start, of which it was both creditor and sponsor, as well as shareholder. The investment has generated losses of NOK100 million in 2009 and the bank's CEO, chairman and deputy chairman of the board resigned. The Board appointed Geir Bergskaug as new CEO of the bank in July 2010. We do not expect any major strategic change to result from the reshuffling of the management.

Risk management procedures at the bank are considered adequate. Sparebanken Sør has a dedicated risk management unit reporting to the CEO. The bank's overall risk exposure and development is reviewed quarterly by the management and the Board of Directors. Sparebanken Sør currently applies the standardised approach of Basel II to calculate its credit risk and reports it is aiming to build a relevant modelling tool to receive the Foundation IRB approval. Overall, we view Sparebanken Sør's risk management as lacking sophistication but we positively note the management's stated intention to further develop procedures in that respect.

Sparebanken Sør's market risk remains modest. Its exposure to interest rates is limited: interest rate risk was NOK0.4 million in relation to a 100 bps change in interest rates at YE 2009. Investments in shares and ECs amounted to NOK350 million at YE 2010, corresponding to around 12% of Tier 1 capital. This figure includes a 1.3% ownership in Eksportfinans. The bank also has limited foreign currency exposure.

Limitations in risk management - e.g. in terms of credit risk modelling and stress testing - as well as high credit risk concentration are constraining factors in the score for risk positioning and push it to D.

#### Factor 3: Regulatory Environment

For a discussion about the regulatory environment, please see Moody's Banking System Outlook on Norway.

#### Factor 4: Operating Environment

Trend: Neutral

The operating environment score takes into account the economic stability, integrity and corruption in the country as well as the legal system. The unadjusted score for Norway's operating environment is B and is constrained by a score of C for economic stability, primarily as a result of volatility in oil prices. To reflect the fact that offshore revenues are allocated to the Government Pension Fund and have a limited impact on the mainland economy, we calculate the score for economic stability as the average of the standard deviations of GDP growth both including (25% weight) and excluding offshore revenue (75% weight), which results in an adjusted score of B. Consequently, the adjusted score for operating environment is B+.

For further discussion of the operating environment, please see Moody's latest Banking System Outlook on Norway.

#### Quantitative Factors (50% weighting)

#### Factor 5: Profitability

Trend: Weakening

Sparebanken Sør is reliant on net interest income, which represented over 60% of its operating income at YE 2010. This source of earnings grew by 7% in 2010, primarily as a result of good loan growth in the retail segment and somewhat lower cost of funding. Fee & commission income, mainly from payment services and real estate operations, income represented some 15% of operating income during the year and was roughly in line with its 2009 level.

Net income from financial investments largely contributed to the bank's improved profitability in 2010. This reflects spread tightening on the bank's fixed income securities as well as a NOK112 million one-off gain from the merger between PBS and Nordito.

Asset quality deterioration has been weighting on the bank's profitability in the three most recent years and continued to do so in 2010, with loan provisions standing at NOK122 million (NOK109 million in 2009) - bucking the positive trend experienced by most Norwegian rated banks, which showed lower provisioning levels in 2010.

The score for profitability is D+ with a weakening trend, mainly reflecting our view that strong competition may keep the margins on check and the developments in loan loss provisions are uncertain.

#### Factor 6: Liquidity

Trend: Neutral

Sparebanken Sør's liquidity is underpinned by a strong deposit base, which accounts for around half of its total funding, and retail deposits that represent almost 60% of total deposits.

At YE 2010 the deposit-to-gross loan ratio was below 60%, meaning the bank is reliant on market funding, most of which comes from the domestic market. Since December 2008, part of market funds has been in the form of covered bonds, through the bank's wholly-owned covered bond company, Sør Boligkreditt. In 2009, covered bonds were mainly used in the (now phased out) government swap arrangement, whereby these instruments were exchanged for government bonds. We expect the covered bond market will remain an attractive source of funding for Sparebanken Sør going forward, as for most Norwegian banks.

Sparebanken Sør enjoyed an asset buffer of almost 16% of total assets and comprised cash and deposits with the central bank and the securities portfolio, which mainly comprise senior bonds of banks and municipalities, as well as some corporate bonds and shareholdings. We note that holdings are concentrated on Norwegian securities, which could be a source of vulnerability from a concentration risk point of view. Overall, we view the increased liquidity level positively but we note that it is chiefly in the form of Norwegian Treasury bills from the government swap arrangement and that the bank will have to repurchase the covered bonds from the government at the same price paid by the government for these bonds.

Sparebanken Sør's liquidity score of D+ is lower than those of its European peers and reflects the bank's reliance on market funding, although we note the positive impact of the bank's liquidity management as well as its access to covered bonds.

#### Factor 7: Capital Adequacy

Trend: Neutral

Sparebanken Sør exhibits strong capitalisation. At YE 2010, the Tier 1 and total capital ratios, as calculated under Basel II's standardised

approach, stood at 14% and 15.5%, respectively. These levels compare positively with the other Moody's-rated Norwegian savings banks and the Tier 1 ratio is above the management's target of 12%.

The bank strengthened its capital buffer in 2009 with a NOK400 million Tier 1 hybrid issue from the State Finance Fund in August 2009. This hybrid capital was repaid in December 2010 and partially replaced with a NOK200 million Tier 1 issue.

