MOODY'S
INVESTORS SERVICE

Credit Opinion: Sparebanken Sor

Global Credit Research - 15 Jan 2016

Kristiansand, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
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]**9-15**	[2]**12-14**	[2]**12-13**	[2]**12-12**	[2]**12-11**	**Avg.**
Total Assets (NOK billion)	**99.4**	**94.1**	**45.8**	**44.1**	**40.5**	[3]**25.2**
Total Assets (EUR million)	**10,442.5**	**10,367.9**	**5,473.7**	**6,013.5**	**5,229.1**	[3]**18.9**
Total Assets (USD million)	**11,656.4**	**12,545.7**	**7,542.5**	**7,928.1**	**6,788.1**	[3]**14.5**
Tangible Common Equity (NOK billion)	**7.5**	**7.1**	**3.1**	**2.8**	**2.6**	[3]**30.9**
Tangible Common Equity (EUR million)	**792.6**	**786.7**	**371.1**	**383.1**	**332.2**	[3]**24.3**
Tangible Common Equity (USD million)	**884.8**	**951.9**	**511.3**	**505.1**	**431.3**	[3]**19.7**
Problem Loans / Gross Loans (%)	**1.5**	**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) (%)	**15.8**	**18.4**	**9.3**	**7.2**	**6.7**	[4]**11.5**
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**	**0.7**	**0.7**	**0.5**	[4]**0.6**
Cost / Income Ratio (%)	**46.4**	**43.2**	**38.1**	**37.0**	**43.3**	[4]**41.6**
Market Funds / Tangible Banking Assets (%)	**30.1**	**30.1**	**32.0**	**36.8**	**52.9**	[4]**36.4**
Liquid Banking Assets / Tangible Banking Assets (%)	**12.7**	**12.3**	**15.9**	**17.8**	**16.6**	[4]**15.1**
Gross loans / Due to customers (%)	**175.9**	**169.2**	**179.4**	**184.3**	**217.7**	[4]**185.3**

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

Moody's assigns Sparebanken Sor a baa1 baseline credit assessment (BCA), an A1 long-term issuer rating, an A1 long-term deposit rating and a short-term obligation rating of Prime 1. We also assign a Counterparty Risk Assessment (CRA) 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 the 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, including a comprehensive review of the corporate portfolio that resulted in write-downs on individual loans. The deposit rating and issuer rating takes 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.

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 exceed 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 deposit volumes

- 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 stable outlooks on the bank's long-term issuer 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 bank's loan-book concentrations; and/or (3) a bolstered liquidity position and continued good access to capital markets; (3) a bolstered liquidity position and continued good access to capital markets

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 concentration as a percentage of Core Tier 1 Capital above 150%; (3) a reduction in the bank's profitability, with net profits falling below 0.5% of tangible assets; and/or (4) a more than currently anticipated deterioration in the macroeconomic environment, leading to a weaker Macro Profile. 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. 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% (12.6% when including a share of the profit for the period). In the third quarter of 2015 Norway's FSA comunicated its expectations that Sparebanken Sør should target a Core Tier 1 capital ratio of 14.5% by the end of 2016 following a risk and capitalization assessment. Sparebanken Sor aims to meet the target through continued improvement of results from normal operations, reduced lending growth or potentially other balance sheet adjustments. Although capital is a relative strength for Sparebanken Sor, additionally demonstrated by the bank's tangible common equity-to-tangible banking assets ratio of 8%, we believe that the bank will not be able to reach this target purely through capital retention and lower loan growth. While we see the likelihood of a rights issue as high, we reflect the uncertainty around this through a negative adjustment in the Capital score.

PROBLEM LOANS EXCEED DOMESTIC PEERS FOLLOWING PORTFOLIO REVIEW

Sparebanken Sor's problem loan ratio (impaired loans as a percentage of total loans) amounted to 1.5% at end-September 2015, improved from around 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 the corporate portfolio in 2014, which identified individual losses as well as a number of loss events which, when viewed in context, resulted in individual write-downs of individual loans. Our Asset Risk score indicates that, overall, the bank's risk management remains a relative strength for Sparebanken Sor; but, it also reflects 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, representing over 66% of the total loan book at end-December 2014. This asset class has been more resilient historically, but we consider its performance as sensitive to interest rate rises and/or a decline in house prices.

Sparbanken 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 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 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. The bank announced plans for further reductions in the mortgage interest rate following reductions in the reference rate from the Central bank. 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 a cost-to-income ratio at 46.4% at end-September 2015 (43.2% in 2014 adjusted for merger costs). 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 2015-16.

Sparebanken Sor reported a NOK475 million profit for the nine months of 2015, slightly lower compared to the same period in 2014 (NOK501 million) albeit with lower loan losses at 0.08% of net loans compared to 0.42% the year before. Its net income-to-tangible assets ratio was at 0.64% at end-September 2015 (0.73% at end 2014), due to lower income from financial isntruments held to maturity; however, 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 (by 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 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. However, we do not expect that, in terms of size, Sparebanken Sor will have the capacity to make larger benchmark issuance and so 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, 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 (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 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 its 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.

Sparebanken Sor's long-term deposit ratings has considered the likely impact on loss-given-failure of the combination of the volume and the amount of debt subordinated to the deposits. This has a resulted in Preliminary Rating Assessment 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.

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

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 NOK 99.4 billion at end September (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).

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

Macro Factors	
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						
Problem Loans / Gross Loans	1.5%	aa3	↑	a3	Geographical concentration	Single name concentration
Capital						
TCE / RWA	12.8%	a2	←→	a3	Risk-weighted capitalisation	Stress capital resilience
Profitability						
Net Income / Tangible Assets	0.6%	baa2	←→	baa2	Expected trend	
Combined Solvency Score		a2		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	30.1%	baa3	←→	ba2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	12.3%	baa3	←→	baa3	Stock of liquid assets	
Combined Liquidity Score		baa3		ba1		

Financial Profile	**baa1**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

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

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

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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