MOODY'S
INVESTORS SERVICE

CREDIT OPINION
9 January 2018

Update

Rate this Research

RATINGS

Sparebanken Sor

Domicile	Kristiansand, Norway
Long Term Debt	(P)A1
Type	Senior Unsecured MTN - Fgn Curr
Long Term Deposit	A1
Type	LT Bank Deposits - Fgn Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Sparebanken Sor

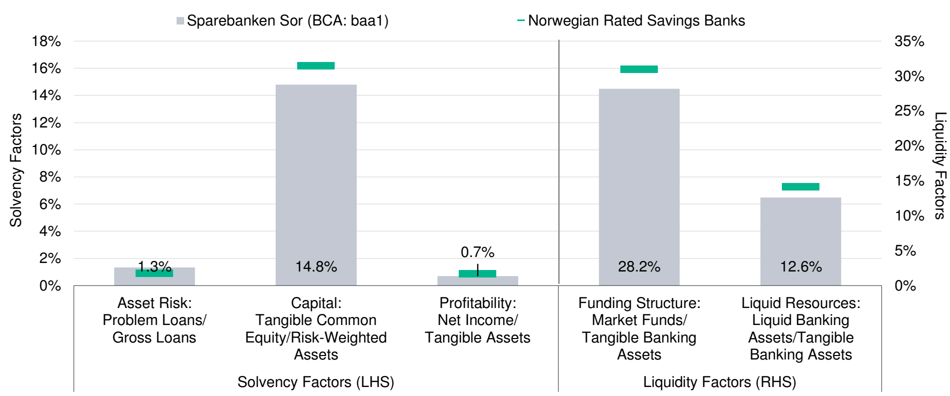
Update to Credit Analysis

Summary

Sparebanken Sor's baa1 BCA reflects its strong asset quality metrics, with ratios of non-performing loans (NPLs) to gross loans of 0.93% and Loan Loss Reserves (LLRs) to NPLs of 66% as of September 2017. The bank's baa1 BCA also captures the increase in Sparebanken Sor's capital buffers which reached 14.7% as of September 2017 from 13.6% in September 2016. Finally the bank's baa1 BCA incorporates its moderate profitability with a 0.8% return on assets and its high reliance on market funding, a common attribute of Norwegian banks, with market funds adjusted to exclude 50% of covered bonds accounting for 27.9% of tangible assets as of September 2017.

The bank's A1 deposit and issuer ratings take into account our Loss Given Failure (LGF) analysis of the bank's liability structure. Sparebanken Sor benefits from a large volume of deposits and substantial layers of subordination, resulting in very low LGF and providing two notches of rating uplift from its BCA. In addition, the bank's A1 rating also incorporates one notch of rating uplift due to government support, although this is likely to be revised downwards following the implementation of BRRD in Norway (please see press release for more details).

Exhibit 1
Rating Scorecard- Key Financial Ratios



Note: Average of other Moody's rated Norwegian savings banks is based on latest available financial data
Source: Moody's Banking Financial Metrics

Credit strengths

» Sparebanken Sor's BCA is supported by its Very Strong - Macro Profile

» Improved capital levels driven by higher regulatory targets

» Sparebanken Sor's asset quality metrics have been resilient and broadly in line with domestic peers

» Large volume of deposits and debt result in a two notch uplift to the deposits and issuer ratings

Credit challenges

» Despite resilient loan book performance, high single borrower and sector loan concentration increases asset risk

» Reliance on market funding renders the bank vulnerable to fluctuations in investor sentiment

» Profitability is supported by efficient operations, though pressure in the bank's core earnings could persist

Rating outlook

Sparebanken Sor's deposit and issuer ratings carry a negative outlook to reflect the potential rating pressure from the upcoming implementation of BRRD in Norway, which will trigger a reassessment of our government support assumptions for all large savings, including Sparebanken Sor.

Factors that could lead to an upgrade

» Over time, upward pressure could develop if the bank demonstrates a combination of: (1) reduced exposure to more volatile sectors such as construction and real estate sectors; (2) sustained strong asset quality and (3) a strengthening in core earnings generation.

Factors that could lead to a downgrade

» Downward rating pressure would develop on Sparebanken Sor's ratings if: (1) the bank's NPLs were to be expected to increase substantially, above our system-wide expectation of approximately 2%; (2) its profitability were to deteriorate materially from its current level and/or (3) the macroeconomic environment weakens meaningfully. Also, any change in the liability structure of the bank that would cause a reduction in the rating uplift under Moody's LGF analysis or, similarly, a revision of the government support assumptions, could lead to downward rating pressure.

