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19 February 2016

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RATINGS

Sparebanken Sor

LT/ST Bank Deposits	A1/P-1
BCA/Adj BCA	baa1/baa1
Covered Bond Program	Aaa

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Sparebanken Sor

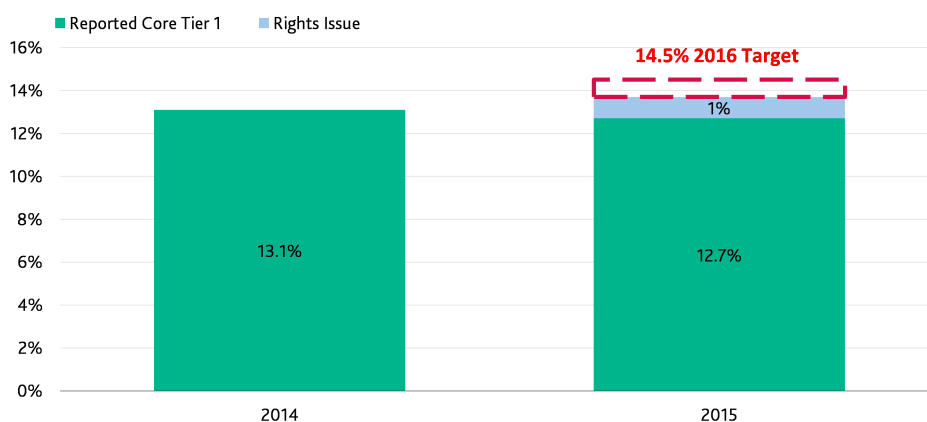
Rights Issue Is Credit Positive but Insufficient to Meet Capital Targets

On 10 February, [Sparebanken Sor](#) (A1 stable, baa1)¹ announced an approximately NOK600 million rights issue to meet Norway's increased capital requirements. The credit-positive rights issue will increase the bank's core equity Tier 1 capital ratio by approximately 1 percentage point to 13.7%, as of 31 December 2015. However, the rights issue on its own will be insufficient to meet a 14.5% capital ratio by the end of 2016 as expected by Norway's Financial Supervisory Authority, which will compel Sparebanken Sor to improve profitability as well as reduce growth in risk-weighted assets, both of which will challenge the bank.

We estimate that growth in risk-weighted assets would have to be limited to 1%-2% in 2016 to achieve the capital target, a significant reduction from Sparebanken Sor's 12% growth in 2015. This takes into account our expectations that net interest margins will remain under pressure as the central bank continues to cut interest rates, wholesale funding costs will not improve from current levels, and loan loss provisions will increase.

Exhibit 1

Sparebanken Sor's Core Equity Tier 1 Ratio With and Without Rights Issue



Source: Company Reports

During 2015, the bank grew its loan portfolio at 9.2%, faster than the Norwegian banking system at 7.1% growth. The retail portfolio grew by 7.7% and corporate lending expanded by 12.2%. Lending was focused on strategically important clients, but resulted in strong growth in risk-weighted assets. As a result, the bank's core Tier 1 capital ratio decreased to 12.7% at the end of 2015 from 13.1% in 2014 (see Exhibit). We expect the bank to constrain 2016 risk-weighted assets growth by a combination of reducing loan growth as well as asset optimisation, such as reducing non-used but capital-absorbing commitments on flexible loans.

Sparebanken Sor's net income to tangible banking assets ratio declined to 0.61% at the end of December 2015, from 0.73% in 2014, mainly because of mark-to-market losses on financial instruments held in the bank's liquidity portfolio. Similar to other Norwegian banks we rate, Sparebanken Sor relies on market funding (equal to 42% of tangible assets at the end of December 2015), which renders the bank vulnerable to changes in investor sentiment.

Profitability will be further pressured by increases in market funding rates affecting net interest margins. Spreads on Norwegian bank bonds have on average doubled during the second half of 2015, and we do not expect them to decrease over the next 6-12 months, which will particularly pressure banks that rely completely on the domestic market to fulfil their refinancing needs. Sparebanken Sor currently issues debt only in the domestic market, but we expect the bank to diversify funding by utilizing its European Medium-Term Covered Bond Programme, set up in third-quarter 2015, and benefit from a wider investor base.

The rights issue is fully subscribed; the Sparebankstiftelsen Sparebanken Sor has pre-subscribed to ensure it maintains its 51% ownership share. The rights issue is subject to approval from the bank's supervisory board, and requires approval from the Norwegian Financial Supervisory Authority and the new equity certificates are expected to be listed in April 2016.

Peer Group:

- » [DNB Bank ASA](#)
- » [SpareBank 1 Nord Norge](#)
- » [SpareBank 1 SMN](#)
- » [Sparebanken Vest](#)
- » [Sparebanken More](#)
- » [Sparebanken Oest](#)
- » [Sparebanken Sogn og Fjordane](#)
- » [Helgeland Sparebank](#)
- » [Fana Sparebank](#)
- » [Sparebanken Hedmark](#)
- » [Sparebank 1 SR](#)

Credit Opinions:

- » [SpareBank 1 SR](#)
- » [DNB ASA](#)
- » [SpareBank 1 Nord-Norge](#)
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Methodologies Used:

- » [Banks](#)

Moody's Related Research

- » [Norway Banking System Outlook](#)
- » [Norway Banking System Profile](#)
- » [Norway Macro Profile: Very Strong -](#)
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Endnotes

¹ The bank ratings shown are Sparebanken Sor's deposit rating and baseline credit assessment.

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REPORT NUMBER 1017235

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