MOODY'S
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CREDIT OPINION
14 June 2017

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

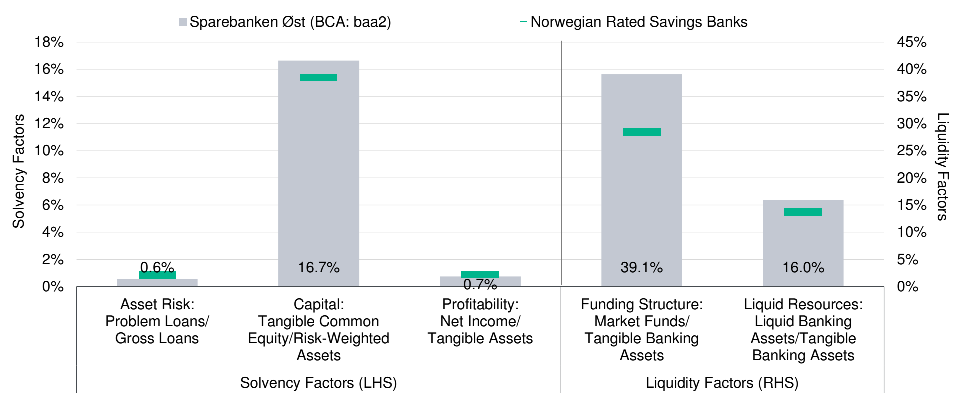
Sparebanken Øst's A3 long-term deposits and issuer ratings are driven by the bank's baa2 baseline credit assessment (BCA) and the application of our Advanced Loss Given Failure (LGF) analysis, which results in two notches of uplift. The uplift is driven by the large volume of deposits, and senior and subordinated debt that is available to absorb losses, reducing the expected loss for the bank's senior creditors.

Sparebanken Øst's baa2 BCA is driven by its improved asset quality, increased coverage of problem loans by its loan loss reserves as well as its better-than peers capital buffers. These rating strengths are balanced against the bank's elevated concentration to the real estate sector, its higher than peers reliance on market funding and the strong competition in its home region, which constrains 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 March 2017**




Note: Figures for Norwegian rated savings banks are based on latest available data
*Source: Moody's Banking Financial Metrics*

## Credit Strengths

» Strengthened capital buffers which compare favorably with those of similarly rated Norwegian savings banks

» Improving asset quality, though concentration to the commercial real estate sector raises asset risk

» Large volume of deposits and debt provide uplift to deposit ratings

## Credit Challenges

» Sparebanken Øst maintains a sizeable reliance to confidence sensitive market funding

» Core profitability showing signs of improvement but strong competition in its region constrains Øst business growth

## Rating Outlook

The stable outlook assinged to the bank's A3 deposit and issuer ratings reflects our view that the bank's financials will remain broadly resilient over the next 12-18 months.

## 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 adequate cash coverage of problem loans

» Continued access to the debt markets without significant changes in pricing

» Resilient earnings generation without an increase in its risk profile or worsening in its business development

## 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]**

| | 3-17[2] | 12-16[2] | 12-15[2] | 12-14[2] | 12-13[3] | CAGR/Avg.[4] |
|---|---|---|---|---|---|---|
| Total Assets (NOK billion) | 36 | 36 | 34 | 35 | 31 | 5.0[5] |
| Total Assets (EUR million) | 3,970 | 3,943 | 3,589 | 3,858 | 3,727 | 2.0[5] |
| Total Assets (USD million) | 4,246 | 4,158 | 3,899 | 4,669 | 5,136 | -5.7[5] |
| Tangible Common Equity (NOK billion) | 3.0 | 3.0 | 2.8 | 2.6 | 2.3 | 8.4[5] |
| Tangible Common Equity (EUR million) | 322 | 331 | 288 | 287 | 272 | 5.3[5] |
| Tangible Common Equity (USD million) | 344 | 349 | 313 | 347 | 375 | -2.6[5] |
| Problem Loans / Gross Loans (%) | 0.6 | 0.7 | 0.9 | 1.5 | 1.9 | 1.1[6] |
| Tangible Common Equity / Risk Weighted Assets (%) | 16.7 | 17.0 | 15.9 | 14.6 | 14.7 | 16.0[7] |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 5.6 | 6.7 | 8.4 | 15.5 | 20.7 | 11.4[6] |
| Net Interest Margin (%) | 1.5 | 1.6 | 1.7 | 1.8 | 1.9 | 1.7[6] |
| PPI / Average RWA (%) | 2.1 | 2.4 | 1.9 | 2.3 | 2.7 | 2.2[7] |
| Net Income / Tangible Assets (%) | 0.7 | 0.9 | 0.7 | 0.9 | 0.9 | 0.8[6] |
| Cost / Income Ratio (%) | 45.5 | 39.1 | 46.9 | 41.7 | 41.9 | 43.0[6] |
| Market Funds / Tangible Banking Assets (%) | 39.1 | 38.2 | 39.7 | 41.0 | 38.5 | 39.3[6] |
| Liquid Banking Assets / Tangible Banking Assets (%) | 15.9 | 14.7 | 16.3 | 14.4 | 14.6 | 15.2[6] |
| Gross Loans / Due to Customers (%) | 220.7 | 214.6 | 213.5 | 215.2 | 206.5 | 214.1[6] |

