MOODY'S INVESTORS SERVICE

Credit Opinion: Sparebanken Sør

Global Credit Research - 10 Apr 2013

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]**12-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	[2]**12-08**	**Avg.**
Total Assets (NOK billion)	**44.5**	**41.8**	**37.7**	**35.3**	**33.7**	[3]**7.2**
Total Assets (EUR million)	**6,062.1**	**5,401.0**	**4,832.6**	**4,263.9**	**3,459.8**	[3]**15.1**
Total Assets (USD million)	**7,992.3**	**7,011.3**	**6,483.1**	**6,117.6**	**4,809.3**	[3]**13.5**
Tangible Common Equity (NOK billion)	**3.2**	**3.0**	**2.7**	**2.6**	**2.1**	[3]**10.9**
Tangible Common Equity (EUR million)	**436.3**	**384.0**	**342.7**	**308.8**	**217.4**	[3]**19.0**
Tangible Common Equity (USD million)	**575.2**	**498.4**	**459.7**	**443.0**	**302.2**	[3]**17.5**
Net Interest Margin (%)	**1.7**	**1.6**	**1.8**	**1.8**	**2.0**	[4]**1.8**
PPI / Average RWA (%)	**1.4**	**1.9**	**2.8**	**1.7**	**0.8**	[5]**1.7**
Net Income / Average RWA (%)	**0.8**	**1.2**	**1.6**	**0.7**	**-0.2**	[5]**0.8**
(Market Funds - Liquid Assets) / Total Assets (%)	**42.6**	**43.5**	**43.3**	**34.9**	**37.3**	[4]**40.3**
Core Deposits / Average Gross Loans (%)	**59.0**	**58.7**	**57.0**	**58.4**	**59.0**	[4]**58.4**
Tier 1 Ratio (%)	**14.1**	**14.2**	**14.0**	**14.1**	**11.2**	[5]**13.5**
Tangible Common Equity / RWA (%)	**13.9**	**13.7**	**12.8**	**13.0**	**10.8**	[5]**12.8**
Cost / Income Ratio (%)	**61.7**	**53.0**	**47.0**	**58.6**	**77.3**	[4]**59.5**
Problem Loans / Gross Loans (%)	**1.6**	**1.9**	**1.8**	**1.3**	**1.2**	[4]**1.6**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**16.9**	**19.1**	**19.4**	**13.1**	**14.4**	[4]**16.6**

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

Sparebanken Sør's C- standalone bank financial strength rating (BFSR), which translates into a standalone credit assessment 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.

Sparebanken Sør's global local currency (GLC) deposit rating of A3 benefits from a two-notch uplift from its standalone credit assessment. 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.

Unless otherwise stated, all figures shown are from the bank's latest annual and interim financial reports.

Rating Drivers

- Sparebanken Sør benefits from a robust local retail franchise in southern Norway.

- The bank's asset quality is currently sound, but substantial exposure to the real estate sector poses downside risks.

- Recent improvements in risk management practices are credit positive.

- Despite its sizeable deposit base, the bank exhibits high reliance on market funding.

- We see room for further retail lending margin improvement, which will help top-line profitability.

- Capital levels are good; the recent conversion to EC adds flexibility.

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

Upward rating momentum could arise from: (1) a sustainable improvement in the bank's efficiency and profitability metrics; (2) a reduction in the loan book concentration and/or (3) further bolstering of its liquidity position and continued good access to capital markets.

What Could Change the Rating - Down

The rating could face downward pressure if there is: (1) a deterioration in asset quality or capitalisation that exceeds Moody's expectations; (2) an increase in the bank's risk profile, for example as a result of increased exposures to more volatile sectors; and/or (3) any sign that the bank is unable to sustain its market positions. In addition, we believe that downward pressure could be exerted on the ratings due to external factors, such as less supportive macroeconomic environment and/or substantially adverse developments in the Norwegian real-estate market.

RECENT CREDIT DEVELOPMENTS

On 12 March 2013, Sparebanken Sør and Sparebanken Pluss (A2 stable, C-/baa1 stable) announced that they intend to merge their operations. The transaction is contingent on approval from the two banks' Boards of Trustees, expected by June 2013, and regulatory approvals. The merger is expected to be effective by 1 January 2014.

Sparebanken Sør and Sparebanken Pluss are two similar-sized banks, operating in southern Norway, where they are major players in retail and SME lending, with reported total assets of NOK44.5 billion and NOK44.1 billion at year-end 2012, respectively. If the transaction proceeds, we expect the combined bank's rating to be close to the rating level of the two individual banks, i.e., A3 for Sparebanken Sør and A2 for Sparebanken Pluss, although we will also factor in our assessment of the risks related to the integration process.

For more details, please see Moody's Comments on the Intended Merger of Sparebanken Sør and Sparebanken Pluss: http://www.moodys.com/research/Moodys-Comments-on-the-Intended-Merger-of-Sparebanken-Sr-and-Issuer-Comment--PBC_151607

DETAILED RATING CONSIDERATIONS

FRANCHISE VALUE - ROBUST LOCAL RETAIL FRANCHISE IN SOUTHERN NORWAY

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% (based on total lending and deposits by county and nationwide according to Statistics Norway).

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), investment (Norne Securities, 14.8% ownership) and leasing (Brage Finans, 14% ownership) products. In addition, Sparebanken Sør owns a real estate brokerage subsidiary (ABCenter).

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.

