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ISSUER COMMENT

Sparebanken Pluss and Sparebanken Sor Covered Bonds: Credit Quality Will Remain Strong after Merger of Their Programmes

Table of Contents:

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On 12 March, Sparebanken Pluss and Sparebanken Sor agreed on a letter of intent to negotiate the merger of both banks. The merger of the banks' covered bond programs[1] would be credit neutral for the current Aaa ratings on the outstanding covered bonds (totalling NOK 17.3 billion, EUR 2.3 billion equivalent).

The following factors reflect our view on the credit impact:[2]

» The programs' similarities far outweigh their differences. The programs are similar in legal and structural aspects, and in cover pool composition.

» The main difference of the programs is the issuer rating as we rate Sparebanken Pluss A2 (stable) and Sparebanken Sor A3 (stable).[3] We expect the combined bank's rating to be close to the rating level of the two individual banks, although we will also factor in our assessment of the risks related to the integration process.[4]

» We expect the merger to be credit neutral for the Aaa rated covered bonds from an expected loss as well as TPI framework[5] point of view.

1 The banks have established the covered bond programs via their issuers Pluss Boligkreditt AS ("Pluss") and Sor Boligkreditt AS ("Sor").

2 Given the early stage of the merger, our analysis relies on assumptions and simplifications. Importantly, the analysis assumes a combination of the covered bond programmes as reported to us per 31.12.2012.

3 Sparebanken Pluss: A2 stable, C-/baa1 stable. Sparebanken Sor: A3 stable, C-/baa2 stable. The ratings in this report are the bank's deposit rating, its standalone bank financial strength rating/baseline credit assessment and the corresponding rating outlooks.

4 For further details, please refer to our issuer comment "Moody's Comments on the Intended Merger of Sparebanken Sor and Sparebanken Pluss".

5 For details on our rating methodology, please refer to Moody's Approach to Rating Covered Bonds, published 27 July 2012.

Similar Legal Framework and Structure

The two programs share a similar legal framework and structure. The Norwegian covered bond legislation forms the basis on which the issuers established their programs and the programs therefore incorporate similar structural strengths.

As a further resemblance, both programs incorporate swap agreements that follow Norwegian standards. In our view, the swap agreements are stronger than the standard swaps used in covered bond programmes outside Norway.

In addition, the covered bonds outstanding under both programmes benefit from a twelve month principal payment extension period, which mitigates refinancing risk and improves the likelihood of timely payments of maturing covered bonds, following issuer default.

An important difference between the programmes is the level of over-collateralisation (OC) that is provided to investors on a committed basis. Only covered bonds under Sor's programme benefit from an OC commitment,[6,7] as we do not rely on voluntary OC for issuers rated A3 and lower. For Pluss's covered bonds, given the better issuer rating at A2, we rely in our analysis on voluntary OC. When the proposed merger of the covered bond programmes should materialize, we will consider 1) whether our analysis needs to rely on committed OC and 2) which covered bonds of the merged entity will benefit from an OC commitment.

Similar Credit Quality of the Cover Pool

The characteristics of the cover pools of the programs are similar, because both banks use their respective programs to finance their residential lending activities. The loans in the cover pool form the senior portion of a larger whole loan as the legislative LTV[8] threshold for covered bonds is 75% of prudent property market value, while the whole loan could equal to a LTV of say 85%. Further similarities include that all loans are floating rate with the ability of the lender to re-set interest rates at short notice. The loan underwriting standards of both covered bond programmes are also analogous, using the same risk management system, and are in line with general Norwegian market practice (for further information, see the Norwegian's FSA lending guidelines[9]).

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6 The level of committed OC is 11.5% in the covered bond programme of Sor Boligkreditt AS, which implies that Moody's analysis does not rely on any voluntary OC.
In contrast, Moody's gives full value for uncommitted OC in the covered bond programme of Pluss Boligkreditt AS given the better issuer rating.

7 OC commitment: Sor Boligkreditt AS undertakes to keep an OC of at least 11.5% while the bonds are outstanding. If the parent bank's rating is changed to A2 or better, the issuer's commitment of OC will lapse. For details, please refer to Sor's Covered Bond Agreement.