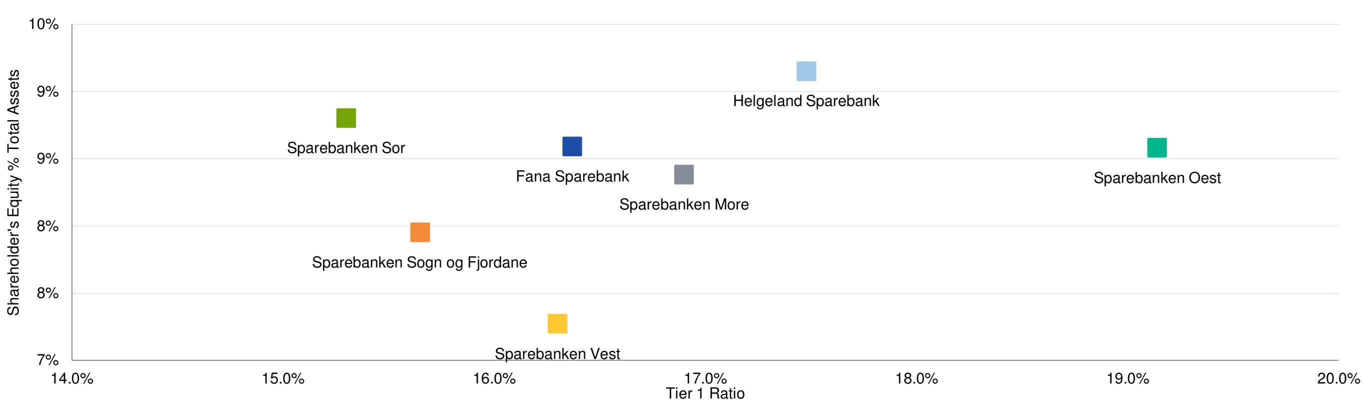
[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented
*Source: Moody's Financial Metrics*

## Detailed Rating Considerations

### Strengthened Capital Buffers, Which Compare Favorably With Similarly Rated Norwegian Savings Banks

Sparebanken Øst's capital buffers have improved over the last years reflecting higher regulatory requirements. As of March 2017, Sparebanken Øst's Common Equity Tier 1 capital (CET1) ratio was 17.2%[1] (March 2016: 16.1%, Dec 2016: 17.21%). The bank's CET1 levels compare favorably with other Norwegian savings banks and exceed both the regulatory requirement of 13.8% (including a Pillar 2 requirement of 2.3% for Sparebanken Øst) and the bank's 14.50% targeted level. Sparebanken Øst also reports a high leverage ratio, which stood at 9.1% as of March 2017[2].