Sparebanken Sør applies a standard approach in calculating its capital adequacy requirement for credit risk. Given the bank's large retail loan book, the capital requirement is estimated to be lower under Basel II IRB model.

Sparebanken Sør scores A for capital adequacy.

#### Factor 8: Efficiency

Trend: Neutral

Sparebanken Sør's efficiency as measured by its cost-to-income ratio is good at below 45% at YE 2010 (60% at YE 2009). In the recent years, the trend in the ratio has been affected by the variation in income but we note that operating costs in relation to total assets have gradually decreased to 1.2% in 2010 from 1.7% in 2007. Costs were helped by a one-off positive effect from a change in the Norwegian pension legislation but, adjusted for that, they were at par with their 2009 level.

The bank uses third party providers when selling services such as insurance and investment products, avoiding the fixed costs that would be related to in-house production. However, going forward, cost containment might prove to be more difficult as an independent bank.

The bank scores C for cost efficiency. However, given the revenue pressure from a challenging operating environment, we view efficiency gains as a challenge for Sparebanken Sør.

#### Factor 9: Asset Quality

Trend: Weakening

Operating in a small geographic region means the bank has significant single-borrower exposure, as measured by the 20 largest exposures in relation to Tier 1 capital or pre-provision income. The bank also has some industry concentration, with the real estate sector (including construction) representing above 20% of gross loans. We view this relatively high exposure to a sector that has historically generated high losses for banks as a potential source of vulnerability, though we note that losses in that sector have remained moderate at Sparebanken Sør. In addition, we note a somewhat unseasoned loan portfolio, which reflects high lending growth (a year-on-year increase of 10% in 2008 and 17% in 2007). Nevertheless, beside the concentration toward real estate exposures, the loan book is well-diversified across industries and comprises almost 70% of loans to retail customers.

Problem loans (defined as commitments in default and other bad and doubtful commitments) continued to increase and accounted for 1.8% of gross loans at YE 2010 (1.3% at YE 2009). The bank reports that these are primarily related to a limited number of corporate exposures. Actual losses have remained at a low level in the recent years, although we note an increasing trend.

Problem loan formation resulted in a reduction in loss reserves coverage to around 50% of problem loans at YE 2010. Additionally, we caution that the sustained increase in house prices in Norway may have underrated the level of provisioning by inflating collateral value.

We further note that at YE 2010, almost 30% of retail mortgages (18% of total loans) were part of Sør Boligkredit's covered pool.

The score for asset quality is B. The economic environment in Norway, and in southern Norway, is still satisfactory, but slower economic growth, fewer exports and weaker domestic demand are challenges for the corporate sector. Further, with regards to retail loans, household indebtedness has increased in recent years, making customers more vulnerable to interest rates rises, although we take comfort in the still low unemployment levels in Norway. Overall, we consider the trend to be weakening.

#### Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A3 to Sparebanken Sør. The rating is supported by its Baa2 BCA and the Aaa local currency deposit ceiling of Norway, which is considered the underlying support provider. Given the bank's importance to its region, and the region's importance to the national economy of Norway, Moody's assesses as high the probability of systemic support in the event of a stress situation.

#### ABOUT MOODY'S BANK RATINGS

##### Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

##### Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

#### National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. AAaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

#### Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

#### Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

#### About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

### Rating Factors

#### Sparebanken Sør

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
<b>Qualitative Factors (50%)</b>						<b>C-</b>	
<b>Factor: Franchise Value</b>						<b>D+</b>	<b>Neutral</b>
<b>Market Share and Sustainability</b>			x				
<b>Geographical Diversification</b>					x		
<b>Earnings Stability</b>			x				
<b>Earnings Diversification [2]</b>							
<b>Factor: Risk Positioning</b>						<b>D</b>	<b>Neutral</b>
<b>Corporate Governance [2]</b>	--	--	--	--	--		
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
<b>Controls and Risk Management</b>				x			
- Risk Management				x			
- Controls			x				
<b>Financial Reporting Transparency</b>		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
<b>Credit Risk Concentration</b>	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
<b>Liquidity Management</b>			x				
<b>Market Risk Appetite</b>	x						
<b>Factor: Operating Environment</b>						<b>B+</b>	<b>Neutral</b>
<b>Economic Stability</b>		x					
<b>Integrity and Corruption</b>		x					

Legal System		x					
Financial Factors (50%)							C
Factor: Profitability							D+
PPI / Average RWA- Basel II			1.80%				Weakening
Net Income / Average RWA- Basel II				0.80%			
Factor: Liquidity							D+
(Mkt funds-Liquid Assets) / Total Assets					29.66%		Neutral
Liquidity Management			x				
Factor: Capital Adequacy							A
Tier 1 Ratio - Basel II	13.10%						Neutral
Tangible Common Equity / RWA- Basel II	12.28%						
Factor: Efficiency							C
Cost / Income Ratio			59.88%				Neutral
Factor: Asset Quality							B
Problem Loans / Gross Loans		1.43%					Weakening
Problem Loans / (Equity + LLR)		15.46%					
Lowest Combined Score (15%)							D+
Economic Insolvency Override							Neutral
Aggregate Score							C
Assigned BFSR							C-

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral



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