

## CREDIT OPINION

14 June 2019

Update

✓ Rate this Research

### RATINGS

#### Sparebanken Sor

Domicile	Kristiansand, Norway
Long Term CRR	A1
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	--
Long Term Debt	A1
Type	Senior Unsecured - Fgn Curr
Outlook	Stable
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

Update to credit analysis following rating outlook change to stable from negative

### Summary

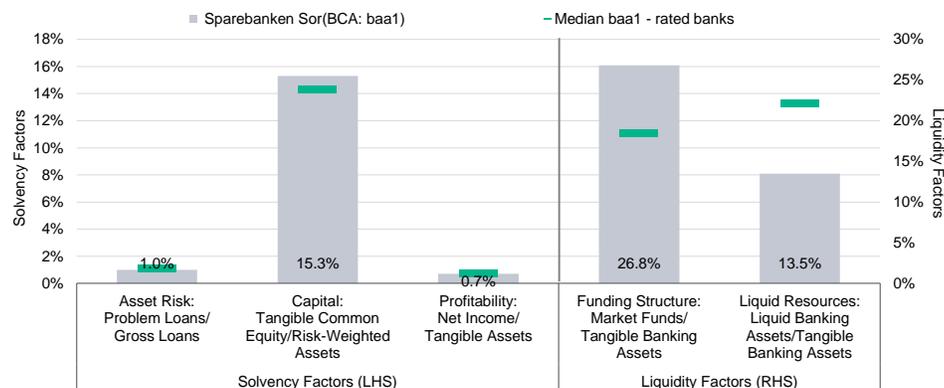
Sparebanken Sor's A1 deposit and issuer ratings take into account its baseline credit assessment (BCA) of baa1, but also our forward-looking Loss Given Failure (LGF) analysis of its liability structure.

The bank's BCA of baa1 reflects its resilient asset quality metrics, with ratios of non-performing loans (NPLs) to gross loans of 0.9% and Loan Loss Reserves (LLRs) to NPLs of 50.4% as of March 2019. The bank's baa1 BCA also captures its adequate capital buffers with a common equity Tier 1 (CET1) ratio of 14.9% as of March 2019. In addition, the bank's standalone credit profile also incorporates its moderate profitability with around 0.8% return on average assets in March 2019, 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 27.5% of tangible assets.

The bank's A1 deposit and issuer ratings take into account our forward looking advanced LGF analysis of the bank's liability structure, which positions them three notches above its BCA. Sparebanken Sor benefits from a large volume of deposits and substantial layers of subordination, resulting in very low LGF. The bank's A1 deposit/senior debt ratings no longer incorporate any rating uplift from government support, due to the implementation of BRRD in Norway from 1 January 2019.

Exhibit 1

### Rating Scorecard- Key Financial Ratios



Source: Moody's Banking Financial Metrics

## Credit strengths

- » Sparebanken Sor's BCA is supported by its Very Strong - Macro Profile
- » Resilient asset quality metrics with gradual reduction of problem loans
- » Adequate capital levels with a strong leverage ratio
- » Large volume of deposits and debt combined with upcoming MREL eligible securities, result in three notches uplift to the deposit and issuer ratings

## Credit challenges

- » Certain high single borrower and sector loan concentration increases asset risk
- » Reliance on market funding renders the bank vulnerable to fluctuations in investor sentiment
- » Some pressure in the bank's core earnings likely to persist

## Rating outlook

The outlook on Sparebanken Sor's deposit and senior debt ratings was recently changed to stable from negative. This rating action was driven by the counterbalancing effect of removal of government support rating uplift, due to the BRRD implementation in Norway from 1 January 2019, and the expected issuance of MREL eligible securities over the next 2-3 years (estimated at approximately NOK10 billion of non-preferred senior notes) that would provide more loss absorbing cushion in our advanced LGF analysis, resulting in an additional notch of rating uplift for senior obligations. Any future changes to the bank's ratings are now expected to be mainly driven by standalone BCA dynamics and credit events.

## Factors that could lead to an upgrade

- » Upward rating momentum 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 without significantly raising its credit risk profile.

## 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 increase above 2% of gross loans; (2) its profitability were to deteriorate materially from its current level; (3) the macroeconomic environment weakens significantly, leading to a lower Macro Profile; and (4) lower than expected issuance of MREL-eligible securities leading to a reduction in the rating uplift through our LGF analysis.