Exhibit 3
**Improved capital levels driven by higher regulatory targets compare favorably with peers**




Note: Figures as of March 2017 apart from figures for Fana Sparebank, which are as of December 2016
*Source: Moody's Banking Financial Metrics*

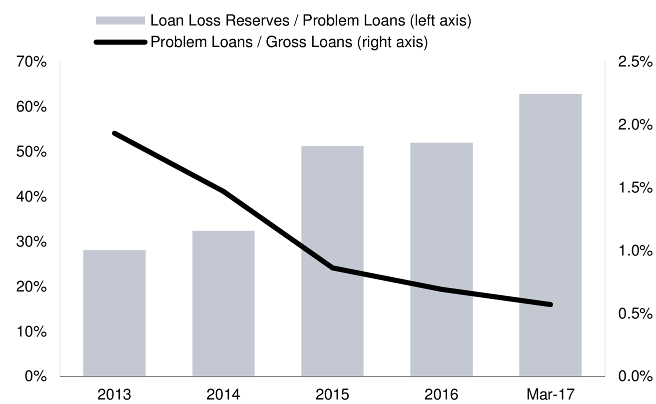
## Improving Asset Quality Though Concentration To The Commercial Real Estate Sector Raises Asset Risk

We expect Sparebanken Øst's asset quality metrics to remain strong reflecting its focus on mortgage lending and limited lending to business customers. The twelve month growth rate in net lending to retail customers was 7.3% at end-March 2017 whilst the net lending to corporate customers decreased by 5.2% over the same period as the bank became more selective in loans.

As of March 2017, the bank's problem loan ratio (measured as impaired loans as a percentage of total loans) declined to 0.57% of gross loans, from 0.69% as of December 2016 and 0.86% as of December 2015 and compares favourably to rated domestic peers. The bank's cash coverage of problem loans improved to 63% as of March 2017 from a low 44.5% as of March 2016.

Exhibit 4

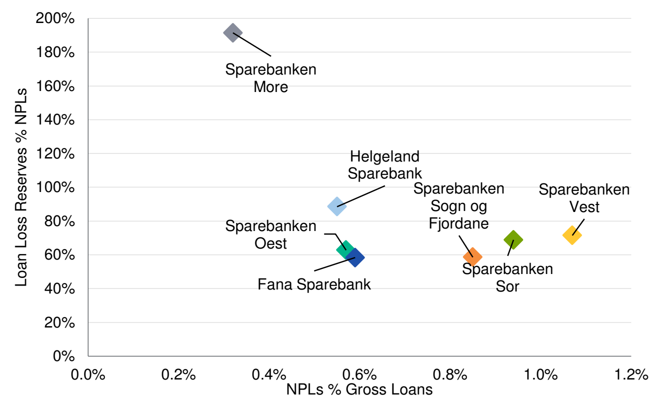
**Sparebanken Øst's asset quality is improving...**




*Source: Moody's Banking Financial Metrics*

Exhibit 5

**... and compares well with Norwegian peers**




Note: Figures as of March 2017 apart from figures for Fana Sparebank, which are as of December 2016
*Source: Moody's Banking Financial Metrics*

The bulk of Sparebanken Øst's lending is in retail loans, mostly in the form of mortgages, accounting for around 86.5% of total loans as of March 2017. Historically Sparebanken Øst, and the banking sector in Norway in general, experienced very low losses in mortgages. 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.

Although Sparebanken Øst's concentration level to the Commercial Real Estate sector has declined it remains significant. Loans in the real estate and construction sector accounted for around 9.3% of gross loans as of March 2017, down from 10% in December 2015. This exposure makes 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 13.5% in March 2017), Sparebanken Øst's business loan balances have been broadly stable in the last few quarters as loan disbursements matched repayments.

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. Nevertheless, despite the contraction in business lending in the first three months of 2017, Sparebanken Øst targets moderate growth of loans to businesses in 2017.

