Credit Opinion: Sparebanken Oest

Global Credit Research - 05 Sep 2011

Drammen, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-2
Bank Financial Strength	C-
Baseline Credit Assessment	Baa2
Adjusted Baseline Credit Assessment	Baa2

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Key Indicators

Sparebanken Oest (Consolidated Financials)[1]

	[2]**12-10**	[2]**12-09**	[2]**12-08**	[3]**12-07**	[3]**12-06**	**Avg.**
Total Assets (NOK billion)	**24.7**	**22.0**	**25.2**	**22.0**	**21.3**	[4]**3.8**
Total Assets (EUR million)	**3,173.6**	**2,650.4**	**2,587.1**	**2,775.4**	**2,598.6**	[4]**5.1**
Total Assets (USD million)	**4,257.5**	**3,802.7**	**3,596.2**	**4,057.8**	**3,426.6**	[4]**5.6**
Tangible Common Equity (NOK billion)	**1.8**	**1.6**	**1.1**	**1.5**	**1.4**	[4]**6.3**
Tangible Common Equity (EUR million)	**235.1**	**189.2**	**111.6**	**195.1**	**174.7**	[4]**7.7**
Tangible Common Equity (USD million)	**315.4**	**271.4**	**155.2**	**285.3**	**230.4**	[4]**8.2**
Net Interest Margin (%)	**1.9**	**2.1**	**1.9**	**1.7**	**1.6**	[5]**1.8**
PPI / Avg RWA (%)	**3.1**	**3.5**	**-2.0**	**2.3**	**1.1**	[6]**1.5**
Net Income / Avg RWA (%)	**2.5**	**2.4**	**-2.9**	**1.7**	**0.9**	[6]**0.7**
(Market Funds - Liquid Assets) / Total Assets (%)	**50.9**	**50.0**	**49.6**	**48.0**	**55.6**	[5]**50.8**
Core Deposits / Average Gross Loans (%)	**42.6**	**43.1**	**44.2**	**45.5**	**41.3**	[5]**43.3**
Tier 1 Ratio (%)	**15.4**	**14.2**	**8.4**	**13.1**	**13.6**	[6]**12.6**
Tangible Common Equity / RWA (%)	**15.2**	**13.4**	**8.4**	**12.1**	**12.4**	[6]**12.3**
Cost / Income Ratio (%)	**45.2**	**41.0**	**835.7**	**49.2**	**68.6**	[5]**207.9**
Problem Loans / Gross Loans (%)	**1.8**	**1.5**	**1.6**	**1.0**	**1.1**	[5]**1.4**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**16.5**	**14.1**	**22.2**	**10.1**	**10.7**	[5]**14.7**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's rate Sparebanken Øst A3/P-2/C-. The bank financial strength rating (BFSR) of C- t translates into a baseline credit assessment (BCA) of Baa2, which reflects the bank's good regional franchise in south-eastern Norway (encompassing the Greater Oslo area). However, the rating is constrained by high credit risk concentrations, a reliance on market funding as well as future profitability challenges arising from intense market competition.

The global local currency (GLC) deposit rating of A3 for Sparebanken Øst is supported by the bank's Baa2 BCA and the Aaa local currency deposit ceiling of Norway, which we consider the underlying support provider. As a result of Sparebanken Øst's position in its region and the region's importance to the national economy of Norway, Moody's assesses a high probability of systemic support for the bank in the event of a stress situation. Consequently, Sparebanken Øst's GLC deposit rating benefits from a two-notch uplift from its BCA.

