Credit Opinion: Sparebanken Sør

Global Credit Research - 10 Jan 2012

Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-2
Bank Financial Strength	C-
Baseline Credit Assessment	(Baa2)
Adjusted Baseline Credit Assessment	(Baa2)

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Key Indicators

Sparebanken Sor (Consolidated Financials)[1]

	[2]**9-11**	[2]**12-10**	[2]**12-09**	[2]**12-08**	[3]**12-07**	**Avg.**
Total Assets (NOK billion)	**40.3**	**37.7**	**35.3**	**33.7**	**30.2**	[4]**7.5**
Total Assets (EUR million)	**5,122.2**	**4,832.6**	**4,263.9**	**3,459.8**	**3,801.4**	[4]**7.7**
Total Assets (USD million)	**6,872.4**	**6,483.1**	**6,117.6**	**4,809.3**	**5,557.8**	[4]**5.5**
Tangible Common Equity (NOK billion)	**3.0**	**2.7**	**2.6**	**2.1**	**2.2**	[4]**7.4**
Tangible Common Equity (EUR million)	**378.8**	**342.7**	**308.8**	**217.4**	**282.2**	[4]**7.6**
Tangible Common Equity (USD million)	**508.3**	**459.7**	**443.0**	**302.2**	**412.5**	[4]**5.4**
Net Interest Margin (%)	**1.7**	**1.8**	**1.8**	**2.0**	**1.9**	[5]**1.8**
PPI / Avg RWA (%)	**2.0**	**2.8**	**1.7**	**0.8**	**1.6**	[6]**1.8**
Net Income / Avg RWA (%)	**1.1**	**1.7**	**0.7**	**-0.2**	**1.1**	[6]**0.8**
(Market Funds - Liquid Assets) / Total Assets (%)	**45.6**	**43.3**	**34.9**	**37.3**	**33.9**	[5]**39.0**
Core Deposits / Average Gross Loans (%)	**55.8**	**57.0**	**58.4**	**59.0**	**60.5**	[5]**58.1**
Tier 1 Ratio (%)	**13.0**	**14.0**	**14.1**	**11.2**	**10.6**	[6]**13.1**
Tangible Common Equity / RWA (%)	**13.3**	**12.8**	**13.0**	**10.8**	**10.6**	[6]**12.5**
Cost / Income Ratio (%)	**52.0**	**46.9**	**58.6**	**77.3**	**57.9**	[5]**58.5**
Problem Loans / Gross Loans (%)	**1.8**	**1.8**	**1.3**	**1.2**	**0.9**	[5]**1.4**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**18.2**	**19.4**	**13.1**	**14.4**	**10.0**	[5]**15.0**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's rates Sparebanken Sør A3/C-/P-2.

The C- bank financial strength rating (BFSR), which translates into a baseline credit assessment (BCA) of Baa2, reflects Sparebanken Sør's sound local franchise, solid retail business and sound capital levels. However, the rating is constrained by the bank's large exposure to the real estate sector, its high borrower concentration and its less sophisticated risk management procedures.

The global local currency (GLC) deposit rating of A3 assigned to Sparebanken Sør is supported by the bank's Baa2 BCA and the Aaa local currency deposit ceiling of Norway, which is deemed 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 a high probability of systemic support in the event of a stress situation. Consequently, Sparebanken Sør's GLC deposit rating benefits from a two-notch uplift from its BCA.

Credit Strengths

- Sound market position in southern Norway

- Resilient earnings from retail banking operations

- A good capital position

Credit Challenges

- Growing revenue in the highly competitive Norwegian market

- Reducing credit risk concentrations, especially to the real estate sector and by single-name borrower

- Further developing risk management practices

- Maintaining asset quality across the economic cycle

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

An upgrade of the BFSR or the GLC deposit rating could be triggered by: (i) an improvement in the bank's profitability metrics; or (ii) a reduction in the loan book concentration.

What Could Change the Rating - Down

The BFSR could be downgraded if there is: (i) any deterioration in asset quality or capitalisation that exceeds Moody's expectations; any change in the risk profile of the bank; or (iii) any sign that the bank is unable to sustain its market positions.

The GLC deposit rating could be downgraded if: (i) the BFSR deteriorates; or (ii) Moody's current assessment of the probability of systemic support for the bank declines.