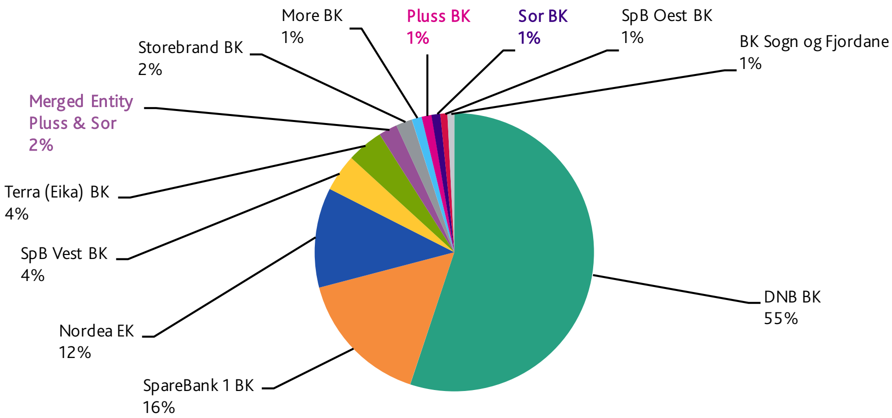
8 LTV = Loan-to-Property Value

9 The guidelines primarily stipulate that 1) a loan may normally not exceed 85% of the value of the property (in 2011 the percentage was 90%), (ii) the LTV should include all loans on a property, 3) the rules for deviations must be set by the board of the bank; 4) loans with an LTV of 70% or higher must be amortising from the first interest payment, 5) loans with variable amounts cannot exceed a 70% LTV and 6) the household budget has to withstand an interest-rate increase of 5%. See Finanstilsynet's (the Norwegian Financial Supervisory Authority) press releases 9/2010 (3 March 2010), 44/2011 (1 December 2011) and 524 (7 May 2012) (in Norwegian).

The cover pools are of similar size, with Pluss contributing 10,420 loans (total loan balance NOK 10.5 billion) and Sor contributing 9,884 loans (NOK 9.0 billion). Combining the current cover pools would result in the sixth-largest covered bond programme in Norway (see Exhibit 1).

EXHIBIT 1

Ranking of Norwegian covered bond programmes by size of cover pool

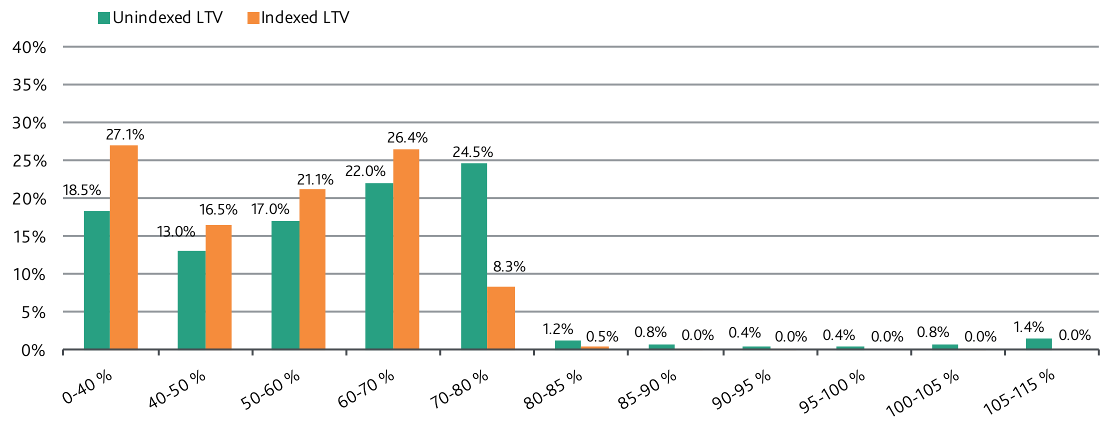


Source: Moody's Performance Overview Reports, Q3-2012

Both cover pools are of similar credit quality as reflected in the Collateral Score, which is 6.4% for Pluss and 7.1% for Sor[10]. Both cover pools exhibit a weighted-average indexed LTV of 50%. Exhibit 2 shows the LTV band that a combined pool would display.

EXHIBIT 2

Balance per LTV-band



Source: Moody's Performance Overview Reports, Q4-2012

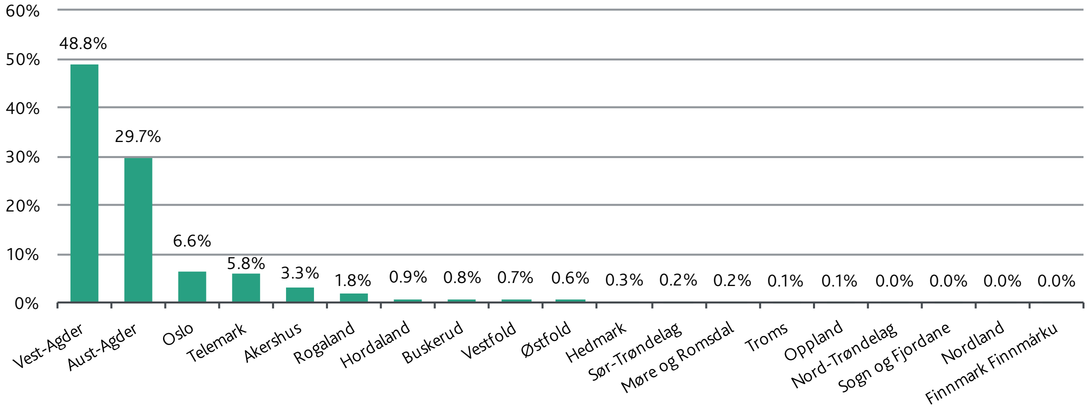
10 The Collateral Score expresses the credit quality of the cover pool. The lower the Collateral Score, the better the credit quality of the cover pool. For further information, please refer to Moody's Approach to Rating Covered Bonds, published 27 July 2012.