Credit Strengths

- Good regional market position in south-eastern Norway

-Open-architecture model allows for a wide product range whilst keeping costs down improving the banks efficiency

- Over 70% of lending to retail customers, of which most are mortgages

- Among the best capitalised banks across Moody's rating universe in Norway

- Successful de-risking of its balance-sheet by shrinking its investment portfolio

Credit Challenges

- Improving earnings from core banking operations, in its highly competitive home region

- Further developing risk management practices

- Very high reliance on wholesale funding

- Maintaining asset quality across the economic cycle

- Reducing credit risk concentrations in terms of largest borrowers and exposure to commercial property

Rating Outlook

The outlook on all ratings is stable. On 28 October 2010, Moody's changed the outlook on Sparebanken Øst's ratings to stable from negative, chiefly reflecting the bank's de-risking of its balance sheet, especially in its investment portfolio and in its syndicated loan exposures to Icelandic and eastern European financial institutions, coupled with good capital levels and improved performance in the latest quarters.

What Could Change the Rating - Up

Upward pressure on the bank's ratings could arise from (i) a continuation of the focus on core business and reduced asset allocation to the investment portfolio; (ii) an improvement in profitability; and/or (iii) sustaining the persistently low problem loan level.

What Could Change the Rating - Down

The BFSR would be negatively affected by a deterioration in financial flexibility, particularly adverse developments in asset quality. In addition, further erosion of the bank's market position, any increase in its overall risk profile (e.g. in the form of investment in less liquid financial securities) or deteriorating liquidity could exert downward pressure on the rating.

Recent Results and Company Events

Sparebanken Øst reported pre-tax profit of NOK164 million in H1 2011, down 38% compared to the corresponding figure in H1 2010. The reported deterioration in profitability was primarily due to one-off gains from the merger between electronic payment services providers Nordito and PBS (NOK80 million) and a change in the Norwegian pension legislation (NOK29 million) . Adjusting for those one-off events, the H1 2011 pre-tax profit would have been 5% higher than in H1 2010, mainly due to increased gains from financial investments. We note core banking earnings have remained steady from last year, increasing only slightly year-on-year(1.73%).

The bank reported a Tier 1 ratio of 13.9% at end-June 2011 (according to the Basel II standardised method).

DETAILED RATING CONSIDERATIONS

Detailed considerations for Sparebanken Øst's currently assigned ratings are as follows:

Bank Financial Strength Rating

The assigned BFSR is one notch lower than the outcome of Moody's bank financial strength scorecard. Based on Moody's loss expectations for Sparebanken Øst's loan book, which are largely driven by the bank's sizeable exposure to commercial real estate, we believe that the bank's financial strength is more consistent with a C- BFSR.

Qualitative Factors (50% weighting)

Factor 1: Franchise Value

Trend: Neutral

Sparebanken Øst enjoys a good market position in the lower Buskerud county of south-eastern Norway. In recent years, the bank has established an online mortgage bank, DinBANK.no, as an additional distribution channel. The bank also introduced YoungBank.no as a brand to target young customers.

The bank offers clients a wide product range via an open-architecture model as well as more recently via companies established with other independent savings banks. Sparebanken Øst owns 14.84% of Frende Holding, which offers life and non-life insurance products. In addition, Sparebanken Øst, along with the savings banks behind Frende Forsikring and Fondsfinans (a Norwegian securities house), established Norne Securities, a securities company, which became operational in winter 2009 and of which it owns 10.12%.

We view these initiatives positively; Sparebanken Øst's cooperation with other small independent savings banks could over time create small-scale acquisition opportunities, especially in the context of the June 2009 regulation on savings bank's equity certificates (EC), which facilitate mergers between savings banks.

Overall, we positively view the bank's attempt to widen its operating area, but caution that the capital region remains increasingly competitive as large domestic and foreign banks are keen to gain a presence there. Therefore, we caution that the bank's franchise could come under pressure, especially outside of its key operating areas, where it benefits from local knowledge of customers' needs and the economy.

Although we acknowledge Sparebanken Øst's strong presence in the local market in which it operates, the D+ score for franchise value is constrained by the bank's lack of geographic diversification.

Factor 2: Risk Positioning

Trend: Neutral

At YE2010, the bank's largest owner, MP Pensjon, had control of 10% of the ECs, with no other EC-holders having ownership above 10%. The 10 largest EC holders together own 35% of the ECs.

