

## CREDIT OPINION

16 December 2016

Update

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### RATINGS

#### Sparebanken Oest

Domicile	Norway
Long Term Deposit	A3
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

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 Oest

### Credit Opinion: Semi Annual Update

#### Summary Rating Rationale

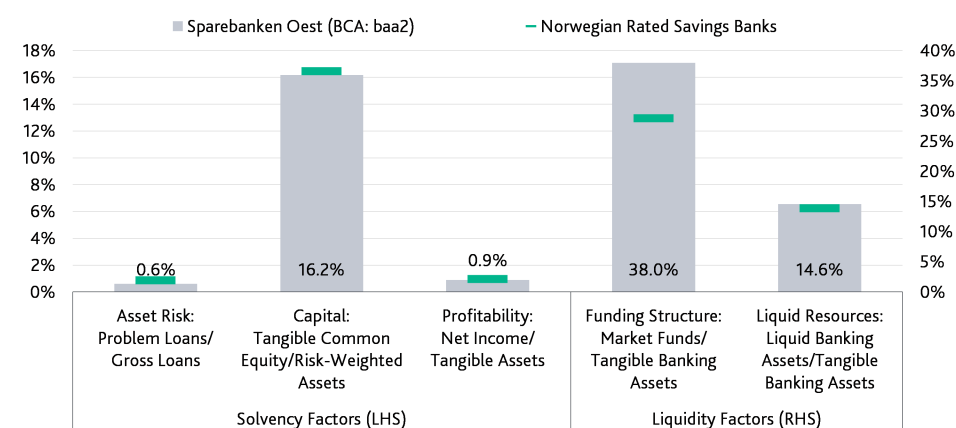
Sparebanken Øst's A3 long-term deposits and issuer ratings are driven by the bank's baa2 baseline credit assessment (BCA) and the application of our Advanced Loss Given Failure (LGF) analysis, which results in two notches of uplift. The uplift is the result of the large volume of deposits, and senior and subordinated debt that is available to absorb losses, resulting in low loss-given-failure for the bank's depositors. We also assign a Counterparty Risk Assessment (CRA) of A2(cr)/Prime-1(cr).

Sparebanken Øst's baa2 BCA is driven by its improved asset quality, reflecting its strategic focus to the retail mortgage sector as well as its improving loan loss reserves and better-than peers capital buffers. These rating strengths are balanced against the bank's still high, though declining, credit risk concentrations, its high reliance on market funding and the strong competition in its home region, which constrain its profitability.

Because of its small size, Sparebanken Øst's ratings do not benefit from government support uplift.

Exhibit 1

#### Key Financial Indicators- as of September 2016



Source: Moody's Banking Financial Metrics

## Credit Strengths

- » Sparebanken Øst's BCA is supported by its Very Strong- Macro Profile
- » Strong asset quality, though it remains vulnerable due to the softening in the economy and concentration to the commercial real estate sector
- » Improved capital ratios compare well with those of similarly rated Norwegian savings banks
- » Large volume of deposits and debt provide uplift to deposit ratings

## Credit Challenges

- » Sparebanken Øst maintains a sizeable reliance to confidence sensitive market funding
- » Profitability will be pressured by still strong competition and low interest rates

## Rating Outlook

The stable outlook assigned to the bank's A3 deposit and issuer ratings reflects our view that the bank's financials will remain broadly resilient, despite the softening in the Norwegian economy.

## Factors that Could Lead to an Upgrade

Upward rating pressure could develop if Sparebanken Øst demonstrates:

- » Continued low levels of problem loans and a decline in sector/single borrower concentration while maintaining cash coverage of problem loans at current levels (as of September the ratio of loan loss reserves to problem loans was 60%)
- » Continued access to the debt markets without significant changes in pricing
- » Stronger earnings generation without an increase in its risk profile

## Factors that Could Lead to a Downgrade

Future downward rating pressure would emerge if:

- » Sparebanken Øst's risk profile increases as a result of increased concentration, for example if construction and real-estate concentration or top-20 client concentration as a percent of Core Tier 1 Capital exceeds 150% or if its problem loan ratio increases above our system wide expectation of approximately 2%
- » Financing conditions become more difficult
- » The macroeconomic environment deteriorates, leading to a lower Macro Profile.