Recent Results

Sparebanken Sør reported pre-tax income of NOK254 million in Q3 2011, down from NOK303 million in Q3 2010 after excluding the NOK22 million one-off gain related to a change in the pension legislation in Norway, as well as the profit on the Nordito shares. Core banking income in the form of net interest income and commission income was down NOK25 million to NOK478 million at end-September 2011 comparing to the same period last year, primarily due to tighter margins on lending as a result of increased competition in both retail and corporate banking markets. The bank's Tier 1 ratio stood at 13% (excluding interim profit) at end-September 2011.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Sparebanken Sør's currently assigned ratings are:

Bank Financial Strength Rating

The assigned BFSR is one notch below the C outcome of Moody's bank financial strength scorecard. Based on Moody's scenario analysis (see Special Comment entitled "Moody's Approach to Estimating Nordic Banks' Credit Losses" published in July 2009), we believe that Sparebanken Sør's sizeable exposure to the real estate sector and its high loan book concentration could exert adverse pressure on its capitalisation. As a result, we believe that the bank's financial strength is more consistent with a C- BFSR.

Qualitative Factors (50% weighting)

Franchise Value

Trend: Neutral

Sparebanken Sør is a regional savings bank with a sound market position in southern Norway in the counties of Vest-Agder, Aust-Agder and Telemark, where Moody's estimates it commands market shares of almost 15% for lending and close to 20% for deposits. However, its national market share is limited, at around 1%.

The bank operates as an independent savings bank, using an open-architecture business model to offer financial services including jointly owned life and non-life insurance (Frende Forsikring, 10% ownership) and investment (Norne Securities, 14.8% ownership) products. In addition, Sparebanken Sør owns a real estate brokerage subsidiary (ABCenter) and established its own covered bond company, Sør Boligkreditt AS, in Q4 2008 for funding purposes.

Although we acknowledge Sparebanken Sør's strong presence in the region in which it operates, we note that the Norwegian banking market is highly competitive and that savings banks generally lack pricing power against the two national market leaders. In addition, the D+ score for franchise value is constrained by the bank's low geographic diversification.

Risk Positioning

Trend: Neutral

Sparebanken Sør is organised as independent entity without external owners. Moody's considers Sparebanken Sør's risk management policies at the bank are considered adequate despite the lack of sophistication. Moody's note that many risk management procedures are newly implemented and that the management of Sparebanken Sør has an intention to develop risk management further. Sparebanken Sør has a dedicated risk management unit reporting to the CEO. The bank's overall risk exposure and development is reviewed quarterly by the management and the Board of Directors. Sparebanken Sør currently applies the standardised approach of Basel II to calculate its credit risk and reports it is aiming to build a relevant modelling tool to receive the Foundation IRB approval.

Sparebanken Sør's market risk remains modest. Its exposure to interest rates is limited: interest rate risk was NOK2.3 million in relation to a 100 bps change in interest rates at Q3 2011. Investments in shares and ECs amounted to NOK346 million at Q3 2011, corresponding to around 12% of Tier 1 capital. This figure includes a 1.3% ownership in Eksportfinans. The bank also has limited foreign currency exposure.

Limitations in risk management - e.g. in terms of credit risk modelling and stress testing - as well as high credit risk concentration are constraining factors in the score for risk positioning and push it to D.

Regulatory Environment

For a discussion about the regulatory environment, please see Moody's Banking System Outlook on Norway.

Operating Environment

Trend: Neutral

The operating environment score takes into account the economic stability, integrity and corruption in the country as well as the legal system. The unadjusted score for Norway's operating environment is B and is constrained by a score of C for economic stability, primarily as a result of volatility in oil prices. To reflect the fact that offshore revenues are allocated to the Government Pension Fund and have a limited impact on the mainland economy, we calculate the score for economic stability as the average of the standard deviations of GDP growth both including (75% weight) and excluding offshore revenue (25% weight), which results in an adjusted score of B. Consequently, the adjusted score for operating environment is B+. For further discussion of the operating environment, please see Moody's latest Banking System Outlook on Norway.

Quantitative Factors (50% weighting)

Profitability

Trend: Weakening

Sparebanken Sør is reliant on net interest income, which represented over 70% of its operating income at end-September 2011. This source of earnings fell by 5% in Q3 2011 compared to same period last year, primarily due to lower margins on lending and rising borrowing costs. Fee and commission income, mainly from payment services and real estate operations, represented some 17% of operating income at end-September 2011 which was a slight decrease from Q3 2010. Net income from financial investments largely contributed to the bank's improved profitability in 2010 and remains volatile.

The cost-to-income ratio has increased to slightly over 50% at end-September 2011 up from approximately 40% in the same period last year. Given the revenue pressure from a challenging operating environment, we view efficiency gains as a challenge for Sparebanken Sør. Asset quality has been affected somewhat by current economic conditions as net non-performing and doubtful commitments, although still at relatively low levels, have risen from roughly 0.7% in Q1 2010 to 1.26 % in Q3 2011.

The score for profitability is D+ with a weakening trend, mainly reflecting our view that strong competition may keep the margins on check and the developments in loan loss provisions are uncertain.

