MOODY'S
INVESTORS SERVICE

Credit Opinion: Sparebanken Sor

Global Credit Research - 01 Apr 2015

Kristiansand, Norway

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*A2/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1

* Rating(s) within this class was/were placed on review on March 17, 2015

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Key Indicators

Sparebanken Sor (Consolidated Financials)[1]

	[2]**12-14**	[2]**12-13**	[2]**12-12**	[2]**12-11**	[2]**12-10**	**Avg.**
Total Assets (NOK billion)	**94.1**	**45.8**	**44.1**	**40.5**	**36.9**	[3]**26.4**
Total Assets (EUR million)	**10,367.9**	**5,473.8**	**6,013.5**	**5,229.1**	**4,731.3**	[3]**21.7**
Total Assets (USD million)	**12,545.7**	**7,542.6**	**7,928.1**	**6,788.1**	**6,347.2**	[3]**18.6**
Tangible Common Equity (NOK billion)	**7.1**	**3.1**	**2.8**	**2.6**	**2.4**	[3]**31.4**
Tangible Common Equity (EUR million)	**786.7**	**372.1**	**383.1**	**332.2**	**307.4**	[3]**26.5**
Tangible Common Equity (USD million)	**951.9**	**512.8**	**505.1**	**431.3**	**412.4**	[3]**23.3**
Problem Loans / Gross Loans (%)	**1.8**	**0.8**	**0.6**	**0.5**	**0.7**	[4]**0.9**
Tangible Common Equity / Risk Weighted Assets (%)	**13.2**	**12.0**	**11.4**	**11.2**	**11.4**	[5]**11.9**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**18.4**	**9.2**	**7.2**	**6.7**	**8.2**	[4]**10.0**
Net Interest Margin (%)	**1.8**	**1.4**	**1.4**	**1.3**	**1.3**	[4]**1.4**
PPI / Average RWA (%)	**2.3**	**1.8**	**1.8**	**1.4**	**1.8**	[5]**1.8**
Net Income / Tangible Assets (%)	**0.9**	**0.7**	**0.7**	**0.5**	**0.7**	[4]**0.7**
Cost / Income Ratio (%)	**42.1**	**37.3**	**36.3**	**42.8**	**37.3**	[4]**39.2**
Market Funds / Tangible Banking Assets (%)	**39.2**	**44.1**	**47.5**	**52.9**	**49.7**	[4]**46.7**
Liquid Banking Assets / Tangible Banking Assets (%)	**12.3**	**15.9**	**17.8**	**16.6**	**15.9**	[4]**15.7**
Gross Loans / Total Deposits (%)	**169.2**	**179.4**	**144.7**	**155.6**	**145.2**	[4]**158.8**

Source: Moody's

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

Opinion

SUMMARY RATING RATIONALE

On 17 March we placed Sparebanken Sor's A2 long-term deposit ratings under review for upgrade. The bank's baa1 baseline credit assessment (BCA), adjusted BCA and short-term ratings remain unchanged.

Sparebanken Sor's BCA primarily reflects its strong franchise on the southern coast of Norway and adequate capital levels. With the increase in size following the merger between Sparebanken Pluss and Sparebanken Sor (effective 2 January 2014), Moody's believes that that synergies could result from the merged bank being better able to service larger companies in its core area.

The review on the bank's long-term deposit ratings was prompted by the implementation of our new methodology for rating banks globally, and changes arising from the introduction of our advanced Loss Given Failure (LGF) analysis in combination with a lowering of our current systemic (government) support assumptions. LGF takes into account the risks faced by the different debt and deposit classes across the liability structure if the bank were to enter resolution.

SPAREBANKEN SOR'S BCA IS SUPPORTED BY ITS `VERY STRONG-' MACRO PROFILE

As a purely domestic bank, Sparebanken Sor's operating environment, and hence its Macro Profile is aligned with that of Norway at `Very Strong-'. Norwegian banks benefit from operating in an affluent and developed country with very high economic, institutional and government financial strength as well as low susceptibility to event risk. The main risks to the system stem from a high level of household indebtedness and domestic banks' reliance on market funding. However, these risks are offset by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared to GDP.