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]

	03-19 <sup>2</sup>	12-18 <sup>2</sup>	12-17 <sup>2</sup>	12-16 <sup>2</sup>	12-15 <sup>2</sup>	CAGR/Avg. <sup>3</sup>
Total Assets (NOK Billion)	123.9	121.1	114.3	105.5	101.3	6.4 <sup>4</sup>
Total Assets (USD Million)	14,384.4	13,988.1	13,975.4	12,251.2	11,448.4	7.3 <sup>4</sup>
Tangible Common Equity (NOK Billion)	10.9	10.7	10.0	9.2	7.7	11.0 <sup>4</sup>
Tangible Common Equity (USD Million)	1,262.3	1,241.1	1,224.5	1,069.4	874.4	12.0 <sup>4</sup>
Problem Loans / Gross Loans (%)	0.9	1.0	0.9	1.0	1.4	1.0 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	15.4	15.3	15.3	14.8	12.8	14.7 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	8.0	8.8	8.4	9.3	14.3	9.8 <sup>5</sup>
Net Interest Margin (%)	1.4	1.4	1.5	1.5	1.6	1.5 <sup>5</sup>
PPI / Average RWA (%)	1.7	1.7	1.9	2.0	1.7	1.8 <sup>6</sup>
Net Income / Tangible Assets (%)	0.7	0.7	0.8	0.9	0.6	0.7 <sup>5</sup>
Cost / Income Ratio (%)	44.0	43.8	39.5	40.1	45.9	42.6 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	28.5	26.8	28.2	28.2	31.5	28.6 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	15.2	13.5	13.5	12.6	11.4	13.2 <sup>5</sup>
Gross Loans / Due to Customers (%)	179.6	182.9	176.5	177.5	184.3	180.2 <sup>5</sup>

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel II; IFRS. [3] May include rounding differences due to scale of reported amounts. [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5] Simple average of periods presented for the latest accounting regime. [6] Simple average of Basel II periods presented.

Source: Moody's Investors Service; Company Filings

## Profile

Sparebanken Sør is a regional Norwegian bank, which provides retail and corporate banking services to individuals, companies and public authorities in the counties of Vest-Agder, Aust-Agder, Telemark and Rogaland. Its products include financing, savings facilities, placements, insurance, pensions and payment facilities. Sparebanken Sør is currently the sixth largest savings bank in Norway with total consolidated assets of NOK123.9 billion (€14.4 billion), as of 31 March 2019.

## Detailed credit considerations

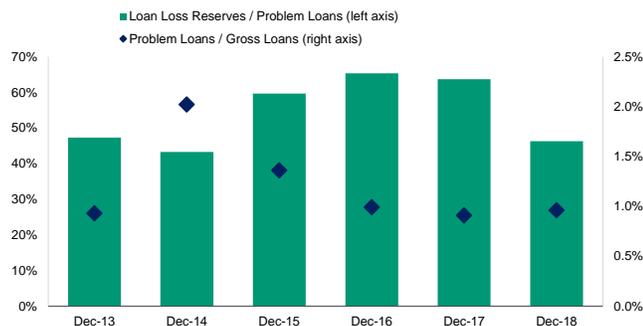
### Sparebanken Sor's BCA is supported by its Very Strong- Macro Profile

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. Norwegian banks benefit from operating in a wealthy and developed country with very high economic, institutional and government financial strength as well as very low susceptibility to event risk. Norway has a diversified and growing economy, which demonstrated resilience to the past weakening 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.

### Resilient asset quality with gradual reduction of problem loans, although some concentrations elevate asset risk

Sparebanken Sor's problem loans, defined as stage 3, was 0.88% of gross loans as of March 2019 from 0.96% as of December 2018 (stage 3 loans reduced to NOK909 million in March 2019 from NOK1,010 million in December 2018), which is comparable with other large savings banks and is broadly in line with the Norwegian average. The bank took several actions to improve its credit quality and limit future losses over the last five years, while it also carried out a comprehensive review of its corporate portfolio. Its annualised credit costs were very low at 0.01% of net loans in March 2019, compared to write-backs in 2018 (-0.17%) and 0% in March 2018. Sparebanken Sor's total provisioning coverage for problem loans was at 50.4% as of March 2019 from 46.3% in December 2018, which was broadly in line with peers.

Exhibit 3

**Sparebanken Sor's Asset Quality metrics have been resilient**

Note: Data as of December 2018

Sources: Moody's Financial Metrics, Sparebanken Sor

Exhibit 4

**..and in line with similarly rated domestic peers**

Note: Data as of December 2018

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 gross loan book as of March 2019, an asset class that has been more resilient historically with lower default levels. However, the bank has also significant concentration to the real-estate and construction sectors at around 23% of gross loans as of March 2019, which poses downside risks to future loan book performance in case there is any material reduction in property prices in the region.