The average Collateral Score for EMEA mortgage covered bond programmes is 12.0%. For further comparisons, please refer to Moody's European Covered Bonds Monitoring Overview: Q3-2012.

A combined pool will exhibit similar credit quality as the individual pools, because the beneficial impact from diversification is low. Both programmes primarily finance owner-occupied detached houses in the Vest-Agder and Aust-Agder area (see Exhibit 3, reflecting the combined pool).

EXHIBIT 3

Main country regional distribution



Source: Moody's Performance Overview Reports, Q4-2012

Market risk is the main driver of refinancing risk for both programs

For both programmes, the main driver of market risk is refinancing risk. Losses from market risk[11] would arise following issuer default of 6.0% (Pluss) and 6.4% (Sor), respectively. The amortisation profile (see Exhibit 4) of a merged programme will slightly improve and our overall market-risk assessment will remain stable.

Interest-rate risk of both programmes is low, because the assets and liabilities carry a floating rate. Also, both programmes currently have no currency risk.

EXHIBIT 4

Amortisation profile

Source: Moody's Performance Overview Reports, Q4-2012

[11] This percentage level of losses will impact the entire cover pool – following issuer default – as a result of refinancing risks and currency and interest-rate mismatches. For further information, please refer to Moody's Approach to Rating Covered Bonds, published 27 July 2012.

The average market risk losses for EMEA mortgage covered bond programmes is 18.3%. For further comparisons, please refer to Moody's European Covered Bonds Monitoring Overview: Q3-2012.

Scope of covered bond rating migration is limited under our scenario analysis

The credit strength of the issuers is the main difference between the covered bond programmes, but we see the scope of rating migration for the covered bonds as very limited even in a scenario where we assess the credit quality of the merged entity as A3.

For both programmes, the issuer itself is unrated but we rate the parents Sparebanken Sor at A3 (stable) and Sparebanken Pluss at A2 (stable). Both banks have established a revolving credit facility for the issuers' benefit and perform a range of functions for their wholly owned subsidiaries. Our covered bond analysis therefore relies on the parent bank ratings to determine the probability of issuer default.

We have analysed the covered bond programmes, assuming a scenario in which the current credit quality of the cover pool, market-risk exposure and programme structure would be the same. We have also assumed that the combined programme would provide OC of 14.5%[12], which reflects the OC in place of the programmes combined as of 31 December 2012. Currently, the covered bonds of both programs are rated Aaa with similar OC level requirements (Pluss 7.5%, Sor 8.0%). Both programs benefit from a timely payment indicator (TPI) of "High."

We conclude that the credit quality of the covered bonds of Sparebanken Pluss and Sparebanken Sor will remain strong after the merger even where we assess the credit quality of the merged entity as A3. Importantly, this assessment assumes that the merged entity will provide the required level of OC on a committed basis.

The robustness of the covered bond rating largely depends on the issuer's credit strength. If we rate the merged entity at A3, the issuer's rating could fall by one notch without resulting in a downgrade of the covered bond rating. If we rate the merged entity at A2, the robustness of the covered bong rating would be stronger and the issuer's rating could fall two notches.

[12] Percentage reflects the amount by which the level of cover pool collateral exceeds the level of covered bonds (liabilities).

Moody's Related Research

Relevant Performance Overview Reports

» Sor Boligkreditt AS - Performance Overview Report Q4-2012, March 2013 (SF320350)

» Pluss Boligkreditt AS - Performance Overview Report Q4-2012, March 2013 (SF321358)

» Moody's European Covered Bonds Monitoring Overview: Q3-2012, Januaray 2013 (SF312869)

Rating Methodologies

» Moody's Approach to Rating Covered Bonds, July 2012 (SF291041)

Banking System Outlook

» Moody's: Outlook for Norway's banking system has been changed to stable, February 2013 (148693)

Special Comments

» Norway – Legal Framework for Covered Bonds, May 2012 (SF274910)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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