

## CREDIT OPINION

4 May 2017

Update

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### RATINGS

#### Sparebanken Sor

Domicile	Kristiansand, Norway
Long Term Debt	(P)A1
Type	Senior Unsecured MTN - Fgn Curr
Long Term Deposit	A1
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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## Sparebanken Sor

### Semiannual Update

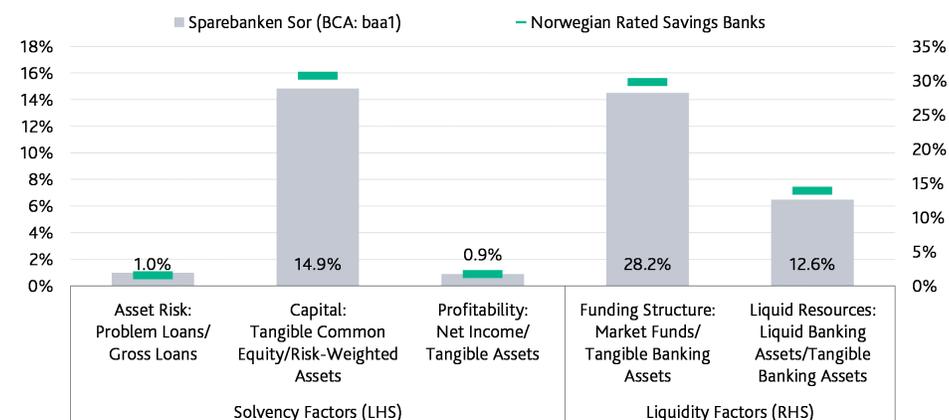
#### Summary Rating Rationale

Sparebanken Sor's A1 deposit and issuer ratings incorporate: (1) one notch of uplift driven by our assumption of moderate likelihood of support from the Norwegian government in case of need, (2) two notches of uplift from the application of Moody's Loss Given Failure (LGF) analysis and (3) the bank's baa1 baseline credit assessment (BCA).

The bank's baa1 BCA reflects its strong asset quality metrics, with ratios of non-performing loans (NPLs) to gross loans of 0.99% and Loan Loss Reserves (LLRs) to NPLs of 65% as of December 2016. The bank's baa1 BCA also captures the increase in Sparebanken Sor's capital buffers which reached 14.7% as of December 2016 from 12.7% in December 2015. Finally the bank's baa1 BCA incorporates its moderate profitability with a 0.9% return on assets and its high reliance on market funding, a common attribute of Norwegian banks, with market funds adjusted to exclude 50% of covered bonds accounting for 28.2% of tangible assets as of December 2016.

Exhibit 1

#### Rating Scorecard- Key Financial Ratios (as of December 2016)



Note: Average of other Moody's rated Norwegian savings banks is based on latest available financial data  
 Source: Moody's Banking Financial Metrics

## Credit Strengths

- » Sparebanken Sor's BCA is supported by its Very Strong- Macro Profile
- » Improved capital levels driven by higher regulatory targets
- » Sparebanken Sor's asset quality metrics have been resilient and broadly in line with domestic peers
- » Large volume of deposits and debt result in a two notch uplift to the deposits and issuer ratings
- » Issuer and deposit ratings benefit from one notch of uplift resulting from our assumption of a Moderate probability of support from the government in case of need

## Credit Challenges

- » Despite resilient loan book performance, high single borrower and sector loan concentration increases asset risk
- » Reliance on market funding renders the bank vulnerable to fluctuations in investor sentiment
- » Profitability is supported by efficient operations, though pressure in the bank's core earnings could persist

## Rating Outlook

Sparebanken Sor's deposit and issuer ratings carry a stable outlook to capture our opinion that the bank's financial performance will remain broadly unchanged in the next 12 to 18 months.

## Factors that Could Lead to an Upgrade

- » Over time, upward pressure could develop if the bank demonstrates a combination of: (1) reduced exposure to more volatile sectors such as construction and real estate sectors; (2) sustained strong asset quality and (3) a strengthening in core earnings generation.