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, but competition will continue to pressure margins despite interest rate increases

Sparebanken Sor reported a 2% year-on-year decrease in net profit and a 8.3% return on equity (after tax) in the three months ending in March 2019, compared to 9.1% the same period last year (8.5% full-year 2018). The contraction in net profit mainly relates to an increase in operating expenses by 8% year-on-year, driven by higher salaries and depreciation. The bank's reported cost-to-income ratio increased to 42.6% in March 2019 from 40.2% a year earlier. However, the bank's profitability is supported by a positive development in net interest income and low loan losses.

Sparebanken Sor relies on stable income from lending: net interest income represented 82% of net revenue in the first three months of 2019, in line with the same period last year. The bank reported an annualised net interest income to average assets of 1.46% in the three months of 2019, marginally down from 1.48% in the same period last year. Lending margins came under pressure in the three months of 2019, reflecting an increase in the interbank interest rate (3 month NIBOR) and intense competition.

Sparebanken Sor recently raised its rates on loans and deposits, in line with the central bank's increase of the key policy rate in March 2019. Although interest rate increases might ease some of the pressure on the bank's margins in coming quarters, intense competition remains which will result on margins remaining roughly in current levels. We generally expect the bank to continue to perform well, although earnings diversification will remain limited.

### Improved capital levels driven by higher regulatory targets

Sparebanken Sor's capitalisation is sound relative to its risk profile with a CET1 ratio of 14.9% as of March 2019 (including share of partially owned companies). The bank's reported CET1 ratio is well above its regulatory minimum of 14%, including a 2% Pillar 2 requirement. The Pillar 2 requirement is effective as of 30 September 2018 and was revised downwards from the previous 2.1% by the Norwegian FSA. Sparebanken Sor's target is to achieve a CET1 ratio that is at least in line with comparable peers.

Sparebanken Sor's total regulatory capital ratio stood at 18.8% and its Tier 1 ratio at 16.6% as of March 2019, compared to 18.9% and 16.8% as of March 2018 respectively. We note that the bank is the only one of the large regional banks in Norway that currently

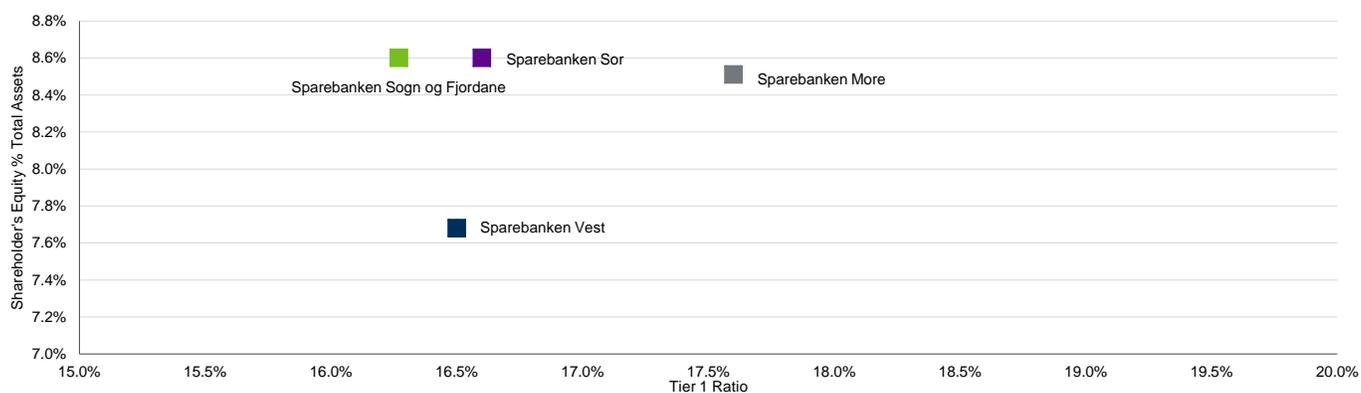
applies the standard method in its capital calculations, and had a high leverage ratio of 9% in March 2019. At the end of November 2017, Sparebanken Sor announced its intention to apply for approval to use the Internal Ratings-based (IRB) approach, and it expects to send its application to the Norwegian FSA by the end of 2020.