Note: The numbers presented in the Key Indicators Exhibit below for the years 2013 and 2012 are for Sparebanken Pluss before its merger with Sparebanken Sor

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 www.moodys.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2

Sparebanken Sor (Consolidated Financials) [1]

	9-17[2]	12-16[2]	12-15[2]	12-14[2]	12-13[2]	CAGR/Avg.[3]
Total Assets (NOK billion)	111	105	101	94	46	26.8[4]
Total Assets (EUR million)	11,829	11,615	10,539	10,368	5,474	22.8[4]
Total Assets (USD million)	13,984	12,251	11,448	12,546	7,542	17.9[4]
Tangible Common Equity (NOK billion)	9.7	9.2	7.7	7.1	3.1	35.6[4]
Tangible Common Equity (EUR million)	1,034	1,014	805	787	371	31.4[4]
Tangible Common Equity (USD million)	1,222	1,069	874	952	511	26.2[4]
Problem Loans / Gross Loans (%)	0.9	1.0	1.4	2.0	0.9	1.2[5]
Tangible Common Equity / Risk Weighted Assets (%)	14.8	14.8	12.8	13.2	12.0	13.5[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	8.7	9.3	14.3	21.0	10.8	12.8[5]
Net Interest Margin (%)	1.5	1.5	1.6	1.8	1.4	1.5[5]
PPI / Average RWA (%)	1.8	2.0	1.7	2.3	1.7	1.9[6]
Net Income / Tangible Assets (%)	0.8	0.9	0.6	0.7	0.6	0.7[5]
Cost / Income Ratio (%)	40.7	40.1	45.9	43.0	38.1	41.5[5]
Market Funds / Tangible Banking Assets (%)	27.9	28.2	31.5	30.1	32.0	29.9[5]
Liquid Banking Assets / Tangible Banking Assets (%)	12.7	12.6	11.4	12.3	15.9	13.0[5]
Gross Loans / Due to Customers (%)	176.9	177.5	184.3	169.2	179.4	177.5[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] May include rounding differences due to scale of reported amounts [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [5] Simple average of periods presented for the latest accounting regime. [6] Simple average of Basel II periods presented

Source: Moody's Financial Metrics

Profile

Sparebanken Sør is a regional Norwegian bank, which provides retail and corporate banking services to individuals, companies and public authorities in the counties of Vest-Agder, Aust-Agder, Telemark and Rogaland. Its products include financing, savings facilities, placements, insurance, pensions and payment facilities. Sparebanken Sør is currently the sixth largest bank in Norway and reported total consolidated assets of NOK111 billion (€11.8 billion), as of 30 September 2017.

Detailed credit considerations

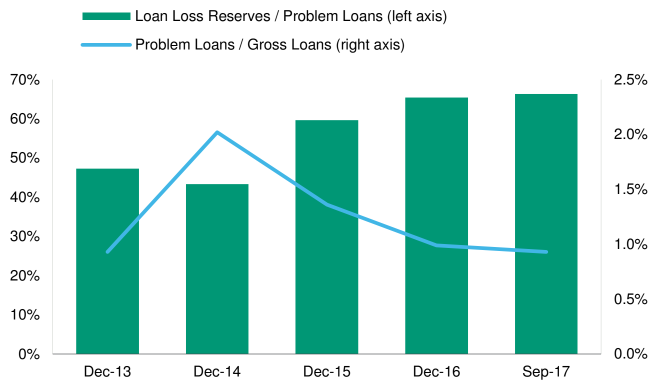
Sparebanken Sor's BCA is supported by its very strong- macro profile

Sparebanken Sor's operations are entirely in Norway. As a result we apply the Very Strong- Macro Profile we have assigned to banks operating in Norway. Banks in Norway benefit from operating in a wealthy and developed country with very high economic, institutional and government financial strength, as well as low susceptibility to event risk. Norway has a diversified and growing economy, which demonstrates resilience to the ongoing weakness in the oil sector. The main risks to the system stem from a high level of household indebtedness, elevated real estate prices and domestic banks' reliance on market funding. However, these risks are mitigated by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared to the total size of the economy.

