

Global Credit Research - 07 Apr 2016

Kristiansand, Norway

## Ratings

Category	Moody's Rating
Outlook	Negative
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

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## Key Indicators

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

	[2]12-15	[2]12-14	[2]12-13	[2]12-12	[2]12-11	Avg.
Total Assets (NOK billion)	101.3	94.1	45.8	44.1	40.5	[3]25.8
Total Assets (EUR million)	10,539.0	10,367.9	5,473.7	6,013.5	5,229.1	[3]19.1
Total Assets (USD million)	11,448.4	12,545.7	7,542.5	7,928.1	6,788.1	[3]14.0
Tangible Common Equity (NOK billion)	7.7	7.1	3.1	2.8	2.6	[3]31.7
Tangible Common Equity (EUR million)	805.0	786.7	371.1	383.1	332.2	[3]24.8
Tangible Common Equity (USD million)	874.4	951.9	511.3	505.1	431.3	[3]19.3
Problem Loans / Gross Loans (%)	1.3	1.8	0.8	0.6	0.5	[4]1.0
Tangible Common Equity / Risk Weighted Assets (%)	12.8	13.2	12.0	11.4	11.2	[5]12.1
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	14.1	18.4	9.3	7.2	6.7	[4]11.1
Net Interest Margin (%)	1.6	1.8	1.4	1.3	1.2	[4]1.5
PPI / Average RWA (%)	1.7	2.3	1.7	1.8	1.4	[5]1.8
Net Income / Tangible Assets (%)	0.6	0.7	0.6	0.7	0.5	[4]0.6
Cost / Income Ratio (%)	45.9	43.0	38.1	37.0	43.3	[4]41.5
Market Funds / Tangible Banking Assets (%)	31.5	30.1	32.0	36.8	52.9	[4]36.7
Liquid Banking Assets / Tangible Banking Assets (%)	11.4	12.3	15.9	17.8	16.6	[4]14.8
Gross loans / Due to customers (%)	184.3	169.2	179.4	184.3	217.7	[4]187.0

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**

We assign Sparebanken Sor a baa1 baseline credit assessment (BCA), an A1 long-term issuer rating, an A1 long-term deposit rating and a Prime 1 short-term obligation rating. We also assign a Counterparty Risk Assessment (CR Assessment) of Aa3(cr) long term and Prime-1(cr) short term.

Sparebanken Sor's baa1 BCA reflects our view that, with the increase in scale following its merger with Sparebanken Pluss, the bank will realise synergies and be better positioned to service larger companies in its core market. The BCA also takes into account the bank's efforts to improve asset quality and limit future losses, including a comprehensive review of the corporate portfolio that resulted in write-downs on individual loans. The deposit rating and issuer ratings take into account our Loss Given Failure (LGF) analysis of the bank's own volume of deposits and senior unsecured debt, as well as the volume of securities subordinated to them.

Sparebanken Sor's deposit and issuer ratings carry a negative outlook to capture increased asset risk in the bank's corporate book as a result of the slowdown in Norway's economic growth driven by a reduction in petroleum investments.

### **Rating Drivers**

- Sparebanken Sor's BCA is supported by its Very Strong- Macro Profile
- Capital levels are expected to improve further against higher FSA proposed targets
- Problem loans in line with domestic peers
- Profitability is supported by efficient operations, but re-pricing puts margins under pressure
- High reliance in market funding, despite a sizeable deposit base
- Large volume of deposits and junior debt results in the deposit ratings benefiting from a very low loss-given-failure rate and a two-notch uplift from the BCA
- Moderate probability of government support, resulting in one notch uplift for debt and deposit ratings from the BCA

### **Rating Outlook**

The negative outlook on the bank's long-term issuer and deposit ratings reflect our view that the bank's asset performance will be negatively impacted by Norway's slowing growth. Sparebanken Sor's exposure to the construction and real-estate sector (24% of gross loans at end-December 2015) poses downside risks to future loan performance as the operating environment weakens further. In addition, we expect that the bank will reduce growth in risk-weighted assets, which puts further pressure on the bank's business as it intends to grow its capital base in order to meet a 14.5% CET1 ratio by the end of 2016 (as expected by Norway's FSA).