## Key Indicators

Exhibit 2

### Sparebanken Oest (Consolidated Financials) [1]

	9-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>3</sup>	12-12 <sup>3</sup>	Avg.
Total Assets (NOK billion)	35.9	34.5	35.0	31.2	29.6	4.9 <sup>4</sup>
Total Assets (EUR million)	3,996.2	3,589.0	3,858.5	3,727.2	4,039.4	-0.3 <sup>4</sup>
Total Assets (USD million)	4,490.9	3,898.7	4,669.0	5,135.9	5,325.5	-4.2 <sup>4</sup>
Tangible Common Equity (NOK billion)	2.9	2.8	2.6	2.3	2.1	9.1 <sup>4</sup>
Tangible Common Equity (EUR million)	325.0	288.1	286.9	272.2	280.6	3.7 <sup>4</sup>
Tangible Common Equity (USD million)	365.2	313.0	347.2	375.0	369.9	-0.3 <sup>4</sup>

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.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

Problem Loans / Gross Loans (%)	0.6	0.9	1.5	1.9	1.9	1.4 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	16.2	15.9	14.6	14.7	14.0	15.5 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.0	8.4	15.5	20.7	19.3	14.0 <sup>5</sup>
Net Interest Margin (%)	1.6	1.7	1.8	1.9	1.8	1.8 <sup>5</sup>
PPI / Average RWA (%)	2.4	1.9	2.3	2.7	2.7	2.2 <sup>6</sup>
Net Income / Tangible Assets (%)	0.9	0.7	0.9	0.9	0.9	0.8 <sup>5</sup>
Cost / Income Ratio (%)	40.8	46.9	41.7	41.9	43.0	42.9 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	38.0	39.7	41.0	38.5	43.2	40.1 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	14.6	16.3	14.4	14.6	20.7	16.1 <sup>5</sup>
Gross loans / Due to customers (%)	215.0	213.5	215.2	206.5	194.3	208.9 <sup>5</sup>

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Source: Moody's Financial Metrics

## Detailed Rating Considerations

### Sparebanken Øst's BCA is supported by its Very Strong- Macro Profile

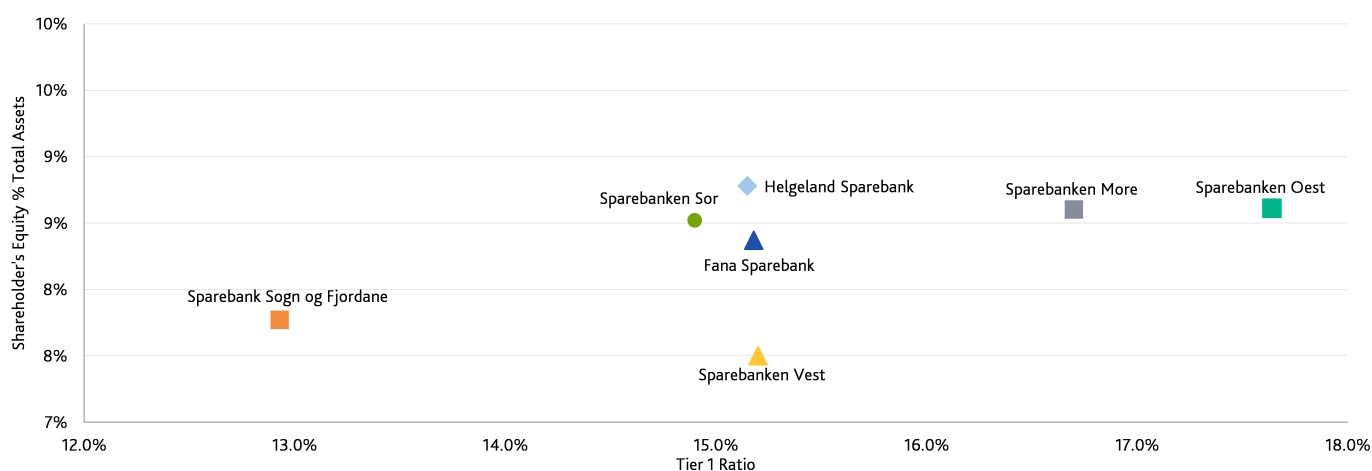
Sparebanken Øst's operations are entirely in Norway. As a result we apply the Very Strong- Macro Profile we have assigned to banks operating in Norway. Banks in Norway benefit from operating in a wealthy and developed country with very high economic, institutional and government financial strength, as 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.