ASSET QUALITY - SOUND, BUT DOWNSIDE RISKS FROM SUBSTANTIAL EXPOSURE TO THE REAL ESTATE SECTOR; IMPROVING RISK MANAGEMENT PRACTICES

Sparebanken Sør's problem loans (defined as commitments in default and other bad and doubtful commitments) accounted for 1.6% of gross loans at year-end 2012, a decrease from 1.9% at year-end 2011.

Whilst this metric shows sound asset quality, Sparebanken Sor's substantial exposure to the real estate and constructions sectors (around 20% of gross loans at year-end 2012), which have generated a significant part of the bank's problem loans in recent years, poses downside risks to future loan book performance. In addition, the bank's corporate loan book exhibits significant borrower concentration, which could accelerate the extent and pace of any deterioration in asset quality.

The main part of Sparebanken Sør's loan book is retail loans, mostly in the form of mortgages (around 70% of gross loans at year-end 2012, including those transferred its wholly-owned covered bond company, Sør Boligkreditt). This asset class has been more resilient historically but we believe that its performance could be undermined by less favourable interest rate and house price levels - especially given households' high indebtedness and as the mortgage loans retained by the parent company have higher loan-to-value ratios than those transferred to the bank's covered bond subsidiary. In addition, high loan growth in recent years (2012: +9.6%; 2011: +8.4%), particularly in retail banking, has resulted in a somewhat unseasoned loan portfolio.

Limitations in risk management practices - e.g. in terms of credit risk modelling and stress testing - and past control issues have been constraining factors in our assessment of the bank's risk positioning. However, we note that Sparebanken Sør's management has focused on improving the bank's risk management practices in recent years (ongoing process to receive regulatory approval to calculate credit risk under IRB is part of these efforts). Whilst these developments are clearly credit positive in our view as they provide the bank with enhanced tools for the prevention and early detection of problems, we note that these risk management procedures are newly implemented and their effectiveness remains to be proven.

LIQUIDITY - HIGH RELIANCE ON MARKET FUNDING

Sparebanken Sør's liquidity is underpinned by a strong deposit base, which accounted for around half of its total funding at year-end 2012, and comprised around 60% of retail deposits.

Nevertheless, deposits covered only around 60% of gross loans at year-end 2012, evidencing the bank's reliance on market funds. Positively, the average maturity of new long-term funds increased to 4.8 years in 2012 from 3.9 years in 2011. Covered bonds have been a growing source of funding since December 2008, when the bank's wholly-owned covered bond company, Sør Boligkreditt, was established. At year-end 2012, retail mortgages totalling around NOK9 billion (or 24% of Sparebanken Sør's loan book) were transferred to the company's cover pool. Moody's cautions that extensive use of covered bond funding results in the structural subordination of Sparebanken Sør unsecured creditors, including depositors.

Sparebanken Sør enjoyed a liquidity buffer of approximately NOK6.4 billion or 14% of total assets at year-end 2012 and comprised cash and deposits with the central bank and the securities portfolio, which mainly includes covered bonds, government and local government bonds, 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.

PROFITABILITY - ROOM FOR FURTHER RETAIL LENDING MARGIN IMPROVEMENT

Sparebanken Sør is reliant on net interest income, which represented over 80% of its operating income at year-end 2012. This source of income grew by around 12% during the year, supported by brisk loan growth (almost 10% year-on-year) and somewhat increased lending margins which more than offset the pressure on deposit margins. In our view, there is room for further margin improvement, as a general repricing movement is under way in the Norwegian banking market in light of expectations of increased regulatory capital requirements.

Fee and commission income also increased during the year (+14%), mainly due to payment services and sales of insurance products, and represented around 20% of 2012 core banking revenue. Net income from financial investments has brought some volatility to the bank's bottom-line and was the primary reason for the somewhat reduced operating income in 2012 compared to 2011.

Operating costs have grown faster than operating income, resulting in a higher 2012 cost-to-income ratio at 62%; most of the increase in costs stem from personal costs. Nevertheless, the ratio of cost-to-total assets has increased only marginally and stood at 1.15% in 2012.

CAPITAL - AT GOOD LEVELS; CONVERSION TO EC IS CREDIT POSITIVE IN OUR VIEW

Sparebanken Sør has good capital levels in our views. At year-end 2012, the bank's Tier 1 ratio stood at 14.1% (standardised approach).This ratio compares well with other Moody's-rated Norwegian savings banks and is above the management's target of 12%. Its common equity Tier 1 ratio of 13.3% at year-end 2012 is also above the 9% minimum required by the Norwegian regulator since end-June 2012. The bank does not have Tier 2 supplementary capital, since it repaid a NOK300 million subordinated loan in Q1 2012.

Furthermore, during Q4 2012 NOK600 million of primary capital in the bank's Savings Bank Fund were converted to Equity Certificates (EC). The EC were issued to Sparebankstiftelsen Sparebank Sør which was established in connection with the conversion. In our view, the conversion to EC is credit positive as it gives the bank increased flexibility and new opportunities to raise capital when needed.

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 standalone credit assessment 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 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)			2.03%				
Net Income % Average RWA (Basel II)			1.21%				
Factor: Liquidity						**E**	**Weakening**
(Market Funds - Liquid Assets) % Total Assets					28.50%		
Liquidity Management					x		
Factor: Capital Adequacy						**A**	**Neutral**
Tier 1 Ratio (%) (Basel II)	14.10%						
Tangible Common Equity % RWA (Basel II)	13.50%						
Factor: Efficiency						**B**	**Neutral**
Cost / Income Ratio		53.90%					
Factor: Asset Quality						**B**	**Weakening**
Problem Loans % Gross Loans		1.77%					
Problem Loans % (Equity + LLR)		18.46%					
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						**baa2**	

[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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