## Factors that Could Lead to a Downgrade

- » Downward rating pressure would develop on Sparebanken Sor's ratings if: (1) the bank's NPLs were to be expected to increase substantially, above our system-wide expectation of approximately 2%; (2) its profitability were to deteriorate materially from its current level and/or (3) the macroeconomic environment weakens meaningfully. Also, any change in the liability structure of the bank that would cause a reduction in the rating uplift under Moody's LGF analysis or, similarly, a revision of the government support assumptions, could lead to downward rating pressure

Note: The numbers presented in the Key Indicators Exhibit below for the years 2013 and 2012 are for Sparebanken Pluss before its merger with Sparebanken Sor

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

## Key Indicators

Exhibit 2

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

	12-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>2</sup>	12-12 <sup>2</sup>	Avg.
Total Assets (NOK billion)	106	101	94	46	44	24.3 <sup>3</sup>
Total Assets (EUR million)	11,615	10,539	10,368	5,474	6,014	17.9 <sup>3</sup>
Total Assets (USD million)	12,251	11,448	12,546	7,542	7,928	11.5 <sup>3</sup>
Tangible Common Equity (NOK billion)	9.2	7.7	7.1	3.1	2.8	34.5 <sup>3</sup>
Tangible Common Equity (EUR million)	1,014	805	787	371	383	27.5 <sup>3</sup>
Tangible Common Equity (USD million)	1,069	874	952	511	505	20.6 <sup>3</sup>
Problem Loans / Gross Loans (%)	1.0	1.4	2.0	0.9	0.6	1.2 <sup>4</sup>
Tangible Common Equity / Risk Weighted Assets (%)	14.8	12.8	13.2	12.0	11.4	12.8 <sup>5</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	9.3	14.3	21.0	10.8	7.2	12.5 <sup>4</sup>
Net Interest Margin (%)	1.5	1.6	1.8	1.4	1.3	1.5 <sup>4</sup>
PPI / Average RWA (%)	2.0	1.7	2.3	1.7	1.8	1.9 <sup>5</sup>
Net Income / Tangible Assets (%)	0.9	0.6	0.7	0.6	0.7	0.7 <sup>4</sup>
Cost / Income Ratio (%)	40.1	45.9	43.0	38.1	37.0	40.8 <sup>4</sup>
Market Funds / Tangible Banking Assets (%)	28.2	31.5	30.1	32.0	36.8	31.7 <sup>4</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	12.6	11.4	12.3	15.9	17.8	14.0 <sup>4</sup>
Gross loans / Due to customers (%)	177.5	184.3	169.2	179.4	184.3	178.9 <sup>4</sup>

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate (%). Any interim period amounts presented are assumed to be fiscal year end amounts for calculation purposes [4] Simple average of periods presented [5] Simple average of Basel II periods presented

Source: Moody's Financial Metrics

## Detailed Rating Considerations

### Sparebanken Sor's BCA is supported by its very strong- macro profile

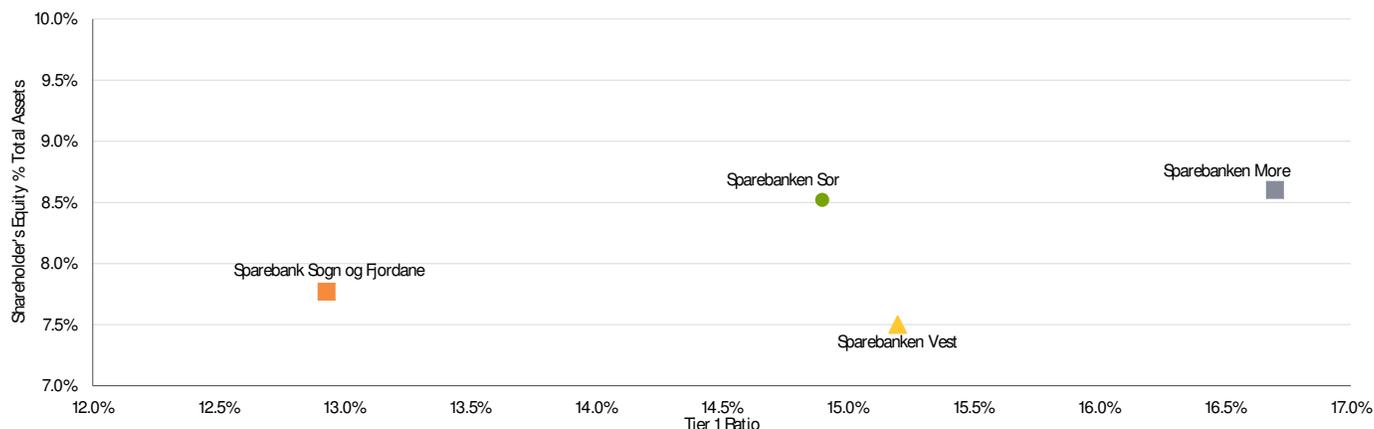
Sparebanken Sor's operations are entirely in Norway. As a result we apply the Very Strong- Macro Profile we have assigned to banks operating in Norway. Banks in Norway benefit from operating in a wealthy and developed country with very high economic, institutional and government financial strength, as well as low susceptibility to event risk. Norway has a diversified and growing economy, which demonstrates resilience to the ongoing weakness in the oil sector. The main risks to the system stem from a high level of household indebtedness, elevated real estate prices and domestic banks' reliance on market funding. However, these risks are mitigated by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared to the total size of the economy.

