

CREDIT OPINION

16 June 2016

Update

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RATINGS

Sparebanken Oest

Domicile	Norway
Long Term Rating	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

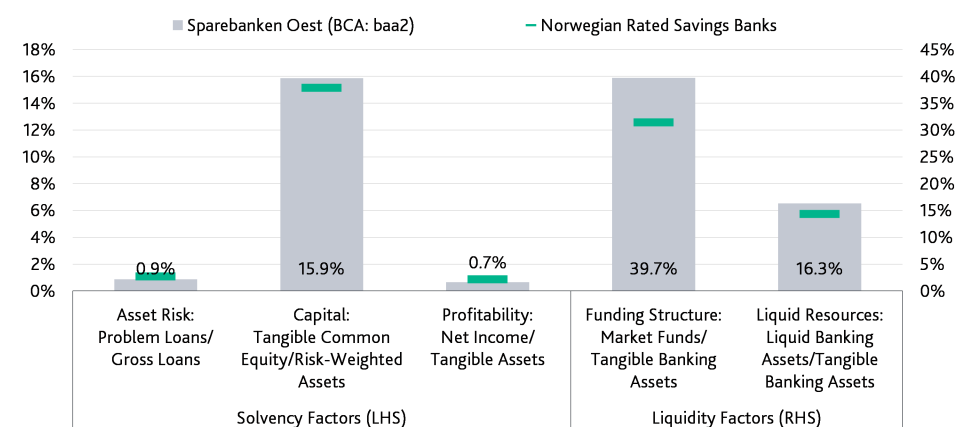
We assign Sparebanken Øst a baseline credit assessment (BCA) of baa2, a long-term deposit and issuer rating of A3, and a Prime-2 short-term obligation rating. We also assign a Counterparty Risk Assessment (CRA) of A2(cr)/Prime-1(cr).

Sparebanken Øst's baa2 BCA primarily reflects the bank's better than peers profitability as well as its low levels of problem loans a positive consequence of its successful implementation of a strategic focus to the retail mortgage sector and away from business lending. These rating strengths are balanced against the bank's still high, though declining, credit risk concentrations, its still lower problem-loan coverage compared to peers and strong competition in its home region, which constrain the BCA.

Sparebanken Øst's A3 deposit rating benefits from two notches of uplift owing to the application of our Advanced Loss Given Failure (LGF) analysis. 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. Sparebanken Øst's ratings do not benefit from government support uplift.

Exhibit 1

Financial Profile Key Factors as of 31 Dec 2015



Source: Moody's Financial Metrics

Credit Strengths and Challenges

- » Sparebanken Øst's BCA is supported by its Very Strong- Macro Profile
- » Improved capital ratios compare well with those of similarly rated Norwegian savings banks
- » Despite the recent asset quality improvement driven by the bank's retail focus, we expect a mild increase in non-performing loans (NPLs) as the economy softens
- » Profitability will be pressured by still strong competition, declining interest rates and a small increase in credit costs
- » Stable deposit levels, although wholesale funding reliance remains
- » Large volume of deposits and debt provide uplift to deposit ratings

Rating Outlook

The stable outlook on 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:

- » Good asset quality in its retail and corporate books, including in the more volatile segments
- » Continued good access to capital markets and improved liquidity
- » 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 exposures to more volatile sectors, 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 more than currently anticipated, leading to a lower Macro Profile.

Key Indicators

Exhibit 2

Sparebanken Oest (Consolidated Financials) [1]

	3-16 ²	12-15 ²	12-14 ²	12-13 ³	12-12 ³	Avg. ⁴
Total Assets (NOK billion)	35.1	34.5	35.0	31.2	29.6	4.3 ⁴
Total Assets (EUR million)	3724.2	3589.0	3858.5	3727.2	4039.4	-2.0 ⁴
Total Assets (USD million)	4243.9	3898.7	4669.0	5135.9	5325.5	-5.5 ⁴
Tangible Common Equity (NOK billion)	2.7	2.8	2.6	2.3	2.1	7.4 ⁴
Tangible Common Equity (EUR million)	290.2	288.1	286.9	272.2	280.6	0.8 ⁴
Tangible Common Equity (USD million)	330.7	313.0	347.2	375.0	369.9	-2.8 ⁴
Problem Loans / Gross Loans (%)	0.9	0.9	1.5	1.9	1.9	1.4 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	15.4	15.9	14.6	14.7	14.0	15.3 ⁶

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 for the most updated credit rating action information and rating history.

Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	8.5	8.4	15.5	20.7	19.3	14.5 ⁵
Net Interest Margin (%)	1.6	1.7	1.8	1.9	1.8	1.8 ⁵
PPI / Average RWA (%)	2.0	1.9	2.3	2.7	2.7	2.1 ⁶
Net Income / Tangible Assets (%)	0.8	0.7	0.9	0.9	0.9	0.8 ⁵
Cost / Income Ratio (%)	45.7	46.9	41.7	41.9	43.0	43.8 ⁵
Market Funds / Tangible Banking Assets (%)	40.8	39.7	41.0	38.5	43.2	40.6 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	16.6	16.3	14.4	14.6	20.7	16.5 ⁵
Gross loans / Due to customers (%)	212.0	213.5	215.2	206.5	194.3	208.3 ⁵

[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

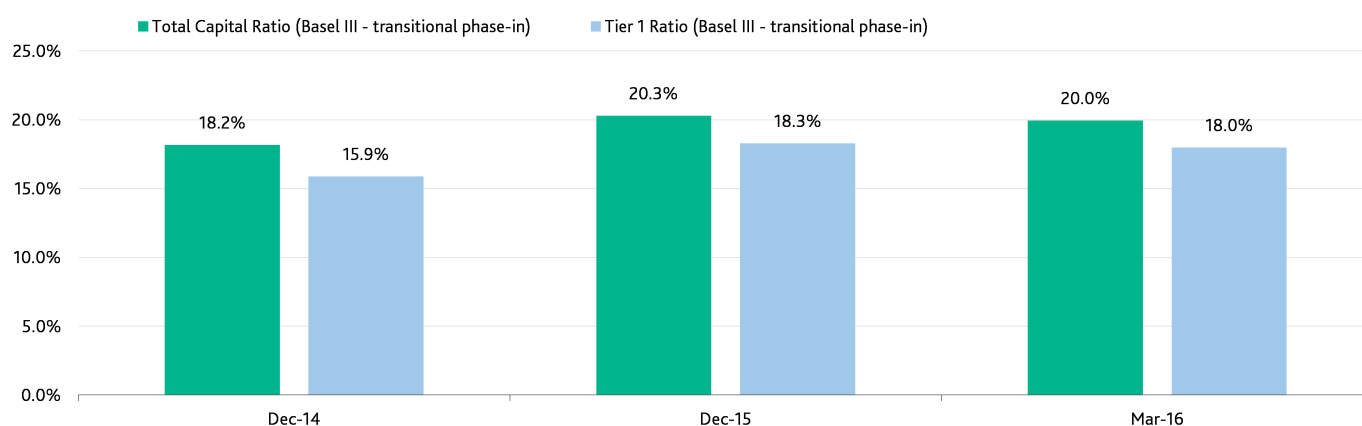
Sparebanken Øst has a purely domestic focus, and its Macro Profile is therefore aligned with that of Norway at Very Strong-. Norwegian banks benefit from operating in a wealthy and developed country with very high economic, institutional and government financial strength, as well as low susceptibility to event risk. The main risks to the system stem from the high level of household indebtedness and domestic banks' reliance on market funding. However, these risks are largely offset by Norwegian households' strong capacity to service debt, banks' adequate capitalisation and the small size of the banking system relative to GDP.