Furthermore, we note that the Ministry of Finance has recently rejected a [proposal](#) by the FSA to designate large regional banks with more than 10% corporate lending market share in one or more defined regions, as systemically important financial institutions (SIFI). Accordingly, Sparebanken Sor will not have an additional CET1 capital requirement of 2% of its risk-weighted assets (RWAs) and 1% in terms of its regulatory leverage ratio. However, the Ministry of Finance has announced that it will likely take other capital measures to moderate the benefit that Norwegian banks will mainly get from the removal of the 80% Basel I floor in the second half of 2019.

Our capital score for the bank in our scorecard is adjusted downwards to reflect the bank's relatively low equity certificates (EC) capital structure, with the EC holders owning only 17.2% of the bank's total capital. We believe that this structure would challenge the bank to raise new capital if needed, especially during periods of financial distress.

Exhibit 5

#### Sparebanken Sor's capital levels are comparable to its similarly-rated peers



Note: Data as of December 2018, Sparebanken Sor and Sparebanken Sogn og Fjordane use the standard method while Sparebanken More and Sparebanken Vest use the Internal Ratings Based Approach for their risk weighted assets and capital calculation.

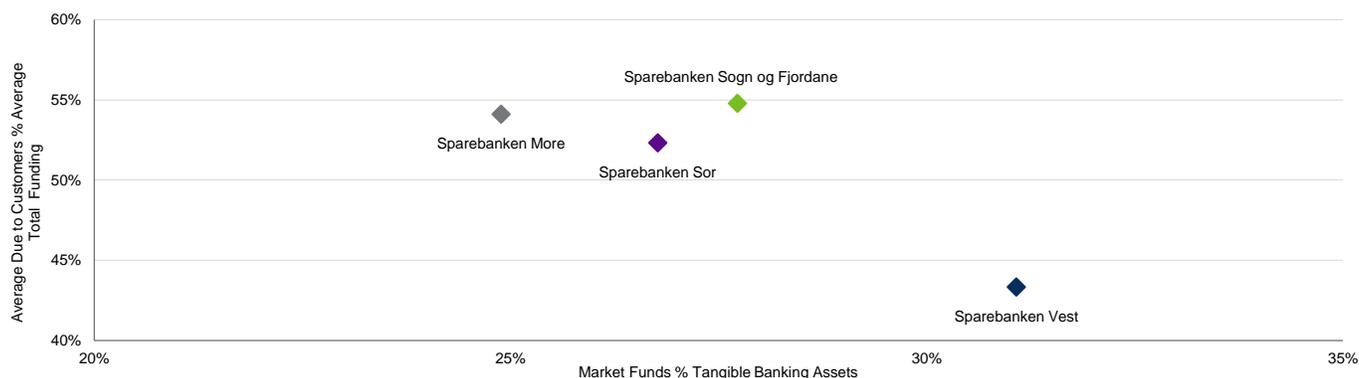
Source: Moody's Financial Metrics, Sparebanken Sor

#### 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 was stable at 51% of non-equity funding as of March 2019. Nevertheless, the bank remains reliant on market funding, which accounted for 27.5% of tangible banking assets as of March 2019 (27.3% as of March 2019), 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. We also expect the bank to replace part of its preferred senior debt maturing over the next 2-3 years, with MREL-eligible non-preferred senior securities, which we estimate at around NOK10 billion. The exact requirement will be communicated to the bank by the FSA in the second half of 2019.

A sizeable and growing portion of market funds is 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. In 2016 Sparebanken Sor made its first international larger benchmark issuance through its fully owned covered bond company Sparebanken Sor Boligkreditt and the bank has carried out several successful issuances since then. 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 relative to the other scorecard metrics.

Exhibit 6

**Reliance on market funding remains a fundamental weakness for the bank, a common attribute of Norwegian banks**

Note: Data as of December 2018

Source: Moody's Financial Metrics

Sparebanken Sor also maintains sizeable buffers of high quality liquid assets. As of December 2018, liquid assets accounted for 13.5% 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. The bank (group) reported a high Liquidity Coverage (LCR) ratio of 180% as of March 2019, well above the regulatory requirement and an increase compared to the 165% as of March 2018.

### Source of facts and figures cited in this report

Unless noted otherwise, we have sourced data relating to system-wide trends and market shares from the central bank. Bank specific figures originate from banks' reports and Moody's Banking Financial Metrics. All figures are based on our own chart of accounts and may be adjusted for analytical purposes. Please refer to the document [Financial Statement Adjustments in the Analysis of Financial Institutions](#) published on 9 August 2018.

