

MOODY'S

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Credit Opinion: Sparebanken Sor

Global Credit Research - 30 May 2014

Kristiansand, Norway

Ratings

Category	Moody's Rating
Outlook	Negative(m)
Bank Deposits	A2/P-1
Bank Financial Strength	C-
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1

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Key Indicators

Sparebanken Sor (Consolidated Financials)[1]

	[2]12-13	[2]12-12	[2]12-11	[2]12-10	[2]12-09	Avg.
Total Assets (NOK billion)	45.8	44.1	40.5	36.9	35.2	[3]6.8
Total Assets (EUR million)	5,473.8	6,013.5	5,229.1	4,731.3	4,245.7	[3]6.6
Total Assets (USD million)	7,542.6	7,928.1	6,788.1	6,347.2	6,091.4	[3]5.5
Tangible Common Equity (NOK billion)	3.4	3.1	2.7	2.5	2.2	[3]11.2
Tangible Common Equity (EUR million)	407.9	423.8	351.5	326.6	269.1	[3]11.0
Tangible Common Equity (USD million)	562.0	558.8	456.4	438.1	386.0	[3]9.8
Net Interest Margin (%)	1.4	1.4	1.3	1.3	1.3	[4]1.3
PPI / Average RWA (%)	1.8	1.8	1.4	1.8	2.0	[5]1.8
Net Income / Average RWA (%)	1.2	1.3	0.9	1.2	1.3	[5]1.2
(Market Funds - Liquid Assets) / Total Assets (%)	29.1	29.6	37.3	35.1	30.8	[4]32.4
Core Deposits / Average Gross Loans (%)	57.4	56.2	47.6	51.7	53.5	[4]53.3
Tier 1 Ratio (%)	13.9	13.4	12.5	12.8	12.2	[5]13.0
Tangible Common Equity / RWA (%)	13.2	12.6	11.9	12.1	11.2	[5]12.2
Cost / Income Ratio (%)	37.3	36.3	42.8	37.3	33.6	[4]37.5
Problem Loans / Gross Loans (%)	0.8	0.6	0.5	0.7	0.5	[4]0.6
Problem Loans / (Equity + Loan Loss Reserves) (%)	8.5	6.5	6.3	7.8	5.4	[4]6.9

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

Rating Rationale

On 5 March 2014 Moody's confirmed Sparebanken Sør's A2/ P-1 long-term/short-term deposit ratings and affirmed the bank's C- standalone bank financial strength rating (BFSR) equivalent to a baseline credit assessment (BCA) of baa1. The bank's BFSR and long-term ratings carry a stable outlook.

Following the merger between Sparebanken Pluss and Sparebanken Sør, effective on 2 January 2014, Moody's withdrew the ratings of Sparebank Sør and kept the A2/P-1 ratings of Sparebanken Pluss (the continuing entity, subsequently renamed as Sparebanken Sør) on review for downgrade. The review for downgrade reflected the old Sparebanken Sør's, deposit ratings of A3/P-2 and Moody's view that the two banks ratings would converge as the merger was implemented.

The confirmation of the A2/ P-1 long-term/short-term deposit rating reflects the rating agency's view that (1) the synergies from the merger, largely resulting from an enlarged franchise in southern Norway, outweigh the implementation risk associated with the merger, and (2) a stable and supportive operating environment in Norway both underpins credit quality and supports pre-provision profitability as evidenced by the merged banks' 2013 financials.

The merged bank is headquartered in Kristiansand, Norway, and is the 4th largest savings bank in Norway (excluding DNB) with total assets of NOK 94 billion at year end 2013. Moody's estimate that the combined entity's market share in its core region of Aust-Agder and Vest-Agder is around 30% with a national market share of around 2%. The two banks previously operated in adjacent areas in southern Norway but with a limited amount of overlap in terms of customers and branches.

The rating on the merged bank is underpinned by adequate capital levels and a strong franchise in a region of Norway which is benefitting from growth in industry sectors related to the oil industry. With the increased size, Moody's believe that synergies could result from the merged bank being better able to service larger companies in its core area, cost synergies resulting from a gradual restructuring of the cost base reflecting the larger scale of the operations, and lower initial borrower concentration levels.

Audited consolidated 2013 numbers are not yet available and Moody's confirmation of the ratings is based on pro-forma consolidated 2013 financials as well as information about the status of the merger process.

Rating Drivers

- The merger between Sparebanken Pluss and Sparebanken Sør, creates a strong bank in Southern Norway but entails some integration risks.
- The bank's franchise is underpinned by a sound market position on the southern coast of Norway.
- It currently shows strong asset quality, although its loan book entails some credit risk concentrations.
- Despite the recent increase in deposits, its reliance on market funding remains substantial.
- Its profit generation capacity benefits from very good cost efficiency and we see room for further retail lending margin improvement.
- Capital levels are adequate.