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

Upward rating momentum is currently unlikely given the negative outlook. Over time, upward pressure could develop if the bank demonstrates: (1) reduced exposure to more volatile sectors such as the construction and real-estate sectors; (2) diversified access to capital markets and improved liquidity; and/or (3) stronger earnings generation without an increase in the risk profile.

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

Future downward rating pressure could follow (1) an increase in the problem loans ratio significantly above our system-wide expectation of approximately 2%; (2) an increase of top-20 loan concentration as a percentage of Core Tier 1 capital above 150%; (3) a reduction in the bank's profitability, with net profits falling below 0.4% of tangible assets; (4) the bank failing to sustain its market position; and/or (5) the macroeconomic environment deteriorating more than currently anticipated, leading to more challenging operating conditions and reduced profitability.

Also, a reduction in uplift as a result of our LGF analysis or a revision of government support assumptions could lead to downward rating pressure.

## DETAILED RATING CONSIDERATIONS

### 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. 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 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.

### CAPITAL LEVELS ARE EXPECTED TO IMPROVE FURTHER AGAINST HIGHER FSA PROPOSED TARGETS

At end-September 2015, Sparebanken Sor reported a Core Tier 1 Capital Ratio of 12.7%, already in excess of the 11.5% minimum requirement that will come into force on 1 July 2016. In the third quarter of 2015, Norway's FSA communicated its expectations that Sparebanken Sor should target a Core Tier 1 capital ratio of 14.5% by the end of 2016 following a risk and capitalisation assessment. In order to reach this target, the bank announced a NOK600 million rights issue in February 2016, which increased its core equity tier 1 capital by approximately 1 percentage to 13.7% (as of December 2015). Although we view this positively, the rights issue on its own will be insufficient to meet the target capital ratio, which will compel Sparebanken Sor to improve profitability as well as reduce growth in risk-weighted assets, both of which will challenge the bank. We estimate that growth in risk-weighted assets would have to be limited to 1%-2% in 2016 to achieve the capital target, a significant reduction from Sparebanken Sor's 12% growth in 2015. These challenges are reflected in the assigned Capital score. This score also takes into account our expectations that (1) the bank's net interest margins will remain under pressure as the central bank continues to cut interest rates; (2) wholesale funding costs will not improve from current levels; and (3) loan-loss provisions will increase.

### PROBLEM LOANS IN LINE WITH DOMESTIC PEERS

Sparebanken Sor's problem loan ratio (impaired loans as a percentage of total loans) amounted to 1.3% at end-December 2015, an improvement from approximately 1.8% at end-December 2014, and in line with the Norwegian average. Following the merger between Sparebanken Pluss and Sparebanken Sor in 2013, the new merged bank has taken several actions to improve its credit quality and limit future losses. The bank carried out a comprehensive review of its corporate portfolio in 2014. This identified individual losses as well as a number of loss events which, when viewed in context, resulted in individual write-downs of loans. Our Asset Risk score indicates that, overall, the bank's risk management remains a relative strength for Sparebanken Sor; but also that the bank is somewhat vulnerable to Norway's less favourable economic conditions, owing to declining oil and gas prices.

Sparebanken Sor's loan book is dominated by retail loans, mostly in the form of mortgages, which represent more than 65% of the total loan book at end-December 2015, an asset class has been more resilient historically. However, Sparebanken Sor's substantial exposure to the real-estate and construction sectors has generated a significant proportion of the bank's problem loans over the years and poses downside risks to future loan book performance. Furthermore, the bank's corporate book exposes significant single-borrower concentrations, 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 85% of 2015 net revenue. In 2015, this source of income remained in line with 2014 levels, despite 9.2% loan growth, as a result of lower lending margins. While deposit rates will be adjusted on a selective basis in order to mitigate the effect of the reduced mortgage lending rates, we expect the bank to experience increasing pressure on net interest margins notwithstanding increases on lending margins of the corporate portfolio announced in December 2015.