### Improved Capital Ratios, Which Compare Favorably With Similarly Rated Norwegian Savings Banks

Sparebanken Øst's capital buffers have improved mainly driven by the higher regulatory requirements. As of September 2016, Sparebanken Øst's Common Equity Tier 1 capital (CET1) ratio was 15.70% (16.40% when we include 50% of interim profit) under Basel III (Dec 2015: 16.29%). These levels compare favorably with other Norwegian savings banks and exceed the bank's 14.50% targeted level. Sparebanken Øst also reports a high leverage ratio, which stood at 8.63% (8.97% including half of the Q3 profit) as of September 2016.

Exhibit 3

Improved capital levels driven by higher regulatory targets compare favorably with peers



Source: Moody's Banking Financial Metrics

### Strong Asset Quality, Though It Remains Vulnerable Owing To The Softening In The Economy and Sizeable Concentration

We expect Sparebanken Øst's asset quality metrics to remain strong reflecting its focus on mortgage lending and the controlled growth in its business book. During 2015 the bank expanded its business book, after a period of deleveraging, lending mainly to business customers with which it has a relationship history.

As of September 2016, the bank's problem loan ratio (measured as impaired loans as a percentage of total loans) declined to 0.61% of gross loans, from 0.86% as of December 2015 and 1.5% at end-December 2014. The bank's cash coverage of problem loans also improved significantly making it more comparable with rated domestic peers. Sparebanken Ost's ratio of loan loss reserves to problem loans increased to 60% as of September 2016 (from 51% as of December 2015).

Exhibit 4

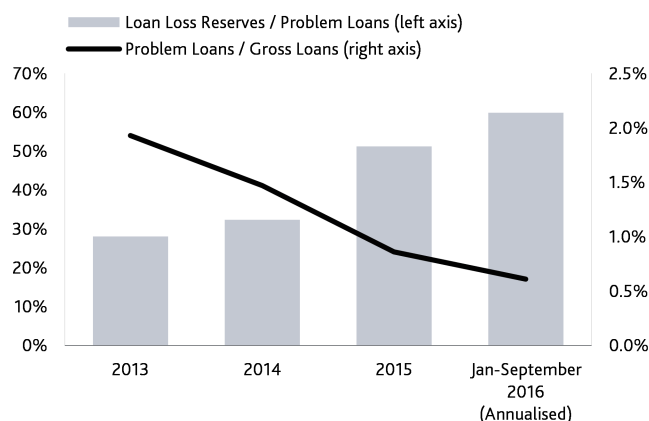
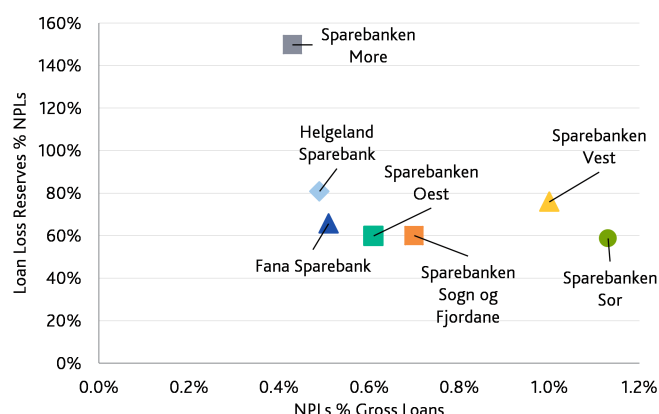