Resilient asset quality with problem loans metrics in line with domestic peers, although concentrations elevate asset risk

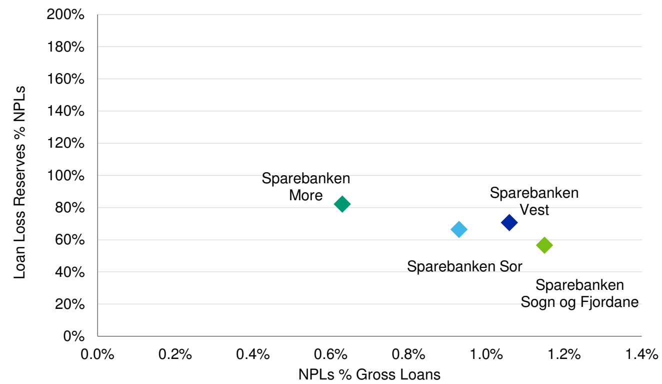
Sparebanken Sor's problem loan ratio (impaired loans as a percentage of total loans) continued to improve during 2017 reaching 0.93% at end-September (0.99% at end-December 2016) in line with its Norwegian peers' average. Following the merger between Sparebanken Pluss and Sparebanken Sor in 2013, the new merged bank took several actions to improve its credit quality and limit future losses. The bank carried out a comprehensive review of its corporate portfolio in 2014 which resulted in individual write-downs of loans and a spike in credit costs to 0.37% of average gross loans in FY2014 from 0.08% in FY2013. However, Sparebanken Sor's credit costs normalised to 0.11% of average gross loans for FY2015 and declined further to 0.06% for FY2016, and 0.05% as of September 2017. Sor's NPLs coverage at 66% as of September 2017 compares well with peers.

Exhibit 3
Sparebanken Sor's Asset Quality metrics have been resilient



Source: Moody's Financial Metrics, Sparebanken Sor

Exhibit 4
..and in line with similarly rated domestic peers



Note: Data as of September 2017
Source: Moody's Financial Metrics

Sparebanken Sor's loan book is dominated by retail loans, mostly in the form of mortgages, which represent around 65% of the total loan book at end-September 2017, an asset class that has been more resilient historically. However, Sparebanken Sor's significant concentration to the real-estate and construction sectors poses downside risks to future loan book performance. Furthermore, the bank's business book exposes significant single-borrower concentrations making the bank vulnerable to a potential default of one of its large customers. Our adjustment to the bank's asset risk score by four notches to a3 captures these concentration risks.

Profitability is supported by efficient operations and reduced funding costs, though core earnings pressure could persist

Sparebanken Sor reported a 6% year-on-year decrease in net profit and a 9% return on equity after tax in the first nine months of 2017, which also decreased compared to 11.1% in the first nine months of 2016 (11.3% full-year 2016). This decrease is largely explained by lower income from financial instruments, as the bank benefitted from one off gains in 2016, while the bank's core profitability improved marginally during 2017 due to loan repricing and reduced funding and credit costs. Sparebanken Sor's profitability was also supported by its best-in-class cost-to-income ratio of 40.7% in the first nine months of 2017 (40.1% in September 2016 and 40.1% in 2016)[1]

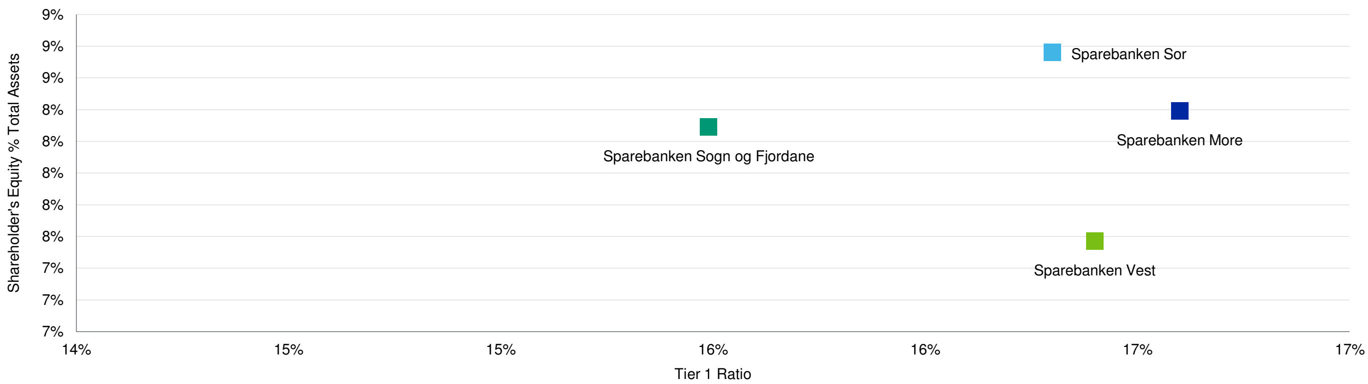
Sparebanken Sor relies on stable income from lending: net interest income represented around 82% of net revenue as of September 2017. This source of income increased compared to the first nine months of 2016, which is also reflected in the bank's net interest income to average assets of 1.53% for the first nine months of 2017 (1.47% in the first nine months of 2016). Lending margins have increased during 2017, as mortgage interest rates increased by around 0.30%. The bank's net interest income will likely be supported by strong loan growth going forward, enabled by the bank's higher capital base. The reported twelve month loan growth as of September 2017 increased to 6.6% compared to 5.5% as of September 2016. However, downside risks to core earnings generation remain as competition may push asset yields lower or the bank's business growth may remain subdued.