Rating Outlook

The negative outlook on the supported ratings takes into account the recent adoption of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) regulation in the EU. In particular, this reflects that, with the legislation underlying the new resolution framework now in place and the explicit inclusion of burden-sharing with unsecured creditors as a means of reducing the public cost of bank resolutions, the balance of risk for banks' senior unsecured creditors has shifted to the downside. While not subject to the BRRD and SRM, we expect that Norway will look to introduce legislation or other tools that include mechanisms similar to those in the BRRD; our expectations are based on public comments as well as governments' track record of mirroring EU banking regulations. Although our support assumptions are unchanged for now, the probability has risen that they will be revised downwards to reflect the new framework. For further details, please refer to our Special Comment entitled "Reassessing Systemic Support for EU Banks," published on 29 May 2014.

What Could Change the Rating - Up

An upgrade of Sparebanken Sor's A2 rating could be triggered by (1) a sustainable improvement in the bank's

profitability metrics without an increase in its risk profile; (2) a reduction in the group's loan-book concentration; and/or (3) bolstered liquidity position and continued good access to capital markets.

What Could Change the Rating - Down

Downward pressure on the ratings could follow (1) indications that the merger is negatively impacting the group's franchise and/or financial strength (2) a deterioration in asset quality and/ or capitalisation to levels not commensurate with the current rating level.

In addition, we believe that downward pressure could be exerted on the ratings due to external factors, such as a less supportive macroeconomic environment and/or substantially adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

NOTE: Effective on 2 January 2014, Sparebanken Pluss and Sparebanken Sør merged with Sparebanken Pluss as the continuing entity, but changing the name to Sparebanken Sør for the merged group. The new group does not yet publish consolidated numbers and the 'Detailed Rating Considerations' section below is hence only for Sparebanken Pluss and will be updated once consolidated numbers are available.

SOUND MARKET POSITION ON THE SOUTHERN COAST OF NORWAY

Sparebanken Pluss is a regional savings bank with a sound market position on the southern coast of Norway in the counties of Vest-Agder and Aust-Agder, where Moody's estimates it commands market shares of 17% for lending and 20% for deposits. However, its national market share is limited at around 1% (based on total lending and deposits by county and nationwide according to Statistics Norway). In addition, Sparebanken Pluss 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).

Sparebanken Pluss operates as an independent savings bank, using an open-architecture business model to offer financial services including life and non-life insurance products (Tennant Forsikring, a subsidiary of Gjensidige Forsikring). In addition, Sparebanken Pluss jointly owns a real-estate brokerage company (Plussmegleren, 20%).

Although we acknowledge Sparebanken Pluss's strong presence in its operational region, our assessment of the bank's franchise value is constrained by its low geographical diversification and by our view that competition in southern Norway is fierce and that, like most other regional savings banks, Sparebanken Pluss lacks pricing power against larger banks such as DNB and Nordea.

STRONG, ALBEIT SIGNIFICANT CREDIT RISK CONCENTRATIONS

Problem loans (defined as gross defaulted loans and other loans subject to individual write-downs) at Sparebanken Pluss accounted for a very low 0.6% of gross loans at end-March 2013 (year-end 2012: 0.6%, year-end 2011: 0.5%); we note that this level is the lowest among rated Norwegian peers of the bank.

The bank's asset quality is underpinned by a relatively large portion of loans to retail customers, mostly mortgages, which comprised approximately 62% of total loans at year-end 2012 (around half of which were part of Pluss Boligkreditt's covered pool).

Nevertheless, Sparebanken Pluss's loan book exhibits some industry concentration, with the real estate sector (including construction) representing around 23% of total loans at year-end 2012. We view this relatively high exposure to a sector that has historically generated high losses for banks as a potential vulnerability. In addition, the bank's corporate book has significant single-borrower exposure, a feature that could heighten the extent and pace of any asset quality deterioration. In addition, the sustained increase in house prices coupled with high household indebtedness pose downside risks to Sparebanken Pluss's currently strong asset quality.

HIGH RELIANCE ON MARKET FUNDING

Sparebanken Pluss' liquidity is underpinned by a strong deposit base, which accounted for almost 50% of total funding at year-end 2012, approximately 40% of which consisted of retail deposits. Deposits grew significantly in 2012 (+27%), largely reflecting the establishment of a dedicated deposit centre in 2012 and incentive programmes for employees based on deposit volumes. Whilst we positively view the bank's increased focus on deposits, we note that a substantial portion of the deposit growth was in the form of corporate deposits, which we deem typically less sticky than retail deposits.

