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ISSUER COMMENT

Moody's Comments on the Intended Merger of Sparebanken Sør and Sparebanken Pluss

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On 12 March 2013, Sparebanken Sør (A3 stable, C-/baa2 stable)[1] 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.

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.

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. On a national basis, the combined entity would be the fifth largest savings bank in terms of total assets. The merger would create a dominant player in Southern Norway; we estimate the combined market share in the counties of Aust-Agder and Vest-Agder would be around 35% for lending and 55% for deposits.[2]

In addition, the banks' robust retail banking operations, their currently sound asset quality and their sizeable deposit bases would continue to support the combined bank's credit profile. We expect that the retail-focus of the combined bank would continue to support asset quality. Loans to the retail sector have historically performed well and accounted for 62% to 70% of Sparebanken Pluss's and Sparebanken Sør's total loans, respectively, at year-end 2012. The combined bank's credit profile would also reflect a robust earnings base from the banks' retail operations (between 60%-70% of 2012 core revenue).[3] This source of earnings has proven resilient over recent years and we expect there will be an opportunity for the bank to increase its lending margin in this segment, in light of the ongoing re-pricing movement in Norway in preparation of the likely increase in regulatory capital.[4]

[1] The ratings are the banks' deposit ratings, their standalone bank financial strength ratings/baseline credit assessments and the corresponding rating outlooks.

[2] Moody's calculation based on lending per county from Statistics Norway

[3] Excluding unallocated revenue and treasury functions.

[4] Please also see "Increased Capital Requirement for Mortgages Is Credit Positive for Norwegian Banks", in Moody's Credit Outlook, 11 March 2013.

However, we expect that the combined bank would continue to face challenges related to maintaining good asset quality in its loans and its reliance on market funding. In particular, we see some downside risks related to high household indebtedness and increased house prices in Norway. In addition, we consider that loan-book concentration towards the real-estate and construction sectors, which is significant at both banks (20%-25% of gross loans at year-end 2012), poses the main risk to asset quality. It will also be crucial that the combined entity establishes risk-management processes that ensure a consistent assessment of the credit risk of the combined loan book.

Both banks' funding is underpinned by a sizeable deposit base, which covered around 55% of gross loans at year-end 2012, but exhibits some reliance on market funding, increasingly in the form of covered bonds. We expect that dependence on market funding and therefore investor sentiment will remain a key risk at the combined bank, although in line with other medium-sized Norwegian savings banks.

We view both banks' capital levels as adequate (around 13.5%-14.2% at year-end 2012, calculated under the standardised method) and expect that the combined entity would show similar levels.

Furthermore, if the transaction proceeds, we expect that the ability of the newly appointed management to efficiently integrate the two banks' operations and design a coherent strategy will be key drivers in our assessment of the combined entity's credit strength.

Given its regional importance and in light of the Norwegian government's strong ability to extend support to the domestic financial sector, we would continue to assume a high probability of systemic support for the combined bank, in case of need.

We will monitor developments and will take appropriate rating actions when the legal issues regarding the merger are resolved and we have more clarity on how the banks will implement the merger.

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