Improved capital levels driven by higher regulatory targets

Sparebanken Sor's capitalisation continued to improve and CET1 ratio increased to 14.7% as of September 2017 from 13.6% at September 2016. The CET1 ratio is already in-line with the bank's target ratio between 14.5% and 15% and regulatory minimum of 14.1% (including a 2.1% Pillar 2 requirement), effective as of 31 December 2017.

The bank strengthened its CET 1 capital mainly through earnings retention and limited growth in risk weighted assets. Sparebanken Sor's total regulatory capital ratio increased to 18.1% in September 2017 compared to 16.9% in September 2016. We note that the bank is the only one of the large regional banks in Norway that currently applies the standard method in its capital calculations. At the end of November 2017, Sparebanken Sor announced its intention to apply for approval to use the IRB approach. The bank expects to send its application to the Norwegian FSA before the end of 2019.

Exhibit 5
Capital levels have improved and compare favorably with peers



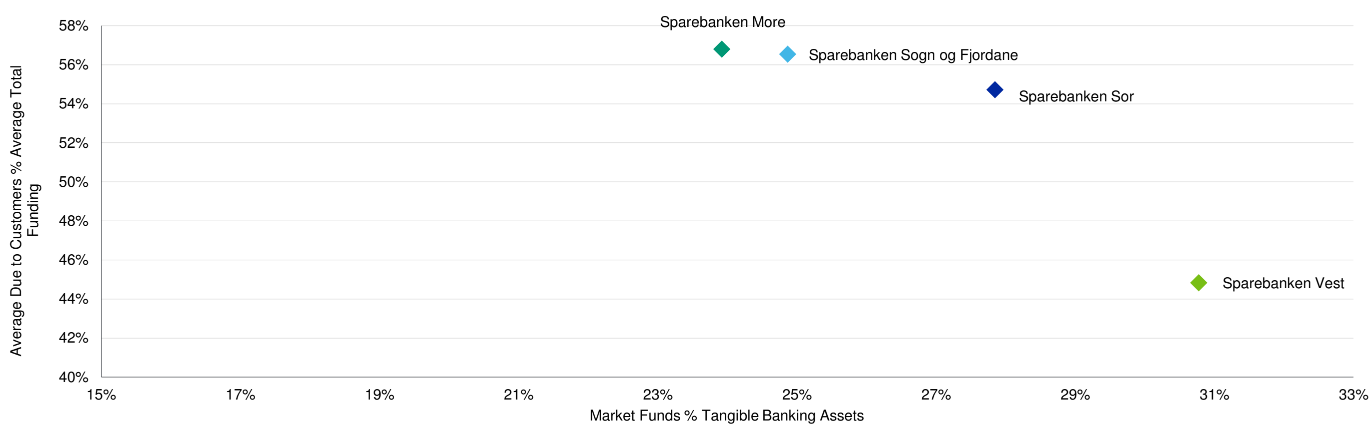
Note: Data as of September 2017, Sparebanken Sor and Sparebanken Sogn og Fjordane use the standardised method while Sparebanken More and Sparebanken Vest use the Internal Ratings Based Approach for their risk weighted assets and capital calculation.
Source: Moody's Financial Metrics, Sparebanken Sor

Reliance on market funding renders the bank vulnerable to fluctuations in investor sentiment

Sparebanken Sor's funding is underpinned by a strong deposit base, which was stable at 54% of non-equity funding as of September 2017. Nevertheless, the bank remains reliant on market funding, which accounted for around 27.9% of tangible banking assets as of September 2017 (28.2% as of December 2016), and which renders the bank susceptible to changes in investor behaviour. While Sparebanken Sor has good access to the domestic capital markets, we expect that the bank will continue accessing the international markets in order to expand its investor base beyond the more limited and concentrated domestic market.