### Improved capital levels driven by higher regulatory targets

Sparebanken Sor's capitalisation has improved through the year of 2016, exceeding the bank's increased capital requirement of 13.6% (including the 2.1% Pillar II component) and will likely improve further as the 1.5% countercyclical capital buffer will be increased to 2.0% in Norway effective as of 31 December 2017. The bank's strategic plan targets Common Equity Tier (CET) 1 ratio of between 14.5% and 15.0%. The bank's CET 1 ratio increased to 14.7% as of December 2016 from 12.7% in December 2015.

The bank strengthened its CET 1 capital through a NOK584 million capital increase completed in the second-quarter of 2016, earnings retention and limited growth in risk weighted assets. The increase in the bank's total regulatory capital ratio to 17.9% as of December 2016 from 15.5% in December 2015 also reflects the issuance of \$315 million of hybrid capital in the second quarter.

Exhibit 3  
Capital levels have improved and compare favorably with peers

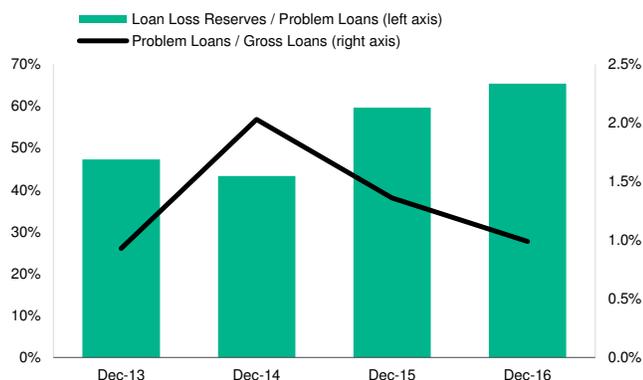


Note: Data as of September 2016, Sparebanken Sor and Sparebanken Sogn og Fjordane use the standardised method while Sparebanken More and Sparebanken Vest use the Internal Ratings Based Approach for their risk weighted assets and capital calculation.  
Source: Moody's Financial Metrics, Sparebanken Sor

**Resilient asset quality with problem loans metrics in line with domestic peers, although concentrations elevate asset risk**

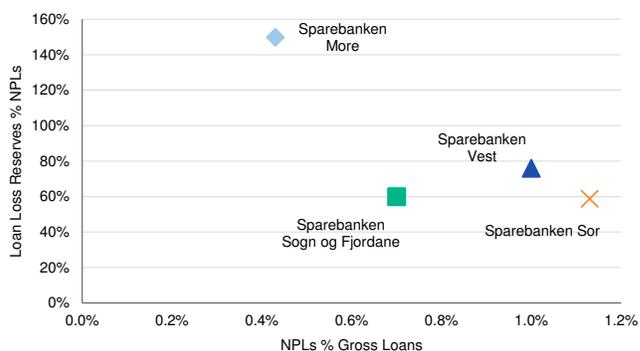
Sparebanken Sor's problem loan ratio (impaired loans as a percentage of total loans) declined to 0.99% at end-December 2016 from 1.36% at end-December 2015. Sor's asset quality metrics are broadly in line with its Norwegian peers' average. Following the merger between Sparebanken Pluss and Sparebanken Sor in 2013, the new merged bank took several actions to improve its credit quality and limit future losses. The bank carried out a comprehensive review of its corporate portfolio in 2014 which resulted in individual write-downs of loans and a spike in credit costs to 0.37% of average gross loans in FY2014 from 0.08% in FY2013. However, Sparebanken Sor's credit costs normalised to 0.11% of average gross loans for FY2015 and declined further to 0.06% for FY2016. Sor's NPLs coverage at 65.4% as of December 2016 compares well with peers.