Exhibit 5



The bulk of Sparebanken Øst's lending is in retail loans, mostly in the form of mortgages, accounting for around 86% of total loans as of September 2016. Historically Sparebanken Ost, and the banking sector in Norway in general, experienced very low losses in mortgages. In addition, despite the softening in the domestic economic conditions, the performance of the bank's mortgage book has not worsened. Nevertheless, we note that the segment's performance could worsen significantly in a scenario whereby unemployment rises significantly, or house prices, which doubled in the last eight years, decline rapidly. The former is particularly a concern, despite the high social benefits for unemployed in Norway, given Norwegian households' high indebtedness.

Sparebanken Ost's concentration level has come down, a credit positive. Nevertheless, the bank maintains a sizeable exposure to the Commercial Real Estate sector making its asset quality vulnerable in the case the sector faces difficulties, particularly given that almost all of the bank's largest customers are active in this sector. After years of deleveraging (corporate loans declined from 24% of gross loans in December 2011 to 14% in December 2014), Sparebanken Ost has begun moderately growing its book as of last year, lending mainly to customers with which the bank has a relationship history. Nevertheless, the main business sector the bank is growing lending to is the more volatile real estate and construction sector. Loans in the CRE sector accounted for around 10% of gross loans as of September 2016 down from 16% in December 2015.

Sparebanken Øst targets moderate (4%-5%) growth of loans to businesses over 2017. The bank's management maintains a cautious approach given the strong competition in its operating region by more sophisticated larger players with more advanced risk pricing tools.

### Profitability Will Be Pressured By Still Strong Competition And Low Interest rates

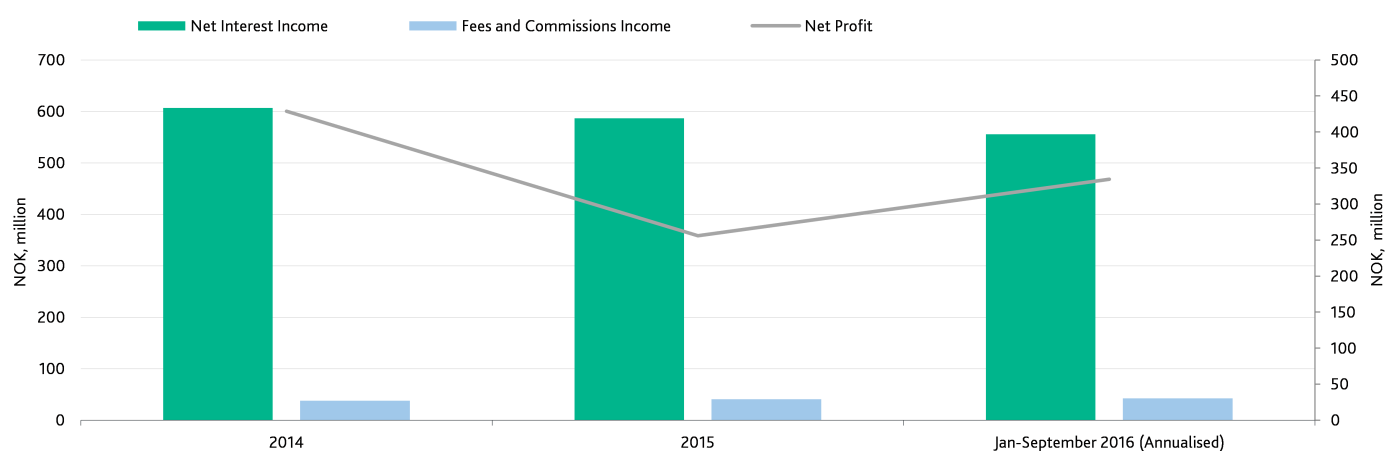
We expect that Sparebanken Øst's profitability will continue to be pressured by the strong competition in its main region of operation and low interest rate levels.

