

# MOODY'S

## INVESTORS SERVICE

### CREDIT OPINION

11 October 2017

#### Update

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#### RATINGS

##### Sparebanken Oest

Domicile	Norway
Long Term Deposit	A2
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: Update following the upgrade of the bank's long-term deposit ratings to A2

### Summary

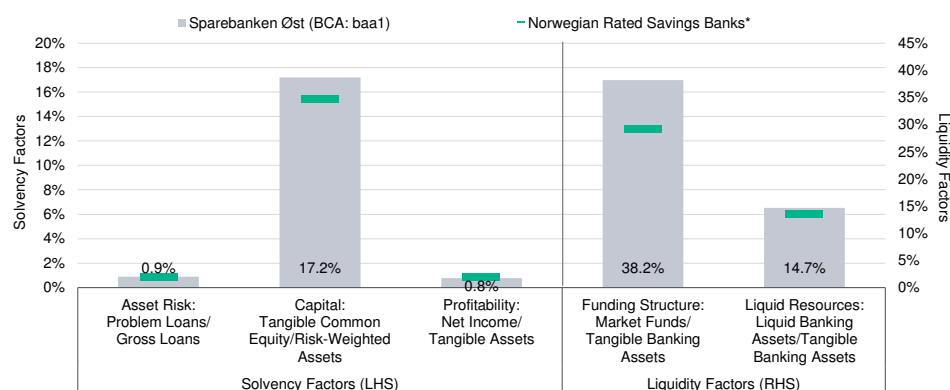
On October 5, we upgraded Sparebanken Øst's base line credit assessment (BCA) to baa1 from baa2 and the long-term deposit and issuer ratings to A2 from A3. We also upgraded the bank's long-term counterparty risk assessment (CRA) to A1(cr) from A2(cr) and maintained the stable outlook on all ratings.

Sparebanken Øst's upgraded BCA of baa1 BCA primarily reflects its strengthened asset quality and increased coverage of problem loans despite the challenging economic conditions in Norway over the last two years, as well as the maintenance of its solid capitalization, which bring its credit profile well in line with baa1-rated peers. From this strengthened base, we expect the bank's performance to remain steady for the foreseeable future, as asset quality and profitability will benefit from a gradually recovering operating environment.

The bank's A2 deposit and issuer ratings take into account our Loss Given Failure (LGF) analysis of the bank's large volume of deposits and substantial layers of subordination, resulting in two notches of rating uplift. Because of its small size, Sparebanken Øst's ratings do not benefit from government support uplift.

Exhibit 1

#### Key Financial Indicators



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

## Credit strengths

- » Improving asset quality, through increased granularity in the bank's balance sheet and decreased single name concentrations
- » Resilient profitability, which compares favorably with similarly rated Norwegian savings banks
- » Strengthened capital buffers which compare favorably 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
- » Core profitability showing signs of improvement but strong competition in its region constrains Øst business growth
- » Exposure to the Oslo real estate market that has been witnessing a price correction since May 2017

## Rating outlook

The stable outlook assigned to Sparebanken Øst remains unchanged, and 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:

- » Strong earnings generation without an increase in its risk profile or worsening in its business development
- » Sustained good asset quality in its retail and corporate books 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

## 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%
- » Any indication that the improvements achieved in recent years are not sustainable
- » Financing conditions become more difficult

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.

## Key Indicators

Exhibit 2

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

	6-17 <sup>2</sup>	12-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>3</sup>	CAGR/Avg <sup>4</sup>
Total Assets (NOK billion)	37	36	34	35	31	4.8 <sup>5</sup>
Total Assets (EUR million)	3,838	3,943	3,589	3,858	3,727	0.8 <sup>5</sup>
Total Assets (USD million)	4,377	4,158	3,899	4,669	5,136	-4.5 <sup>5</sup>
Tangible Common Equity (NOK billion)	3.1	3.0	2.8	2.6	2.3	8.8 <sup>5</sup>
Tangible Common Equity (EUR million)	320	331	288	287	272	4.7 <sup>5</sup>
Tangible Common Equity (USD million)	365	349	313	347	375	-0.8 <sup>5</sup>
Problem Loans / Gross Loans (%)	0.6	0.7	0.9	1.5	1.9	1.1 <sup>6</sup>
Tangible Common Equity / Risk Weighted Assets (%)	17.2	17.0	15.9	14.6	14.7	16.1 <sup>7</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	5.4	6.7	8.4	15.5	20.7	11.3 <sup>6</sup>
Net Interest Margin (%)	1.5	1.6	1.7	1.8	1.9	1.7 <sup>6</sup>
PPI / Average RWA (%)	2.3	2.4	1.9	2.3	2.7	2.2 <sup>7</sup>
Net Income / Tangible Assets (%)	0.9	0.9	0.7	0.9	0.9	0.8 <sup>6</sup>
Cost / Income Ratio (%)	40.2	39.1	46.9	41.7	41.9	42.0 <sup>6</sup>
Market Funds / Tangible Banking Assets (%)	37.1	38.2	39.7	41.0	38.5	38.9 <sup>6</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	15.7	14.7	16.3	14.4	14.6	15.2 <sup>6</sup>
Gross Loans / Due to Customers (%)	215.1	214.6	213.5	215.2	206.5	213.0 <sup>6</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] 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