Rating Drivers

- Capital levels are adequate.

- Asset quality is weaker than that of domestic peers following portfolio review

- Profitability is supported by efficient operations, but re-pricing puts margins under pressure

- High reliance in market funding despite recent increase in the volume of deposits

- Large volume of deposits and junior debt results in the deposit ratings benefiting from a very low loss-given-failure rate and a likely two-notch uplift from the BCA

- Moderate probability of government support, resulting in no uplift for debt and deposit ratings from the BCA

Rating Outlook

The review on Sparebanken Sor's long-term deposit ratings was prompted by changes arising from the implementation of our new methodology, and specifically our advanced Loss Given Failure analysis, which applies to those institutions subject to an operational resolution regime. While not subject to the EU's Bank Recovery and resolution Directive (BRRD), we expect that Norway - as a European Economic Area (EEA) member - will seek to introduce legislation or other tools that include mechanisms similar to those in the BRRD; our expectations are based on publicly stated comments from Norwegian authorities as well as the government's track record of mirroring EU banking regulations. Our advanced LGF analysis on Sparebanken Sor's long-term and short-term deposit ratings prompted the review for upgrade. The review will focus on the liability structure, in particular the amount of deposits, senior long-term debt outstanding and the amount of debt subordinated to it.

We consider the probability of government support for Sparebanken Sor's long-term deposits to be moderate, and we expect uplift of one notch from its unsupported level. We expect the long-term deposit rating to be upgraded by one notch.

What Could Change the Rating - Up

As stated in the Summary Rating Rationale Sparebanken Sor's ratings are under review in response to the implementation of our new banking methodology.

What Could Change the Rating - Down

After the above-mentioned review is completed, future downward rating pressure could follow (1) indications that the 2013 merger with Sparebanken Pluss is negatively impacting the group's franchise and/or financial strength; (2) deterioration in asset quality and/or capitalisation to levels not commensurate with the current rating level.

DETAILED RATING CONSIDERATIONS

ADEQUATE CAPITAL LEVELS

At end-December 2014, Sparebanken Sor had a tangible common equity (TCE) ratio of 13.15% under Basel III. The current capital levels compare well with other rated Norwegian savings banks, and we deem these metrics adequate relative to the bank's risk profile. The Capital score reflects this strength as well as the banks TCE-to-tangible banking assets ratio of 8% which is well within international standards.

ASSET QUALITY IS WEAKER THAN PEERS FOLLOWING PORTFOLIO REVIEW

Sparebanken Sor's problem loan ratio (impaired loans as a percentage of total loans) amounted to 1.8% at end-December 2014, which is above the Norwegian average. Since the merger with Sparebanken Pluss in 2013, the bank has taken several actions to improve credit quality and limit future losses of the merged entity. A comprehensive review of the corporate portfolio was carried out in 2014, which identified individual losses as well as a number of loss events which - when viewed in context - resulted in individual write-downs on individual loans. The Asset Risk score indicates that, overall, the bank's management of asset risk remains a relative strength for Sparebanken Sor but the bank is still somewhat vulnerable to less favourable economic conditions due to declining oil and gas prices.

Sparebanken Sor's book is dominated by retail loans, mostly in the form of mortgages representing over 66% of the total loan book at end-December 2014. This asset class has been more resilient historically, but we believe that its performance is sensitive to any rise interest rates and/or decline in house prices.

Sperbanken Sor's substantial exposure to the real estate and construction sectors (above 22% of gross loans at end-December 2014), has generated a significant proportion of the bank's problem loans over the years and has posed downside risks to future loan book performance. Furthermore, the bank's corporate book has significant single-borrower exposure, a common characteristic amongst Norwegian savings banks, and a feature that could heighten the extent and pace of any asset quality deterioration.