Improved capital ratios compare well with those of similarly rated Norwegian savings banks

Sparebanken Øst benefits from a strong capital base that has been improving over the years and is a relative strength for the bank. As of March 2016, Sparebanken Øst had a common equity tier 1 capital (CET1) ratio of 16.01% (16.20% when we include 50% of interim profit) under Basel III (Dec 2015: 16.29%). These levels are above the average of Moody's-rated Norwegian banks and above the bank's 14.50% targeted level. The increase in Sparebanken Øst's loss-absorption buffers in recent years has been driven by the higher regulatory capital requirements. Our assigned Capital Score also captures the bank's leverage ratio of 8.86% (8.95% including half of the Q1 profit) as of March 2016, which meets international standards comfortably.

Exhibit 3

High capital levels are a credit strength



Source: Moody's Financial Metrics

Despite the recent asset quality improvement driven by the bank's retail focus, we expect a mild increase in NPLs as the economy softens

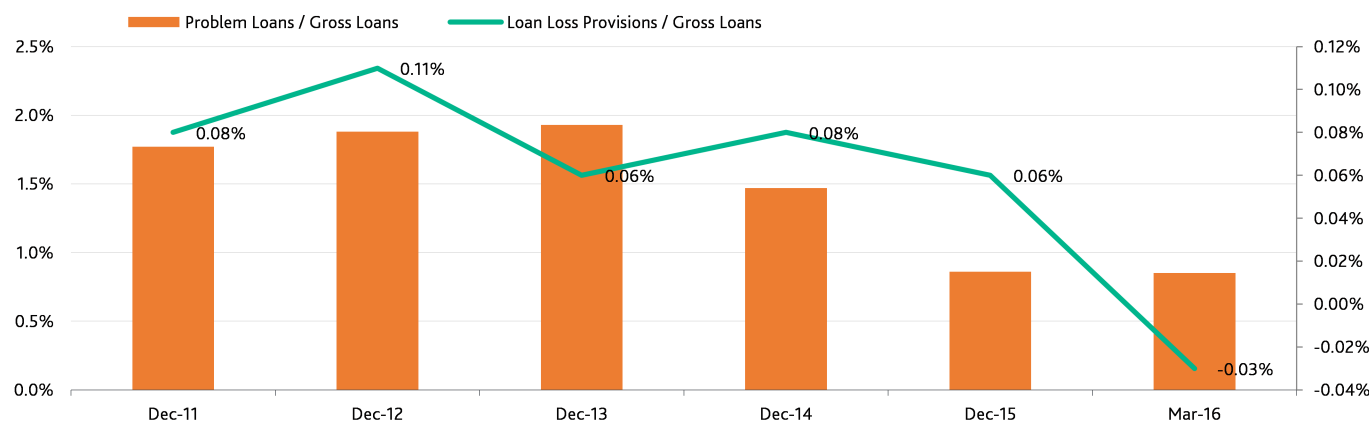
Our assigned Asset Risk score reflects Sparebanken Øst's strong asset quality metrics, a credit strength and our expectation of a mild increase in problem loans driven by the softening in the economy. As of March 2016, the bank's problem loan ratio (measured as impaired loans as a percentage of total loans) accounted for 0.85% of gross loans, stable from 0.86% as of December 2015 and down

from 1.5% at end-December 2014. The asset risk score also captures the bank's worse than peers, though improving problem loan coverage, with a ratio of loan loss reserves to problem loans of 45% as of March 2016.

Sparebanken Øst's loan book is characterised by a large and increasing proportion of retail loans, mostly in the form of mortgages, accounting for around 85% of total loans as of March 2016, of which around 40% are part of its wholly owned covered bond company, Sparebanken Øst Boligkreditt's cover pool. Although this asset class has been more resilient historically, we believe that its performance could be undermined by a decline in house price levels, especially given households' high indebtedness.