Sparebanken Sor's cost efficiency is among the best in the Nordic region, with a cost-to-income ratio of 46.2% at end-December 2015 (43.2% in 2014, adjusted for merger costs). Following the aforementioned merger, the

bank consolidated its branch network, while workforce downsizing is being carried out as planned. We expect the bank to achieve further cost-related synergies in 2016.

Sparebanken Sor reported a NOK624 million profit for 2015, slightly lower than in 2014 (NOK685 million) albeit with lower loan losses at 0.11% of net loans compared to 0.33% the year before. Its net income-to-tangible assets ratio stood at 0.61% at end-December 2015 (0.72% at end 2014), mainly owing to mark-to-market losses on financial instruments held in the bank's liquidity portfolio. However, we forecast 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 A SIZEABLE DEPOSIT BASE

Sparebanken Sor's funding is underpinned by a strong deposit base, which accounted for 52% of total funding at end-December 2015. Nevertheless, the bank remains reliant on market funding, which accounted for around 40% of tangible banking assets at end-December 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, owing to the bank's increased size following the Sparebanken Sor-Pluss merger in 2013.

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. 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. While, Sparebanken Sor has only recently made its first international larger benchmark issuance through its fully owned covered bond company, we do not expect the bank will yet fully benefit from the depth of the markets. Our Funding Structure score reflects that the bank's overall funding profile remains a fundamental weakness for Sparebanken Sor.

At end-December 2015, liquid assets accounted for around 11.4% 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 AND ADDITIONAL NOTCHING

We expect that Norway will seek to introduce legislation to implement the EU Bank Resolution and Recovery Directive in 2017. In our LGF 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 deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt.

Sparebanken Sor's long-term deposit and issuer ratings take into consideration the likely impact on loss-given-failure of the bank's own volume of deposits and senior unsecured debt, as well as the volume of securities subordinated to them. This has resulted in a Preliminary Rating Assessment of two notches above the BCA, reflecting very low loss-given-failure.

##### 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 fourth-largest savings bank in Norway with total assets of NOK101.3 billion at end-December 2015 (NOK94.1 billion at end December 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).

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 Factors

### Sparebanken Sor

<b>Macro Factors</b>	
<b>Weighted Macro Profile</b>	<b>Very Strong</b>

<b>Financial Profile</b>						
<b>Factor</b>	<b>Historic Ratio</b>	<b>Macro Adjusted Score</b>	<b>Credit Trend</b>	<b>Assigned Score</b>	<b>Key driver #1</b>	<b>Key driver #2</b>
<b>Solvency</b>						
<b>Asset Risk</b>						
<i>Problem Loans / Gross Loans</i>	1.3%	aa2	← →	a3	Geographical concentration	Single name concentration
<b>Capital</b>						
<i>TCE / RWA</i>	12.8%	a2	↑	a2	Risk-weighted capitalisation	Stress capital resilience
<b>Profitability</b>						
<i>Net Income / Tangible Assets</i>	0.6%	baa2	↓	baa3	Expected trend	
<b>Combined Solvency Score</b>		a2		a3		
<b>Liquidity</b>						
<b>Funding Structure</b>						
<i>Market Funds / Tangible Banking Assets</i>	31.5%	baa3	← →	ba2	Extent of market funding reliance	
<b>Liquid Resources</b>						
<i>Liquid Banking Assets</i>	11.4%	baa3	← →	baa3	Stock of liquid	

/ Tangible Banking Assets					assets	
<b>Combined Liquidity Score</b>		baa3		ba1		

<b>Financial Profile</b>	<b>baa1</b>
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<b>Qualitative Adjustments</b>	<b>Adjustment</b>
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
<b>Total Qualitative Adjustments</b>	<b>0</b>

Sovereign or Affiliate constraint	Aaa
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Scorecard Calculated BCA range	a3 - baa2
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<b>Assigned BCA</b>	<b>baa1</b>
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Affiliate Support notching	0
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<b>Adjusted BCA</b>	<b>baa1</b>
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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

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