Sparebanken Øst's main income line is net interest income from its lending operations, which are predominantly retail, a more stable income source. Net interest income represented over 75% of net revenue for the first nine months of 2016.

The bank's annualised return on assets as of September 2016 was a high 0.89%. Profit for the first nine months of the year grew by 26% compared to the same period in the previous year to NOK251 million, reflecting modest growth in fees and commissions, market related income and loan recoveries. In the first nine months of 2016, Sparebanken Øst's net profit included NOK26.9 million dividends from Frende and Visa gain and NOK 15.7 million due to changes in guarantee liability with Eksportfinans. Operational efficiency is high and compares well with peers, with a cost-to-income ratio of 41% as of September 2016.

Despite the growth in earnings, the bank's net interest income declined by 5% in the first nine months to September 2016 compared to the same period the previous year. However, we note that the interest expense in the nine months to September 2016 includes the entire annual fee for the Norwegian Deposit Guarantee Fund while the interest expense for the nine months to September 2015 included the fee for the first three quarters only. While we expect that Sparebanken Øst will follow moves made by competitor banks and increase interest rates on mortgages, we believe that the bank's top line will remain under pressure owing to overall tight margins resulting from strong competition.

Exhibit 6

**Sparebanken Oest Profitability Evolution**

Source: Moody's Banking Financial Metrics

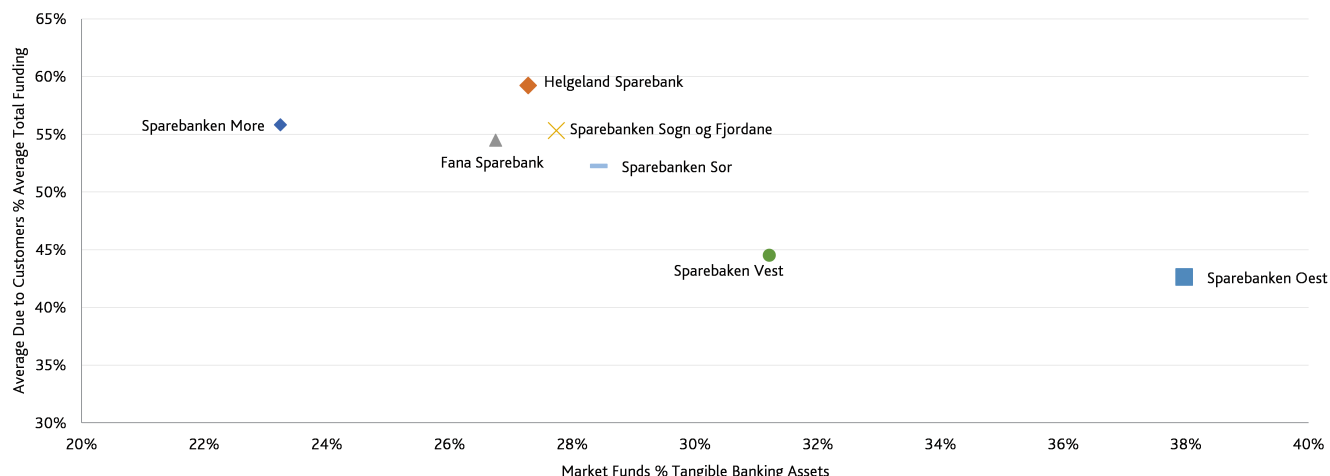
**High Reliance To Wholesale Funding**

Sparebanken Øst remains to a greater extent than domestic peers reliant on market funds, which constituted around 38% of the bank's tangible banking assets as of September 2016. As such, the bank is therefore sensitive to fluctuations in investor sentiment, a credit weakness.