Although risk management practices are adequate for the level and type of risk in the bank, they lack the sophistication of other larger players in the Nordic region. Over the most recent years the bank has made efforts to strengthen the risk management in relation to securities investment and also de-risking the bank. The nominal value of the investment portfolio has shrunk from NOK1,134 million at YE 2008 to NOK403 million at YE 2010. The bank's total securities portfolio, excluding shares and treasury bills has seen a significant reduction in the level of securities classified within the high risk category (NOK289 million at YE 2010 down from NOK684 million at YE 2009).

Furthermore, high risk concentrations in the loan portfolio (see Asset Quality, below) remain a constraining factor for the score on risk management.

The bank's shareholdings on the balance sheet were NOK505 million at YE 2010, representing around 27% of Tier 1 capital. The largest shareholding is in Eksportfinans (4.84%), for which the bank also provides a guarantee of NOK59.4 million via a portfolio hedge agreement together with the other owners. The bank's net exposure to interest-rate risk was below the NOK30 million limit (equivalent to around 1.5% of Tier 1 capital). Its foreign currency risk is also low; its net currency position was NOK14.0 million (total gross limit is NOK100 million). In addition, we note that the ownership in the insurance business increases its exposure to market volatility.

Sparebanken Øst scores C for risk positioning, with its high credit risk concentration its main constraining factor.

Factor 3: Regulatory Environment

For a discussion of the regulatory environment, please see Moody's latest Banking System Outlook on Norway.

Factor 4: Operating Environment

Trend: Neutral

The operating environment score takes into account the economic stability, integrity and corruption in the country as well as the legal system. The unadjusted score for Norway's operating environment is B and is constrained by a score of C for economic stability, primarily as a result of volatility in oil prices. To reflect the fact that offshore revenues are allocated to the Government Pension Fund and have a limited impact on the mainland economy, we calculate the score for economic stability as the average of the standard deviations of GDP growth both including (25% weight) and excluding (75% weight) offshore revenue, which results in an adjusted score of B. Consequently, the adjusted score for the operating environment is B+.

For further discussion of the operating environment, please see Moody's latest Banking System Outlook on Norway.

Quantitative Factors (50% weighting)

Factor 5: Profitability

Trend: Weakening

For years Sparebanken Øst has been reliant on net interest income, which represented more than 60% of its core operating income in 2010. A decrease of approximately 10% year-on-year of net interest income in 2010 was primarily due to increasing funding costs the bank is facing in its bid to increase lending. Going forward, we believe growth in net interest income will remain subdued as any increase in volume will need to be funded with market funds as competition for deposits remains fierce.

Commission income has been a limited but a stable source of additional income, representing around 10% of the bank's operating income in 2010.

Value adjustments in the securities portfolio contributed positively to core income in 2010, continuing a trend that began with a turnaround in 2009 after years of negative adjustments. Exposures have been significantly reduced and we do not foresee negative valuation effects to the extent of those reported in 2008 going forward, although some volatility remains.

The ongoing derisking of the bank's exposures was also reflected in the reduction in loan loss provisions, which stood at NOK10 million, significantly down from NOK25 million in 2009 and NOK245 million in 2008. The bank has now provisioned for the bulk of its exposure to Icelandic and Eastern Europe financial institutions, hence our expectation are that such high provisioning levels will not be seen in the future.

While the three-year average score for profitability of D+ reflects the negative performance in 2008, the 2010 score of B+ evidences the good performance last year. However, we keep a weakening trend on the score due to our view that the bank's net profitability is dependent upon the success of ongoing efforts to contain the volatility of its investments and our expectations that growth in net interest income will be challenging.