Exhibit 4  
Sparebanken Sor's Asset Quality metrics have been resilient



Source: Moody's Financial Metrics, Sparebanken Sor

Exhibit 5  
..and in line with similarly rated domestic peers



Note: Data is as of September 2016  
Source: Moody's Financial Metrics

Sparebanken Sor's loan book is dominated by retail loans, mostly in the form of mortgages, which represent around 65% of the total loan book at end-December 2016, an asset class that has been more resilient historically. However, Sparebanken Sor's significant concentration to the real-estate and construction sectors poses downside risks to future loan book performance. Furthermore, the bank's business book exposes significant single-borrower concentrations making the bank vulnerable to a potential default of one of its large customers. Our adjustment to the bank's asset risk score by four notches to a3 captures these concentration risks.

### Profitability is supported by efficient operations, though core earnings pressure could persist

Sparebanken Sor reported a 53% year-on-year increase in profit and a 10.6% return on equity after tax before unusual items in 2016, compared to 8.2% in 2015. The bank's net profit was boosted by NOK224 million profit from financial investments due to positive performance of the bank's liquidity portfolio and one off gains, mainly NOK34 million one off gain from the sale of VISA and NOK22 million from the sale of NETS in 2014. Sparebanken Sor's profitability was also supported by its best-in-class cost-to-income ratio of 40.1% in 2016<sup>1</sup> (45.9% in 2015 and 42.9% in 2014).

Sparebanken Sor relies on stable income from lending: net interest income represented over 74% of net revenue in 2016. This source of income increased slightly compared to 2015 levels despite the decline in net interest margin to 1.50% in December 2016 from 1.55% in 2015 reflecting lower yields and low loan growth of 2.9% in 2016.

There was a small uptick in core earnings, interest income and fees and commissions, in the fourth quarter reflecting upwards loan repricing and reduced funding costs. Further the bank's net interest income will likely be supported by stronger loan growth in 2017 enabled by the bank's higher capital base. However, downside risks to core earnings generation remain as competition may push asset yields lower or the bank's business growth may remain subdued.

### Reliance on market funding renders the bank vulnerable to fluctuations in investor sentiment

Sparebanken Sor's funding is underpinned by a strong deposit base, which accounted for 54% of non-equity funding as of December 2016. Nevertheless, the bank remains reliant on market funding, which accounted for around 28.2% of tangible banking assets at end-December 2016 (31.5% at end-2015), and which renders the bank susceptible to changes in investor behaviour. While Sparebanken Sor has good access to the domestic capital markets, we expect that the bank will continue accessing the international markets in order to expand its investor base beyond the more limited and concentrated domestic market.

A sizeable and growing portion of market funds are in the form of covered bonds, which provide the bank with an additional source of funding. Based on our methodology, we reflect the stability of covered bonds relative to unsecured market funding through an adjustment to our market funds to tangible assets ratio and our adjusted ratio for the bank is 28.2% as of December 2016. In 2016 Sparebanken Sor made its first international larger benchmark issuance through its fully owned covered bond company. We believe the bank will benefit from the depth of the markets, increasing its potential investor base and mitigating its refinancing risk. Our Funding Structure score reflects that the bank's overall funding profile remains a fundamental weakness for Sparebanken Sor.

Exhibit 6



Note: Data as of September 2016  
Source: Moody's Financial Metrics

Sparebanken Sor also maintains sizeable buffers of high quality liquid assets. As of December 2016, liquid assets accounted for around 12.6% of tangible assets, in line with the Norwegian banking average, comprising cash and deposits with the central bank and the securities portfolio. The portfolio primarily includes Norwegian covered bonds, bonds from the government, other public entities and

other issuers, and a limited amount of equity investments. We note that these holdings are mostly Norwegian securities, which could be a source of vulnerability from a concentration-risk perspective, but reduces the bank's currency exposure.

## Notching Considerations

### Loss Given Failure

We expect that Norway will transpose the EU Bank Resolution and Recovery Directive (BRRD) into local legislation and as such we consider the country an Operational Resolution Regime. In accordance with our methodology we therefore apply our Advanced LGF analysis, considering the risks faced by different debt and deposit classes across the liability structure should the bank enter resolution.