Deposits accounted for about 43% of Sparebanken Øst's total funding as of September 2016, at the lower end of the range of similarly rated Norwegian savings banks. For the 12 months to September 2016 deposits grew by 5%, with retail deposits registering particularly strong 7% annual growth. Over recent years, a significant source of deposit growth has been Sparebanken Øst's alternative delivery channels, specifically its website Topprente.no, which offers competitive savings rates to retail customers. While we view positively the increased deposit base, we also note that such deposits can be price-sensitive and therefore less sticky.

A relatively large part of Sparebanken Øst's market funding consists of covered bonds issued via Sparebanken Øst Boligkreditt, with this source of funding representing around 48% of Sparebanken Øst's debt issuance as of September 2016. According to our methodology, we reflect the stability of covered bonds relative to unsecured market funding through a standard adjustment in our market funds calculations. However, because we do not expect that Sparebanken Øst will have the capacity to make larger benchmark issuances given its smaller size and as a result will not benefit from a more stable and diversified investor base, in our assigned funding score for Sparebanken Øst we reverse our methodology's positive treatment of covered bonds from the bank's market funds ratio.

Exhibit 7

**A relatively large part of Sparebanken Øst's market funding consists of covered bonds**

Source: Moody's Banking Financial Metrics

Mitigating its high reliance on market funds, Sparebanken Øst holds a relatively large liquidity buffer. As of September 2016, liquid assets stood at NOK5.2 billion or 14.6% of total assets (in line with the Norwegian average) and consisted of cash as well as government and government-related bonds and covered bonds. Furthermore, according to the bank, liquid assets cover its funding needs for the next 12 months.

## Notching Considerations

### Loss Given Failure

Norway is in the process of introducing legislation to implement the EU Bank Recovery and Resolution Directive (BRRD). In our LGF analysis we assume residual tangible common equity of 3%, losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, as well as a 5% run-off in preferred deposits. We assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

For Sparebanken Øst's long-term deposit ratings, our ratings have considered the likely impact on loss-given-failure of the volume of deposits and the amount of debt subordinated to them. This has resulted in a 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. Sparebanken Øst benefits from a well-established market position in the lower Buskerud County of south-eastern Norway. Whilst its market share in this county is material (we estimate it at around 6% by loans), it falls to around 1.7% if we include the greater Oslo and Akershus areas, in which Sparebanken Øst also operates. We also note that the close proximity of the bank's home region to Oslo means that a number of other Norwegian banks are operational in the area. Therefore we consider the probability of government support for debt and deposits as low, resulting in no rating uplift. Sparebanken Øst's market share in loans on a national basis is around 0.6%.

### Counterparty Risk Assessment

We assign a long-term and short-term CR assessment of A2(cr) and P-1(cr) respectively to the bank. 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.

## Rating Methodology and Scorecard Factors

Exhibit 8

### Sparebanken Oest

#### Macro Factors

Weighted Macro Profile	Very Strong -	100%
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#### 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	1.4%	aa2	↓	a3	Geographical concentration	Sector concentration
Capital						
TCE / RWA	15.9%	aa2	← →	aa2	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.7%	baa2	← →	baa2	Expected trend	
Combined Solvency Score		aa3		a2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	39.7%	ba2	← →	ba3	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	16.3%	baa2	← →	baa2	Stock of liquid assets	
Combined Liquidity Score		ba1		ba1		
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				baa2		
Affiliate Support notching				0		
Adjusted BCA				baa2		

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	a2 (cr)	0	A2 (cr)	--
Deposits	2	0	a3	0	A3	A3

Source: Moody's Financial Metrics

## Ratings

Exhibit 9

Category	Moody's Rating
<b>SPAREBANKEN OEST</b>	
Outlook	Stable
Bank Deposits	A3/P-2
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A2(cr)/P-1(cr)
Issuer Rating	A3

Source: Moody's Investors Service



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