Factor 6: Liquidity

Trend: Neutral

Deposits represented around 35% of Sparebanken Øst's total funding as of YE 2010, which falls below those of larger Moody's-rated savings banks in Norway. In 2010, its deposit base increased by 5% compared with an increase in gross loans by more than 17% year-on-year. The significant increase in customer lending led to a deterioration in the deposit-to-gross loans ratio to 39% from 44% at YE2009.

With a deposits-to-gross loans ratio at 39%, the bank is reliant on market funding; Although Sparebanken Øst's dependence on market funding has been stable over the years, it is somewhat higher than its rated peers, consistently representing around 65%-70% of its total funding. We positively note the bank has gradually begun to focus more on longer-term funding from the capital markets rather than the interbank market. The percentage of market funding from interbank funding was 13% at YE 2010 decreasing from 19% at YE 2009 and 28% at YE 2008. Moody's notes that NOK2.5 billion (around 17% of market funding) is maturing in 2011.

In April 2009, the bank established its wholly-owned covered bond company, Sparebanken Øst Boligkreditt A/S. During 2009, covered bonds were only used in the (now phased out) government swap arrangement, whereby these instruments were exchanged for government bonds. We view this new funding tool positively, as it will address the bank's relatively less diversified funding. Issuing covered bonds is increasingly becoming the preferred method to issue bonds as a source of funding at Sparebanken Øst, covered bonds issuance represented 19% of total outstanding bond issuance in 2010, up from 9% in 2009. We expect covered bonds will remain an important source of funding for Sparebanken Øst, especially as Norges Bank will no longer accept securities issued by banks but will continue to accept covered bonds from February 2012. However, Moody's cautions that extensive use of covered bond funding through these structures, whereby prime assets come off the bank's balance sheet, might result in the structural subordination of Sparebanken Øst's unsecured creditors, including depositors. Any significant structural subordination might impact the bank's senior debt and deposit ratings.

Compared with its Norwegian savings bank peers, Sparebanken Øst has a relatively large proportion of liquid assets on its balance sheet, around 18% at YE 2010, which partly reflects the bank's higher dependence on market funding. The bank's total securities portfolio consists of the fixed-income securities of financial institutions and Norwegian companies as well as government bonds and covered bonds totalling NOK3.5 billion at YE 2010. We caution that Sparebanken Øst's fixed-income investments have showed some volatility in recent years.

The D+ score for liquidity, although lower than that of its European counterparts, is in line with that of the other rated Norwegian banks.

Factor 7: Capital Adequacy

Trend: Neutral

Sparebanken Øst reported a Tier 1 ratio of 15.4% and a total capital ratio of 17.2% at YE 2010 as calculated under Basel II's standardised approach. The substantial improvement from 8.4% and 11.5%, respectively at YE 2008 is largely attributable to the bank's NOK182 million rights issue in April 2009 although the risk weighted assets have slightly increased from last year, associated with the increased focus on lending from last year. The bank has maintained its recent increase in its capital adequacy targets from 2009, whereby the bank aims to keep its Tier 1 ratio above 11% and its capital ratio above 13%. We view these developments favourably and note that Sparebanken Øst compares well with its rated Norwegian peers (as has been the case in the past few years).

However, we note that hybrid capital, which we assess as less loss-absorbing than pure equity, makes up 15% of the bank's Tier 1 capital, which is the maximum amount that can be included in Tier 1 in Norway.

We regard capitalisation as a positive rating factor and believe the current levels provide a good buffer to absorb potential losses. The score for capital adequacy is A.

Factor 8: Efficiency

Trend: Neutral

Cost efficiency slightly deteriorated in 2010, with the bank's cost-to-income ratio at 45%, which is still a healthy figure especially when compared against the 2008 figures when the ratio was adversely affected by weak financial results. This slight increase in the ratio was due to a decrease in operating income. Operating expenses increased by 1% from 2009, mainly as a result of higher admin and other operating expenses. Although we acknowledge the bank's cost efficiency ratio is low, we caution that it is likely to remain under pressure from intense competition and higher funding costs. Additionally, while the bank avoids the fixed costs of product manufacturing through taking minority shares in its product development companies, going forward cost containment might prove to be more difficult as an independent bank.