Exhibit 4

We expect a mild increase in credit costs and delinquencies which have reached very low levels



Source: Moody's Financial Metrics

Although the bank's overall concentration level has come down, a credit positive, the bank's asset quality remains vulnerable from its significant industry concentration towards the property management and construction sectors, which accounted for around 11% of gross loans as of March 2016 (December 2011: 16%). Additionally, the bank's corporate loan book exhibits high borrower concentration to single borrowers, which makes asset quality vulnerable to a default of one of the bank's large customers.

Sparebanken Øst's lending has increased at a varying pace in the aftermath of the global financial crisis, as the bank has shifted its strategy to focus on the retail sector, mainly mortgages and reduce its lending to businesses. As a result the diversification in terms of single borrowers has improved, a credit positive. The bank has increased retail lending to 85% of gross loans from 76% in 2011. While Sparebanken Øst's risk management practices lack the sophistication of many larger players in the Nordic region, the bank has made efforts to strengthen risk management, particularly in relation to investments, which we view positively.

Profitability will be pressured by strong competition, declining interest rates and a small increase in credit costs

Our assigned Profitability score reflects our expectations that Sparebanken Øst's profitability will continue to be pressured by the strong competition in its main area of operation, low interest rate levels and higher credit costs. In the first half of 2015, we saw signs of renewed margin pressure across the Norwegian banking market, with most banks reducing mortgage rates, following a margin expansion over the recent years. Sparebanken Øst's main source of income is net interest income, which, together with its increased retail focus adds to the stability and predictability of income and represented over 90% of its 2015 operating income.

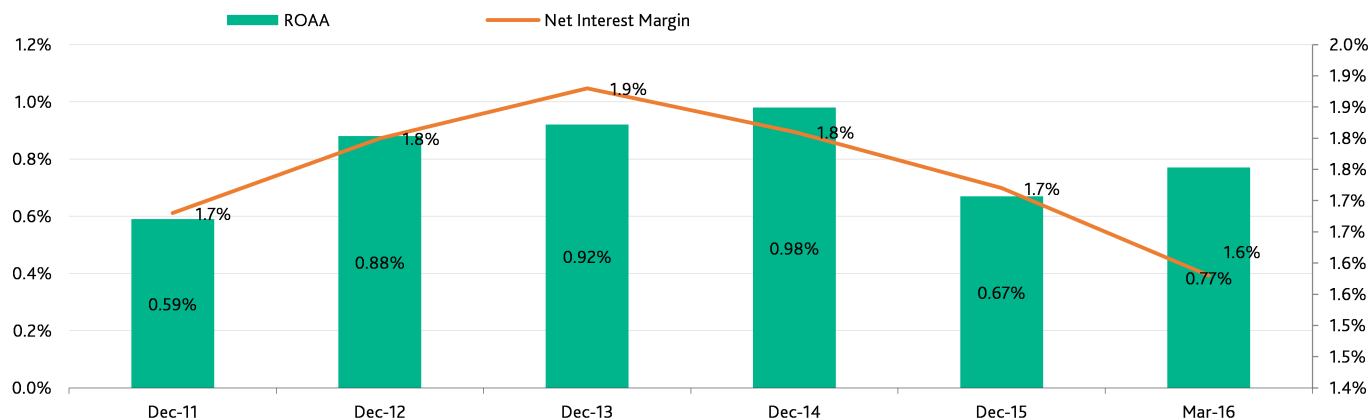
Although the bank's net interest income in Q1 2016 included the annual interest expense for the Norwegian Banks Guarantee Fund, the annualised return on assets remained relatively high at 0.77%. The good return on assets was driven by strong fees and commissions, market related income and loan recoveries. In the first three months of 2016, Sparebanken Øst's net profit included NOK2.4 million of previously provisioned amounts that the bank recovered. Operational efficiency is high and compares well with peers, with a cost-to-income ratio of 46% as of March 2016.

However, profits in the first three months of the year were 23% lower compared to the same period in the previous year, which included NOK31 million from the sale of a property. We expect that profits will remain under pressure owing to tight margins in the

retail sector and higher credit costs. We expect that loan loss provisions will increase as the softening in the economy reduces cash recoveries and leads to a small rise in delinquencies.