## Profile

Sparebanken Øst is a savings bank with a well-established market position in southeastern Norway. Traditional banking services including deposit accounts, loans and money-transfer services are provided to retail customers and medium-size enterprise (SMEs). Through agreements with external suppliers, the bank also distributes pension insurance, life and general insurance, and asset management services. As of 30 June 2017, the bank reported total consolidated assets of NOK36.7 billion (€3.8 billion).

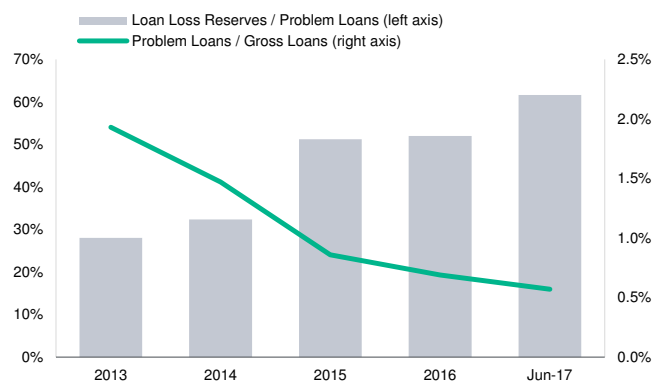
## Detailed credit considerations

### Improving asset quality through increased granularity in the bank's loan book and decreased single name concentrations

We expect Sparebanken Øst's asset quality metrics to remain strong reflecting its focus on mortgage lending and limited lending to business customers, following a quality improvement program in relation to the bank's corporate portfolio implemented during 2011-2015. Corporate loans declined from 24% of gross loans in December 2011 to 13.7% in June 2017. Although Sparebanken Øst's concentration level to the Commercial Real Estate (CRE) sector has declined, it remains significant. Loans in the real estate and construction sector accounted for around 9.5% of gross loans as of June 2017 (16.7% in December 2011). Sparebanken Øst established its own debt collection company in 2016 whose main objective is to engage in debt collection operations and other activities naturally associated with this, including reminder services and long-term monitoring of debt collection portfolios.

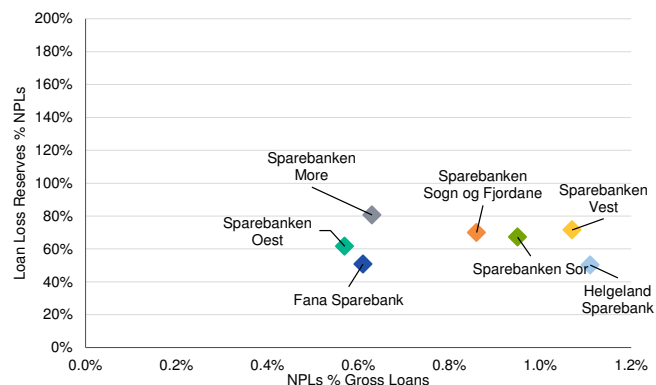
As of June 2017, the bank's problem loan ratio (measured as impaired loans as a percentage of total loans) declined to 0.57% of gross loans, from 0.69% as of December 2016 and 0.86% as of December 2015 and compares favourably to rated domestic peers. The bank's cash coverage of problem loans improved to 62% as of June 2017 from below 30% in 2013 (see Exhibit 4 and 5).

Exhibit 3

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

Source: Moody's Banking Financial Metrics

Exhibit 4

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

Note: Figures as of June 2017

Source: Moody's Banking Financial Metrics

Although, the exposure in the CRE sector makes its asset quality vulnerable in the case the sector faces difficulties, particularly given that many of the bank's large customers are active in this sector, Sparebanken Øst's portfolio has been decreasing as witnessed by negative growth rates since 2011 while both residential and commercial real estate prices have witnessed exceptional growth, particularly in the Oslo metropolitan area.