## Support and structural considerations

### Loss Given Failure

The EU Bank Recovery and Resolution Directive (BRRD) has entered into force as of 1 January 2019 in Norway, which confirms our current assumptions regarding LGF analysis. For our resolution analysis, we assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

For Sparebanken Sor's long-term deposit rating and senior unsecured debt rating, our LGF analysis considers the combination of the bank's junior deposits, its outstanding debt volume and the amount of debt subordinated to this. The assigned LGF notchings for long-term deposit and senior unsecured bank debt are positioned one notch higher than the correspondent LGF notching guidance (two notches above the adjusted BCA). This reflects our expectation that the bank will issue non-preferred senior debt in order to comply with its MREL requirement.

Moody's expects that the bank will issue MREL-eligible non-preferred senior (NPS) debt over the coming 2-3 years, estimated at around NOK10 billion. This has resulted in a Preliminary Rating Assessment (PRA) of three notches above the BCA, reflecting very low loss given-failure. For junior securities issued by Sparebanken Sor, our LGF analysis confirms a high level loss-given-failure, given the small volume of debt and limited protection from more subordinated instruments and residual equity.

### Government support

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 around 24% for lending and around

35% for deposits. As a result of the implementation of the BRRD legal framework in Norway from 1 January 2019, which is aligned with that of the EU, we revised our government support assumption for the bank's preferred senior debt and deposits to low from moderate. This has resulted in no rating uplift from its PRA, positioning the ratings at A1.

### Counterparty Risk (CR) Assessment

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.

#### **Sparebanken Sor's CR Assessment is positioned at A1(cr)/P-1(cr).**

The CRA is positioned three notches above the Adjusted BCA of baa1, based on the substantial cushion against default provided to the senior obligations represented by the CRA by subordinated instruments, along with one notch of government support. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CRA captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

### Counterparty Risk Rating (CRR)

CRRs are opinions of the ability of entities to honour the uncollateralised portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRRs are distinct from ratings assigned to senior unsecured debt instruments and from issuer ratings because they reflect that, in a resolution, CRR liabilities might benefit from preferential treatment compared with senior unsecured debt. Examples of CRR liabilities include the uncollateralised portion of payables arising from derivatives transactions and the uncollateralised portion of liabilities under sale and repurchase agreements.

#### **Sparebanken Sor's CRRs are positioned at A1/P-1.**

The CRRs are positioned three notches above Sparebanken Sor's Adjusted BCA of baa1, reflecting extremely low loss-given-failure from the high volume of instruments that are subordinated to CRR liabilities.

### 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.

## Methodology and scorecard

### 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

Weighted Macro Profile	Very Strong -	100%				
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	0.9%	aa2	↔	a3	Geographical concentration	
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel II)	15.4%	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	26.8%	baa2	↔	baa2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	13.5%	baa3	↔	baa3	Stock of liquid assets	
Combined Liquidity Score		baa2		baa2		
Financial Profile				baa1		
Qualitative Adjustments				Adjustment		
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	43,803	35.4%	49,675	40.1%								
Deposits	57,568	46.5%	51,696	41.7%								
Preferred deposits	42,600	34.4%	40,470	32.7%								
Junior Deposits	14,968	12.1%	11,226	9.1%								
Senior unsecured bank debt	16,105	13.0%	16,105	13.0%								
Dated subordinated bank debt	1,600	1.3%	1,600	1.3%								
Preference shares (bank)	1,075	0.9%	1,075	0.9%								
Equity	3,716	3.0%	3,716	3.0%								
Total Tangible Banking Assets	123,867	100.0%	123,867	100.0%								
Debt Class	De jure waterfall		De facto waterfall		Notching		LGF	Assigned	Additional	Preliminary		
	Instrument	Sub-ordination	Instrument	Sub-ordination	De jure	De facto	notching guidance versus BCA	LGF notching	notching	Rating Assessment		
Counterparty Risk Rating	27.2%	27.2%	27.2%	27.2%	3	3	3	3	0	a1		
Counterparty Risk Assessment	27.2%	27.2%	27.2%	27.2%	3	3	3	3	0	a1(cr)		
Deposits	27.2%	5.2%	27.2%	18.2%	2	3	2	3	0	a1		
Senior unsecured bank debt	27.2%	5.2%	18.2%	5.2%	2	2	2	3	0	a1		

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Counterparty Risk Rating	3	0	a1	0	A1	A1
Counterparty Risk Assessment	3	0	a1(cr)	0	A1(cr)	
Deposits	3	0	a1	0	A1	A1
Senior unsecured bank debt	3	0	a1	0	(P)A1	A1

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

## Ratings

Exhibit 8

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

Source: Moody's Investors Service

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