

Credit Opinion: Sparebanken Sor

Global Credit Research - 19 May 2015

Kristiansand, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A1/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1

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Key Indicators

Sparebanken Sor (Consolidated Financials)[1]

	[2]12-14	[2]12-13	[2]12-12	Avg.
Total Assets (NOK billion)	94.1	45.8	44.1	[3]46.0
Total Assets (EUR million)	10,367.9	5,473.7	6,013.5	[3]31.3
Total Assets (USD million)	12,545.7	7,542.5	7,928.1	[3]25.8
Tangible Common Equity (NOK billion)	7.1	3.1	2.8	[3]59.3
Tangible Common Equity (EUR million)	786.7	371.1	383.1	[3]43.3
Tangible Common Equity (USD million)	951.9	511.3	505.1	[3]37.3
Problem Loans / Gross Loans (%)	1.8	0.8	0.6	[4]1.1
Tangible Common Equity / Risk Weighted Assets (%)	13.2	12.0	11.4	[5]12.2
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	18.4	9.3	7.2	[4]11.6
Net Interest Margin (%)	1.8	1.4	1.3	[4]1.5
PPI / Average RWA (%)	2.3	1.7	1.8	[5]1.9
Net Income / Tangible Assets (%)	0.9	0.7	0.7	[4]0.7
Cost / Income Ratio (%)	43.2	38.1	37.0	[4]39.4
Market Funds / Tangible Banking Assets (%)	39.2	44.2	47.5	[4]43.6
Liquid Banking Assets / Tangible Banking Assets (%)	12.3	15.9	17.8	[4]15.3
Gross Loans / Total Deposits (%)	167.1	163.8	144.7	[4]158.5

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 11 May we upgraded Sparebanken Sor's long-term deposit rating to A1 from A2. We also affirmed the bank's

baa1 baseline credit assessment (BCA), baa1 adjusted BCA and Prime 1 short-term rating.

The affirmation of the bank's baa1 BCA reflects our view that, with the increase in scale following its merger between Sparebanken Sor and 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 from the merged entity, including a comprehensive review of the corporate portfolio that resulted in write-downs on individual loans. The upgrade of the bank's deposit rating takes into account the Loss Given Failure (LGF) analysis of the bank's own volume of deposits and senior unsecured debt, and the volume of securities subordinated to them, which reduces the severity of the decrease in government support assumptions.

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 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 stable outlooks on the bank's long-term senior debt and deposit ratings reflect our view that the bank's financials will remain broadly resilient in the face of a modest slowdown in Norway's still strong economic performance.

What Could Change the Rating - Up

An upgrade of Sparebanken Sor's 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

Future downward rating pressure could follow (1) indications that the 2013 merger between Sparebanken Pluss and Sparebanken Sor 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 and/or (3) deterioration in the macroeconomic environment, more than estimated, leading to adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

ADEQUATE CAPITAL LEVELS

At end-March 2015, Sparebanken Sor had a tangible common equity (TCE) ratio of 13.16% according to the standard method under Basel II. 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 1.7% at end-March 2015, which is above the Norwegian average. Since the merger between Sparebanken Pluss and Sparebanken Sor in 2013, the merged 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. Our 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.

Sparebanken 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 size, Sparebanken Sor will have the capacity to make larger benchmark issuance and thus fully benefit from the depth of the markets. Our 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 to implement the EU Bank Resolution and Recovery Directive (BRRD). 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.

Our upgrade of Sparebanken Sor's long-term deposit ratings has considered the likely impact on loss-given-failure of the combination of their own volume and the amount of debt subordinated to them. This has resulted 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).

We regard the probability of government support for debt and deposits as moderate which results in one notch of 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

SparebankenSor

Macro Factors	
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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						
<i>Problem Loans / Gross Loans</i>	1.8%	aa3	← →	baa1	Geographical concentration	Single name concentration
Capital						
<i>TCE / RWA</i>	13.2%	a2	← →	a2		
Profitability						
<i>Net Income / Tangible Assets</i>	0.7%	baa2	← →	baa2	Expected trend	
Combined Solvency Score		a2		a3		
Liquidity						
Funding Structure						
<i>Market Funds / Tangible Banking Assets</i>	39.2%	ba2	← →	ba2	Extent of market funding reliance	
Liquid Resources						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	12.3%	baa3	← →	baa3	Stock of liquid assets	
Combined Liquidity Score		ba1		ba1		

Financial Profile	baa1
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Qualitative Adjustments	Adjustment
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	0

Sovereign or Affiliate constraint	Aaa
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Scorecard Calculated BCA range	a3 - baa2
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Assigned BCA	baa1
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Affiliate Support notching	0
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Adjusted BCA	baa1
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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	0	A1	A1
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