Exhibit 5

NIM's will remain under pressure due to low interest rates and competition



Source: Moody's Financial Metrics

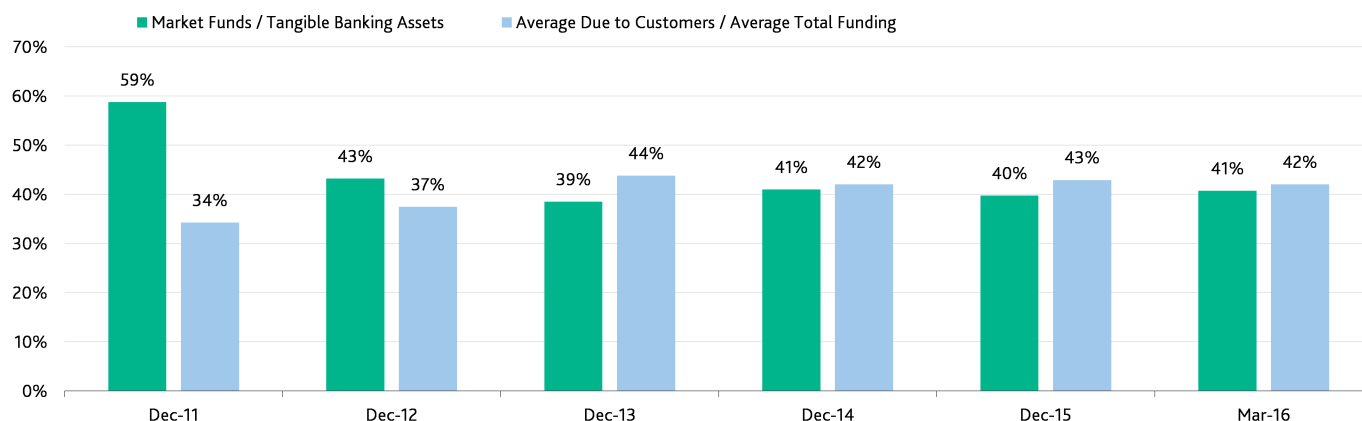
Stable deposit levels, although wholesale funding reliance remains

Sparebanken Øst remains reliant on market funds, which constituted around 41% of the bank's tangible banking assets as of March 2016. As such, the bank is therefore sensitive to fluctuations in investor sentiment a credit weakness which is reflected in its Funding score.

Deposits accounted for about 42% of Sparebanken Øst's total funding as of March 2016, significantly above the year-end 2011 figure of 34%, but still at the lower end of the range of similarly rated Norwegian savings banks. Although during 2015 deposits contracted slightly on an annual basis, in the first three months of 2016 deposits grew by 3.3% year-on-year outpacing the year-on-year loan growth of 2.8%. 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 43% of Sparebanken Øst's debt issuance as of March 2016. Under our methodology, we reflect globally the stability of covered bonds relative to unsecured market funding through a standard adjustment in our scorecard. However, we do not expect that, in terms of size, Sparebanken Øst will have the capacity to make larger benchmark issuance, which ultimately restricts its investor base. In addition, extensive use of covered bond funding causes structural subordination of Sparebanken Øst's unsecured creditors, including depositors.

Exhibit 6

Broadly stable deposit funding in last three years, reliance on market funding remains high

Source: Moody's Financial Metrics

Mitigating its high reliance on market funds, Sparebanken Øst holds a relatively large liquidity buffer. As of March 2016, liquid assets stood at NOK5.8 billion or 16.6% 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

We expect that Norway will seek to introduce legislation to implement the EU Bank Resolution and Recovery Directive. 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, as the bank's market share on a national basis is small at around 0.6% by loans.

Counterparty Risk Assessment

We also 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 7

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 8

Category	Moody's Rating
SPAREBANKEN OEST	
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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