Notwithstanding an increased deposit-to-gross loan ratio at 55% at end-March 2013 (year-end 2012: 54%; year-end 2011: 46%), the bank remains reliant on market funding. In particular, a sizeable and growing portion of market funds (year-end 2012: 33%; year-end 2010: 17%) are in the form of covered bonds issued via Pluss Boligkreditt, the bank's wholly-owned covered bond company. This provides the bank with an additional source of funding, a factor that we view as credit positive, but we caution that the use of covered bond funding results in the structural subordination of Sparebanken Pluss's unsecured creditors, including depositors.

At end-March 2013, liquid assets accounted for around 16% of total 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.

SUPPORTED BY GOOD EFFICIENCY; ROOM FOR FURTHER RETAIL LENDING MARGIN IMPROVEMENT

Sparebanken Pluss is reliant on net interest income, which represented over 80% of its 2012 net revenue. This source of income grew by 15% during the year, supported by good loan growth (about 7%) and increased lending margins which more than offset the pressure on deposit margins. In our view, there is room for further improvement, as a general repricing movement is under way in the Norwegian banking market in light of expectations of increased regulatory capital requirements.

Sparebanken Pluss's efficiency is among the best in the Nordic region. The bank's cost-to-income ratio was 37% in 2012 and we note it has consistently kept the ratio at good levels in recent years (below 40% on average). These good levels are largely due to Sparebanken Pluss's lean organisation, which comprises smaller headcount (182 man years at year-end 2012) and branch network (14 branches) than its similar-size peers.

In addition, Moody's notes that loan loss provisions are appreciably lower than most of its Norwegian rated peers; in 2012 loan loss provisions amounted to NOK21 million (2011: NOK20 million).

ADEQUATE CAPITAL LEVELS

Sparebanken Pluss exhibits sound capitalisation. At end-March 2013, the bank's Tier 1 ratio was 13.2% (standardised approach). The bank does not have Tier 2 supplementary capital.

Sparebanken Pluss increased its capital base gradually over the years without using external sources (Tier 1 ratio at year-end 2008: 11.4%). The current capital levels compare well with other rated Norwegian savings banks and we deem them adequate relative to the bank's risk profile.

NOTE ON DATA

Unless noted otherwise, all figures shown in this report are sourced from the bank's latest annual and interim financial reports and our Banking Financial Metrics. These metrics are based on our own chart of account, and are adjusted for analytical purposes. Please refer to the documents entitled "Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies" and "Frequently Asked Questions: Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies", both published on 19 July 2012.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A2 to Sparebanken Sør. The rating is supported by its baa1 standalone credit assessment and the Aaa local-currency deposit ceiling of Norway, which we consider to be the underlying support provider. Given the bank's importance to its region, and the region's importance to the national economy of Norway, Moody's assesses as high the probability of systemic support in the event of a stress situation. We are likely to gradually reduce such unusual support uplift as such support mechanisms are phased out, as banks' stand-alone profiles improve, and as regulators globally consider implementing bank resolution regimes.

Foreign Currency Deposit Rating

The bank's foreign-currency deposit ratings are unconstrained, because Norway has a country ceiling of Aaa. Sparebanken Sør's foreign-currency deposit rating is A2.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognise the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. An Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and

regions. The model 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

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C-	
Factor: Franchise Value						D+	Neutral
Market share and sustainability				x			
Geographical diversification					x		
Earnings stability		x					
Earnings Diversification [2]							
Factor: Risk Positioning						D	Neutral
Corporate Governance [2]	--	--	--	--	--		
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management		x					
- Risk Management			x				
- Controls	x						
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information				x			
Credit Risk Concentration	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management					x		
Market Risk Appetite	x						
Factor: Operating Environment						A-	Neutral
Economic Stability		x					
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						C	
Factor: Profitability						C	Neutral
PPI % Average RWA (Basel II)			1.68%				
Net Income % Average RWA (Basel II)			1.14%				
Factor: Liquidity						E	Weakening
(Market Funds - Liquid Assets) % Total Assets					32.02%		
Liquidity Management					x		
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	13.27%						
Tangible Common Equity % RWA (Basel II)	12.55%						
Factor: Efficiency						A	Neutral
Cost / Income Ratio	38.83%						
Factor: Asset Quality						A	Weakening
Problem Loans % Gross Loans	0.64%						
Problem Loans % (Equity + LLR)	7.11%						
Lowest Combined Financial Factor Score (15%)						E	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						C-	

Aggregate BCA Score		baa1/baa2	
Assigned BFSR		C-	
Assigned BCA		baa1	

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

[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.



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