The twelve month growth rate in net lending to retail customers was 4.11% at end-June 2017 whilst the net lending to corporate customers decreased by 0.8% over the same period as the bank became more selective in its lending to the corporate segment. Going forwards we expect the bank to witness moderate growth in its corporate portfolio of around 4% in 2017.

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 June 2017. Sparebanken Oest is based in Drammen, which is located in the outskirts of Oslo, and residential property prices have increased significantly over the past years. Since May 2017, the growth in real estate prices in Oslo and Drammen, has slowed down significantly owing to tighter lending regulation that came into effect in early 2017.

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

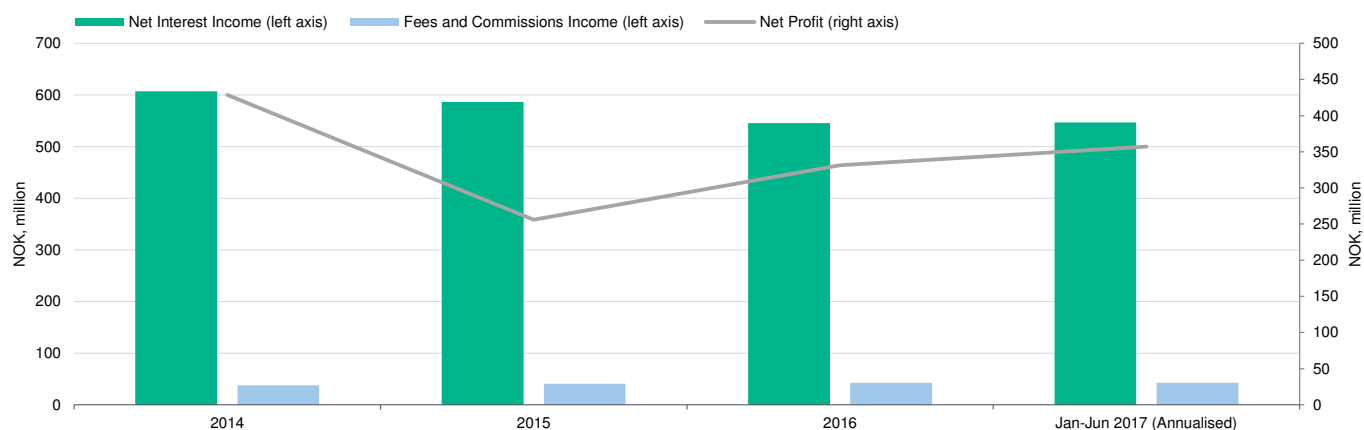
Sparebanken Øst's core profitability is showing signs of improvement with net interest income rising, on a quarterly basis, in the first two quarters of 2017 following consecutive declining quarters in 2016 <sup>1</sup>. However, the strong competition the bank faces in the greater Oslo and Akershus areas, where 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 six months of 2017 and around 76% in 2016.

The bank's annualised return on assets, as calculated by Moody's, was 0.86% in the first half of 2017. Reported profit for the first half of 2017 grew by 3% to NOK 178.5 million from NOK 173.5 million in the first half of 2016, reflecting modest growth in fees and commissions, market related income and other operating income. However, the bank's net interest income in the first half of 2017 declined by 4% to NOK 273.3 million compared to the same period in 2016. In the first half of 2017, Sparebanken Øst's net profit included gains related to the group's sale of its shares in Eiendoms kreditt, proceeds from the sale of property and tenant's compensation. Operational efficiency is sound and compares well with peers, with a cost-to-income ratio of 40.2% as of June 2017.