Liquidity

Trend: Neutral

Sparebanken Sør's liquidity is underpinned by a strong deposit base, which accounts for around half of its total funding, and retail deposits that represent almost 60% of total deposits. Since December 2008, part of market funds has been in the form of covered bonds, through the bank's wholly-owned covered bond company, Sør Boligkreditt. Moody's cautions that extensive use of covered bond funding through these structures, whereby prime assets are transferred from the bank's balance sheet, might result in the structural subordination of Sparebanken Sør unsecured creditors, including depositors. Any significant structural subordination might impact the bank's senior debt and deposit ratings.

Sparebanken Sør enjoyed an asset buffer of over 15% of total assets and comprised cash and deposits with the central bank and the securities portfolio, which mainly comprise senior bonds of banks and municipalities, as well as some corporate bonds and shareholdings. We note that holdings are concentrated on Norwegian securities, which could be a source of vulnerability from a concentration risk point of view.

In 2011 Sparebanken Sør issued NOK4.07 billion senior unsecured funding with maturities ranging between 3 months and 5.25 years. Furthermore, NOK2.7 billion covered bonds (of which Sparebanken Sør parent company issued NOK0.4 billion) with maturities ranging between 3.25-6 years were issued. During 2011 NOK 2.1 billion were transferred to Sør Boligkreditt, the mortgage company of Sparebanken Sør.

Sparebanken Sør's liquidity score of D+ is lower than those of its European peers and reflects the bank's reliance on market funding, although we note the positive impact of the bank's liquidity management as well as its access to covered bonds.

Capital Adequacy

Trend: Neutral

Sparebanken Sør exhibits strong capitalisation. At Q3 2011, the Tier 1 and total capital ratios, as calculated under Basel II's standardised approach, stood at 13% and 14.3%, respectively. These levels compare positively with the other Moody's-rated Norwegian savings banks and the Tier 1 ratio is above the management's target of 12%. Sparebanken Sør applies a standard approach in calculating its capital adequacy requirement for credit risk. Given the bank's large retail loan book, the capital requirement is estimated to be lower under Basel II IRB model. Sparebanken Sør scores A for capital adequacy.

Asset Quality

Trend: Weakening

Operating in a small geographic region means the bank has significant single-borrower exposure, as measured by the 20 largest exposures in relation to Tier 1 capital or pre-provision income. The bank has about 70% exposure to retail loans including loans transferred to Sør Boligkreditt. It should be noted that an increasing proportion of the high quality loans, low loan-to-value mortgages are transferred to Sør Boligkreditt leaving higher loan to value mortgages and corporate lending in the parent company. Further, the bank has some industry concentration where the commercial real estate sector (including construction) is representing approximately 20% of gross loans. We view this relatively high exposure to a sector that has historically generated high losses for banks as a potential source of vulnerability, though we note that losses in that sector have remained moderate at Sparebanken Sør. In addition, high loan growth in recent years, particularly in retail banking, has resulted in a somewhat unseasoned loan portfolio.

Problem loans (defined as commitments in default and other bad and doubtful commitments) accounted for just below 2% of gross loans at 3Q 2011 and a loss reserves coverage of around 50%. The score for asset quality is B. The economic environment in Norway, and in southern Norway, is still satisfactory, but slower economic growth, fewer exports and weaker domestic demand are challenges for the corporate sector. Further, with regards to retail loans, household indebtedness and house prices have increased notably in recent years, making customers more vulnerable to interest rates rises, although we take comfort in the still low unemployment levels in Norway. Overall, we consider the trend to be weakening.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A3 to Sparebanken Sør. The rating is supported by its Baa2 BCA and the Aaa local currency deposit ceiling of Norway, which is considered 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 however 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.

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 honor 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 recognize 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 Sør

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						B+	Neutral
Economic Stability		x					
Integrity and Corruption		x					
Legal System	x						
Financial Factors (50%)						C	
Factor: Profitability						D+	Weakening
PPI / Average RWA - Basel II			1.74%				
Net Income / Average RWA - Basel II				0.75%			
Factor: Liquidity						D+	Neutral
(Mkt funds-Liquid Assets) / Total Assets					28.68%		
Liquidity Management			x				
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio - Basel II	13.09%						
Tangible Common Equity / RWA - Basel II	12.19%						
Factor: Efficiency						C	Neutral
Cost / Income Ratio			60.93%				
Factor: Asset Quality						B	Weakening
Problem Loans / Gross Loans		1.43%					
Problem Loans / (Equity + LLR)		15.63%					
Lowest Combined Score (15%)						D+	
Economic Insolvency Override						Neutral	
Aggregate Score						C-	
Assigned BFSR						C-	

[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