## Core Profitability Showing Signs Of Improvement But Strong Competition In Its Region Constrains Øst's Business Growth

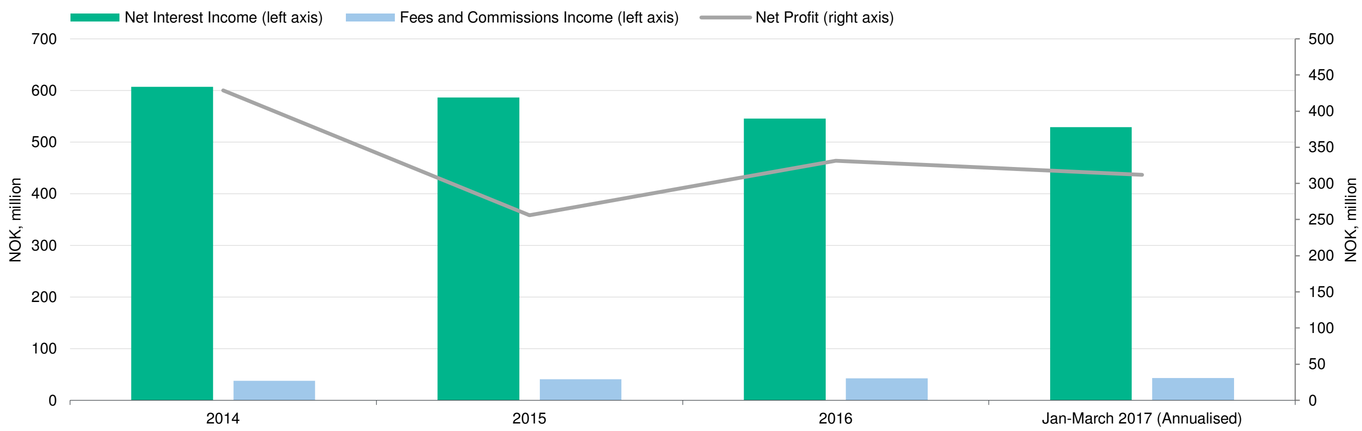
Sparebanken Øst's core profitability is showing signs of improvement with net interest income rising, on a quarterly basis, in the first quarter of 2017 following consecutive declining quarters in 2016[3]. However, the strong competition the bank faces in the greater Oslo and Akershus areas it also operates, may negatively affect its business prospects constraining its profitability.

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 73% of net revenue in the first three months of 2017 and around 76% in 2016.

The bank's annualised return on assets as of March 2017 was at 0.74%. Reported profit for the three first months of 2017 grew by 16% to NOK 78 million from NOK 67.2 million in the first three months of 2016, reflecting modest growth in fees and commissions, market related income and other operating income. However, on an annual basis the bank's net interest income declined by 3.4% to NOK 132.2 million in the first quarter of 2017. In the first quarter of 2017, Sparebanken Øst's net profit included NOK 2.4 million gains related to the group's sale of its shares in Eiendomskreditt, NOK 13.4 million proceeds from the sale of a property and NOK 3 million in tenant's compensation. Operational efficiency is sound and compares well with peers, with a cost-to-income ratio of 45.5% as of March 2017.

Sparebanken Øst followed the moves made by competitor banks and increased interest rates on mortgages during the first quarter of 2017, while lowering deposit costs. These rate rises combined with an increase in higher yielding business loans would support the bank's top line.

Exhibit 6
**Sparebanken Øst Profitability Evolution**




*Source: Moody's Banking Financial Metrics*

### Sparebanken Øst maintains a sizeable reliance to confidence sensitive market funding

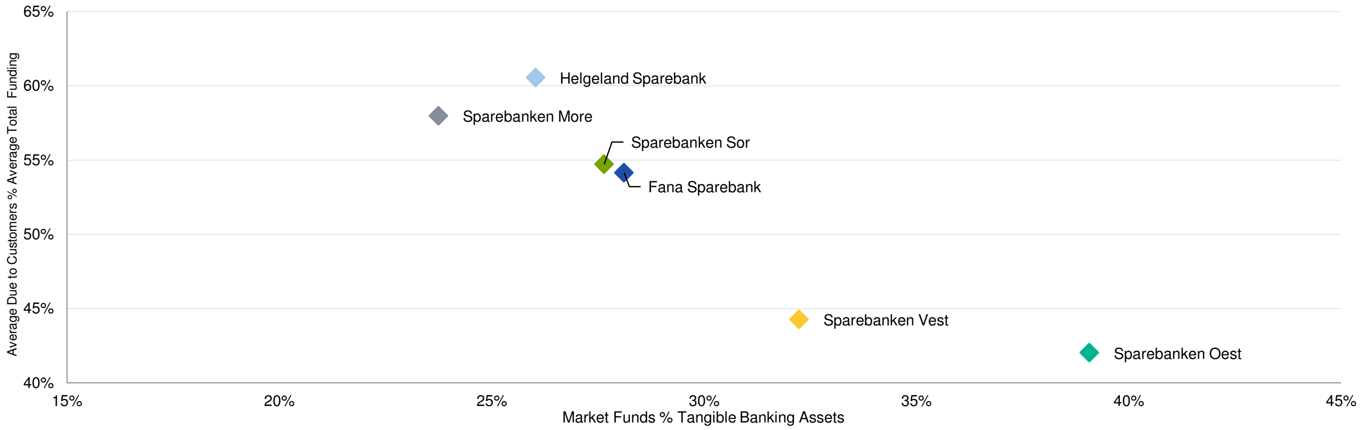
Sparebanken Øst remains to a greater extent than domestic peers reliant on market funds, which constituted around 38% of the bank's tangible banking assets as of December 2016. As such, the bank is therefore sensitive to fluctuations in investor sentiment, a credit weakness.