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. Based on our methodology, we reflect the stability of covered bonds relative to unsecured market funding through an adjustment to our market funds to tangible assets ratio. In 2016 Sparebanken Sor made its first international larger benchmark issuance through its fully owned covered bond company Sparebanken Sor Boligkreditt and in May 2017, the bank carried out another successful Euro benchmark issuance. We believe the bank will benefit from the depth of the markets, increasing its potential investor base and mitigating its refinancing risk. Our Funding Structure score reflects that the bank's overall funding profile remains a fundamental weakness for Sparebanken Sor relative to the other scorecard metrics.

Exhibit 6



Note: Data as of September 2017
Source: Moody's Financial Metrics

Sparebanken Sor also maintains sizeable buffers of high quality liquid assets. As of September 2017, liquid assets accounted for around 12.7% of tangible assets (12.6% as of December 2016), 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, other public entities and 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 bank's currency exposure.

Support and structural considerations

Loss given failure

We expect that Norway will shortly pass the recently proposed legislation to cover the EU's Bank Recovery and Resolution Directive (BRRD) confirming our current assumptions regarding 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” wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These metrics are in line with our standard assumptions.

Under these assumptions, Sparebanken Sor's deposits and issuer ratings are likely to face very low loss-given-failure, due to the volume of the deposits and senior debt themselves and the amount of debt subordinated to them. This results in a Preliminary Rating Assessment (PRA) two notches above the BCA.

Government support

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 24% for lending and around 30% for deposits. Headquartered in Kristiansand, Norway, Sparebanken Sor is the sixth-largest savings bank in Norway with reported total assets of NOK111.3 billion at end-September 2017 (NOK105.5 billion at end December 2016). 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 Sparebanken Sor's debt and deposits as moderate, which results in one notch of rating uplift.

However, the expected implementation of an official resolution regime in Norway in the coming months, might cause us to reconsider/ lower our government support assumptions for all rated savings banks in Norway, including Sparebanken Sor.

Counterparty risk assessment

Sparebanken Sor's CR Assessment is positioned at Aa3(cr)/P-1(cr).

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 methodology and scorecard factors

Exhibit 7

Sparebanken Sor

Macro Factors		
Weighted Macro Profile	**Very Strong -**	**100%**

Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.3%	aa2	↓	a3	Geographical concentration	
Capital						
TCE / RWA	14.8%	aa3	←→	a1	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.7%	baa2	↓	baa2	Expected trend	
Combined Solvency Score		a1		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	28.2%	baa2	←→	baa2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	12.6%	baa3	←→	baa3	Stock of liquid assets	
Combined Liquidity Score		baa2		baa2		
Financial Profile				baa1		
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		

Balance Sheet	**in-scope (NOK million)**	**% in-scope**	**at-failure (NOK million)**	**% at-failure**
Other liabilities	35,514	31.9%	41,084	36.9%
Deposits	54,605	49.1%	49,035	44.1%
Preferred deposits	40,408	36.3%	38,387	34.5%
Junior Deposits	14,197	12.8%	10,648	9.6%
Senior unsecured bank debt	16,627	14.9%	16,627	14.9%
Dated subordinated bank debt	1,203	1.1%	1,203	1.1%
Equity	3,339	3.0%	3,339	3.0%
Total Tangible Banking Assets	111,288	100%	111,288	100%

Debt class	De Jure waterfall		De Facto waterfall		Notching		LGF Notching Guidance vs. Adjusted BCA	Assigned LGF notching	Additional notching	Preliminary Rating Assessment
	Instrument volume + subordination	Sub-ordination	Instrument volume + subordination	Sub-ordination	De Jure	De Facto				
Counterparty Risk Assessment	28.6%	28.6%	28.6%	28.6%	3	3	3	3	0	a1 (cr)
Deposits	28.6%	4.1%	28.6%	19.0%	2	3	2	2	0	a2
Senior unsecured bank debt	28.6%	4.1%	19.0%	4.1%	2	2	2	2	0	a2

Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Assessment	3	0	a1 (cr)	1	Aa3 (cr)	--
Deposits	2	0	a2	1	A1	A1
Senior unsecured bank debt	2	0	a2	1	(P)A1	(P)A1

Source: Moody's Financial Metrics

Ratings

Exhibit 8

Category	Moody's Rating
SPAREBANKEN SOR	
Outlook	Negative
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
Senior Unsecured MTN	(P)A1

Source: Moody's Investors Service

Endnotes

1 This figure reflects Moody's standard adjustments. The bank's reported cost-to-income ratio for the first nine months of 2017 was 39.7% (38.1% in September 2016 and 37.3% in December 2016).

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