PROFITABILITY IS SUPPORTED BY EFFICIENT OPERATIONS BUT RE-PRICING PUTS MARGINS UNDER PRESSURE

Sparebanken Sor receives stable income from lending: net interest income represented over 75% of its 2014 net revenue. In 2014, this source of income grew by 4.7%, supported by good loan growth (about 4.5% pro-forma) notwithstanding two interest rate reductions on mortgages in April and October. The bank announced plans for further reductions in the mortgage interest rate (up to 40bps which should take effect in March 2015 for existing loans); and while deposit rates will be adjusted on a selective basis in order to partly mitigate the effect of the reduced mortgage lending rates, we expect the bank to experience increasing pressure on net interest margins.

Sparebanken Sor's cost efficiency is among the best in the Nordic region, with cost-to-income ratio at 39.2% at end-December 2014 (adjusted for merger costs), compared to 41.7% in 2013 (pro-forma). Following the aforementioned merger, the bank consolidated its branch network while staff downsizing is being carried out as planned. We expect the bank to achieve further cost-related synergies in 2015.

Sparebanken Sor reported NOK792 million profit for 2014, in line with 2013 (pro-forma) albeit with larger loan losses at NOK268 million. The net income-to-tangible assets ratio was at 0.9% at end-December 2014, and we expect a mild deterioration from these levels as a result of additional margin pressure and uncertainty over provisioning levels which is reflected in our assigned Profitability score.

HIGH RELIANCE ON MARKET FUNDING, DESPITE RECENT INCREASE IN THE VOLUME OF DEPOSITS

Sparebanken Sor's funding is underpinned by a strong deposit base, which accounted for 56% of total funding at end-December 2014. Deposits grew significantly in 2014 (+10.3% pro-forma), largely reflecting the bank's focus on deposit gathering which we view positively, especially as both corporate and retail deposits witnessed similar growth rates.

Nevertheless, the bank remains reliant on market funding which accounted for 39% of the bank's tangible banking assets at end-December 2014, and which renders the bank susceptible to changes in investor behaviour. In particular, a sizeable and growing portion of market funds are in the form of covered bonds which provides the bank with an additional source of funding. Under our new methodology, we reflect the stability of covered bonds relative to unsecured market funding at a global level through a standard adjustment in our scorecard. However, we do not expect that, in terms of wise, Sparebanken Sor will have the capacity to make larger benchmark issuance and thus benefit from the depth of the markets. The bank's Funding Structure score reflects that its overall funding profile remains a fundamental weakness for Sparebanken Sor, as the use of covered bond funding results in the structural subordination of Sparebanken Sor's unsecured creditors, including depositors.

At end-December 2014, liquid assets accounted for around 12% of tangible assets, comprising cash and deposits with the central bank and the securities portfolio. The portfolio primarily includes Norwegian covered bonds, bonds from the government or other public entities as well as 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 currency exposure.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We expect that Norway will seek to introduce legislation or other tools that include mechanisms similar to those in the EU Bank Resolution and Recovery Directive (BRRD).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.

Our review of Sparebanken Sor's long-term deposit ratings will consider the likely impact on loss-given-failure of the combination of their own volume and the amount of debt subordinated to them. We expect this will result in Preliminary Rating Assessment (PRA) of two notches above the BCA, reflecting very low loss-given-failure.

GOVERNMENT SUPPORT

The expected 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. However, its national market share is limited - at around 2% (based on total lending and deposits by county and nationwide according to Statistics Norway). Headquartered in Kristiansand, Norway, Sparebanken Sor is the fourth-largest savings bank in Norway with total assets of NOK93.3 billion at end September 2014. 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).

Therefore, we regard the probability of government support for debt and deposits as moderate, which is likely to result in one notch of uplift to the PRA.

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 A2 (rating under review for upgrade).

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 Factors

Sparebanken Sor

Macro Factors	
Weighted Macro Profile	**Very Strong -**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.8%	aa3	←→	baa1	Geographical concentration	Single name concentration
Capital						
TCE / RWA	13.2%	a2	←→	a2		
Profitability						
Net Income / Tangible Assets	0.8%	baa1	↓	baa2	Expected trend	
Combined Solvency Score		a2		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	39.2%	ba2	←→	ba2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	12.3%	baa3	←→	baa3	Stock of liquid assets	
Combined Liquidity Score		ba1		ba1		

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**

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	--	--	--	--	A2 RUR Possible Upgrade	A2 RUR Possible Upgrade

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