The unadjusted score of E reflects the very low operating income in 2008. However we have adjusted the score to B, which we think more appropriately reflects the bank's efficiency.

Factor 9: Asset Quality

Trend: Weakening

Operating in only one region means that the bank has significant single-borrower concentration as measured by the 20 largest exposures in relation to Tier 1 capital or pre-provision income. There is also some industry concentration: property management and construction account for some 13% of the total loan portfolio and is a source of potential vulnerability; also in addition, exposures are largely concentrated in a limited geographic area. The largest exposures also include a number of real estate-related entities.

Nevertheless, the relatively high proportion of retail loans (77% of lending including loans transferred to Sparebanken Øst Boligkreditt A/S) brings some stability in the loan book. In addition, the majority of retail lending is in the form of mortgages. Around 80% of mortgages are within an 80% LTV.

At YE 2010, problem loans (defined as gross loans in default and non-performing loans that are not in default) accounted for 1.8% of gross loans, slightly up from 1.5% at YE 2009.

Sparebanken Øst's problem loan coverage by loan loss reserves is around 47% of problem loans, which we consider satisfactory given the high share of retail mortgage lending. We caution that the sustained increase in house prices in Norway may have underrated the level of provisioning by inflating collateral value. We further note that at YE 2010, some 14% of the bank's retail mortgages were part of Sparebanken Øst Boligkreditt A/S's covered pool.

The score for asset quality is B. The economic environment in Norway is still satisfactory, but slower economic growth, fewer exports and weaker domestic demand are challenges for the corporate sector. Further, with regards to retail loans, household indebtedness has increased in recent years, making customers more vulnerable to interest rates rises, although we take comfort in the still low unemployment levels in Norway. Overall, we consider the trend to be weakening.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A3 to Sparebanken Øst. The rating is supported by the bank's Baa2 BCA and the Aaa local currency deposit ceiling of Norway, which we consider the underlying support provider. As a result of Sparebanken Øst's importance to its region and the region's importance to the national economy of Norway, Moody's assesses a high probability of systemic support for the bank in the event of a stress situation. Consequently, there is a two-notch uplift for the GLC deposit rating from the bank's BCA.

Foreign Currency Deposit Rating

The A3 foreign currency deposit rating is unconstrained given that Norway has a country ceiling of Aaa.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognise the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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 Factors

Sparebanken Oest

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C	
Factor: Franchise Value						D+	Neutral
Market Share and Sustainability			x				
Geographical Diversification					x		
Earnings Stability			x				
Earnings Diversification [2]							
Factor: Risk Positioning						C	Neutral
Corporate Governance [2]	--	--	--	--	--		
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management			x				
- Risk Management			x				
- Controls		x					
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
Credit Risk Concentration	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management			x				
Market Risk Appetite		x					
Factor: Operating Environment						B+	Neutral
Economic Stability		x					
Integrity and Corruption		x					
Legal System	x						
Financial Factors (50%)						C	
Factor: Profitability						D+	--
PPI / Average RWA - Basel II			1.54%				
Net Income / Average RWA - Basel II				0.67%			
Factor: Liquidity						D+	--
(Mkt funds-Liquid Assets) / Total Assets					39.07%		
Liquidity Management			x				
Factor: Capital Adequacy						A	--
Tier 1 Ratio - Basel II	12.64%						
Tangible Common Equity / RWA - Basel II	12.32%						
Factor: Efficiency						B	--
Cost / Income Ratio		45.15%					
Factor: Asset Quality						B	--
Problem Loans / Gross Loans		1.66%					
Problem Loans / (Equity + LLR)		17.58%					
Lowest Combined Score (15%)						D+	
Economic Insolvency Override						Neutral	
Aggregate Score						C	
Assigned BFSR						C-	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral

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