Deposits accounted for about 41% of Sparebanken Øst's total funding as of March 2017 (43% at December 2016), at the lower end of the range of similarly rated Norwegian savings banks. For the 12 months to March 2017 total deposits increased by 1.3% mainly due to an increase in the corporate sector while retail deposits in contrast decreased by 3.3%. Over the past years retail deposits grew significantly driven by the bank's alternative delivery channels, especially its website Topprente.no, which offers competitive savings rates to retail customers. Although that was a positive development, also note that such deposits as more 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 46% of Sparebanken Øst's market funds as of December 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**




Note: Figures as of March 2017 apart from figures for Fana Sparebank, which are as of December 2016
*Source: Moody's Banking Financial Metrics*

Mitigating its high reliance on market funds, Sparebanken Øst holds a relatively large liquidity buffer. As of December 2016, liquid assets stood at NOK 5.3 billion or 14.7% 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 junior deposits account for 26% of total, 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 Ost'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%** |

| **Factor** | **Historic Ratio** | **Macro Adjusted Score** | **Credit Trend** | **Assigned Score** | **Key driver #1** | **Key driver #2** |
|---|---|---|---|---|---|---|
| Solvency | | | | | | |
| Asset Risk | | | | | | |
| Problem Loans / Gross Loans | 0.9% | aa2 | ↓ | a3 | Geographical concentration | Sector concentration |
| Capital | | | | | | |
| TCE / RWA | 16.7% | 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 | 38.2% | ba2 | ←→ | ba3 | Market funding quality | |
| Liquid Resources | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 14.7% | baa3 | ←→ | baa3 | Stock of liquid assets | |
| Combined Liquidity Score | | ba1 | | ba2 | | |
| 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 | | |

| **Balance Sheet** | **in-scope (NOK million)** | **% in-scope** | **at-failure (NOK million)** | **% at-failure** |
|---|---|---|---|---|
| Other liabilities | 11,445 | 31.4% | 12,825 | 35.2% |
| Deposits | 13,527 | 37.1% | 12,147 | 33.3% |
| Preferred deposits | 10,010 | 27.5% | 9,510 | 26.1% |
| Junior Deposits | 3,517 | 9.6% | 2,638 | 7.2% |
| Senior unsecured bank debt | 9,696 | 26.6% | 9,696 | 26.6% |
| Dated subordinated bank debt | 703 | 1.9% | 703 | 1.9% |
| Equity | 1,094 | 3.0% | 1,094 | 3.0% |
| Total Tangible Banking Assets | 36,465 | 100% | 36,465 | 100% |

| Debt class | De jure waterfall | | De facto waterfall | | Notching | | LGF notching guidance versus 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 | 38.8% | 38.8% | 38.8% | 38.8% | 3 | 3 | 3 | 3 | 0 | a2 (cr) |
| Deposits | 38.8% | 4.9% | 38.8% | 31.5% | 2 | 3 | 2 | 2 | 0 | a3 |
| Senior unsecured bank debt | 38.8% | 4.9% | 31.5% | 4.9% | 2 | 2 | 2 | 2 | 0 | a3 |

| 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 |
| Senior unsecured bank debt | 2 | 0 | a3 | 0 | A3 | A3 |

*Source: Moody's Financial Metrics*

## Ratings

Exhibit 9

| 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*

## Endnotes

1 The ratio increases to 17.4% when we include 50% of interim profit.

2 9.2% when we include 50% of interim profit.

3 When we adjust to exclude the impact of taking the full levy for the deposit guarantee funds of Nok11.7 million in the first quarter of 2016.

REPORT NUMBER 1072655

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