In our LGF analysis for the bank we use our standard assumptions and assume residual tangible common equity of 3%, losses postfailure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, and a 5% run-off in preferred deposits. We assign a 25% probability to deposits being preferred to senior unsecured debt.

Under these assumptions, Sparebanken Sor's deposits and issuer ratings are likely to face very low loss-given-failure, due to the volume of the deposits and senior debt themselves and the amount of debt subordinated to them. This results in a Preliminary Rating Assessment (PRA) two notches above the BCA.

### Government Support

Our expectation of the implementation of resolution legislation has caused us to reconsider the probability that government support would benefit certain creditors.

Sparebanken Sor is a regional savings bank with a sound market position on the southern coast of Norway, in the counties of Vest-Agder, Aust-Agder and Telemark, where we estimate it commands combined market shares of almost 26% for lending and 35% for deposits. Headquartered in Kristiansand, Norway, Sparebanken Sor is the sixth-largest savings bank in Norway with reported total assets of NOK105.5 billion at end-December 2016 (NOK101.3 billion at end December 2015). Sparebanken Sor is the market leader in providing financial services to Christian organisations in Norway, largely as a result of its agreement with the Norwegian Christian Purchasing Organisation (KNIF).

We regard the probability of government support for Sparebanken Sor's debt and deposits as moderate, which results in one notch of rating uplift.

### Counterparty Risk Assessment

We assign a long-term and short-term CR Assessment of Aa3(cr) and P-1(cr) respectively.

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than the likelihood of default and the expected financial loss suffered in the event of default; and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

### Foreign Currency Deposit Rating

The bank's foreign-currency deposit ratings are unconstrained, because Norway has a country ceiling of Aaa. Sparebanken Sor's foreign-currency deposit rating is A1.

### About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our rating committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard 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 Methodology and Scorecard Factors

Exhibit 7

### Sparebanken Sor

#### Macro Factors

<b>Weighted Macro Profile</b>	<b>Very Strong -</b>	<b>100%</b>
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Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.5%	aa2	↓	a3	Geographical concentration	
Capital						
TCE / RWA	14.8%	aa3	← →	a1	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.7%	baa2	↓	baa2	Expected trend	
Combined Solvency Score		a1		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	28.2%	baa2	← →	baa3	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	12.6%	baa3	← →	baa3	Stock of liquid assets	
Combined Liquidity Score		baa2		baa3		
Financial Profile						
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				Aaa		
Scorecard Calculated BCA range				a3-baa2		
Assigned BCA				baa1		
Affiliate Support notching				0		
Adjusted BCA				baa1		

Balance Sheet	in-scope (NOK million)	% in-scope	at-failure (NOK million)	% at-failure
Other liabilities	32,889	31.2%	38,148	36.2%
Deposits	51,562	48.9%	46,303	43.9%
Preferred deposits	38,156	36.2%	36,248	34.4%
Junior Deposits	13,406	12.7%	10,055	9.5%
Senior unsecured bank debt	16,617	15.8%	16,617	15.8%
Dated subordinated bank debt	1,203	1.1%	1,203	1.1%
Equity	3,163	3.0%	3,163	3.0%
Total Tangible Banking Assets	105,434	100%	105,434	100%

Debt class	De jure waterfall		De facto waterfall		Notching		LGF notching guidance versus BCA	Assigned LGF notching	Additional notching	Preliminary Rating Assessment
	Instrument volume + Subordination	Sub-ordination	Instrument volume + Subordination	Sub-ordination	De jure	De facto				
Counterparty Risk Assessment	29.4%	29.4%	29.4%	29.4%	3	3	3	3	0	a1 (cr)
Deposits	29.4%	4.1%	29.4%	19.9%	2	3	2	2	0	a2
Senior unsecured bank debt	29.4%	4.1%	19.9%	4.1%	2	2	2	2	0	a2

Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Deposits	2	0	a2	1	A1	A1
Senior unsecured bank debt	2	0	a2	1	A1	A1

Source: Moody's Financial Metrics

## Ratings

Exhibit 8

Category	Moody's Rating
<b>SPAREBANKEN SOR</b>	
Outlook	Stable
Bank Deposits	A1/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	Aa3(cr)/P-1(cr)
Issuer Rating	A1
Senior Unsecured MTN	(P)A1

Source: Moody's Investors Service

## Endnotes

[1](#) This figure reflects Moody's standard adjustments. The bank reported cost-to-income ratio is 35.1%

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