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

Exhibit 5

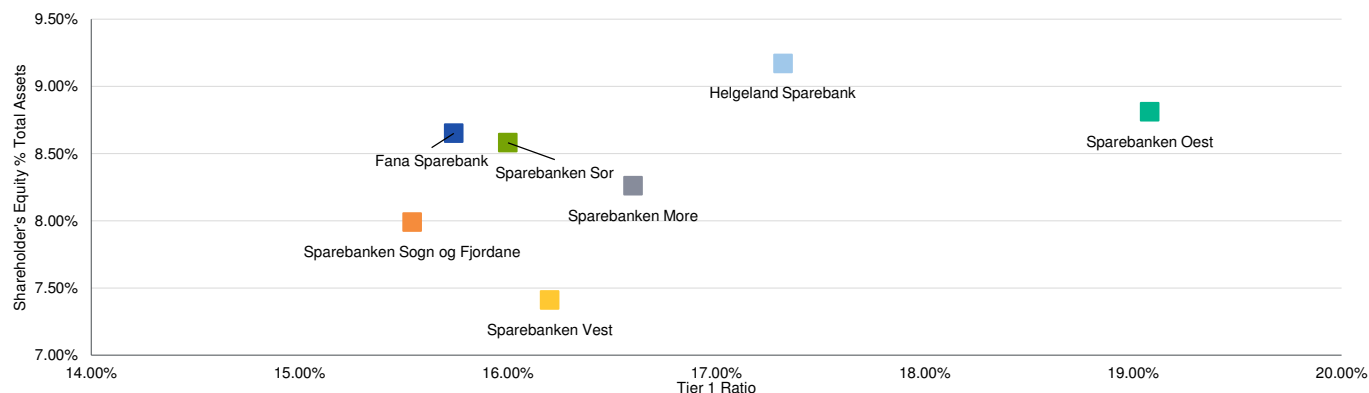
**Sparebanken Øst Profitability Evolution**

Source: Moody's Banking Financial Metrics

**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 June 2017, Sparebanken Øst's Common Equity Tier 1 capital (CET1) ratio was 17.12% <sup>2</sup> (June 2016: 15.71%, Dec 2016: 17.21%). The bank's CET1 levels compare favorably with other Norwegian savings banks and exceed both the current 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% as of June 2017 <sup>3</sup>.

Exhibit 6

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

Note: Figures as of June 2017

Source: Moody's Banking Financial Metrics

**Sparebanken Øst maintains a sizeable reliance to market funding**

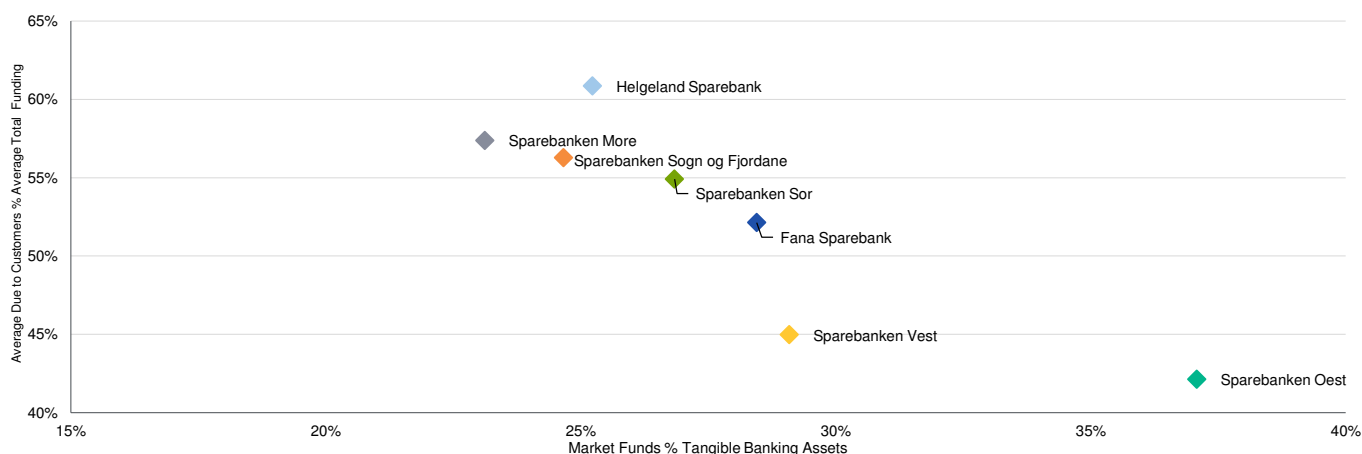
Sparebanken Øst remains to a greater extent than domestic peers reliant on market funds, which constituted around 38% of the bank's tangible banking assets as of December 2016. As such, the bank is therefore sensitive to fluctuations in investor sentiment, a credit weakness.

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. We view the diversification benefit and the typically longer maturity of these funding instruments positively, in particular since recent larger issuances are eligible liquid assets under the liquidity coverage ratio rules.

Deposits accounted for about 42% of Sparebanken Øst's total funding as of June 2017 (43% at December 2016), at the lower end of the range of similarly rated Norwegian savings banks. In the past twelve months ending in June 2017, total deposits decreased by 1.2% mainly due to the 6.4% decline in retail deposits. Deposits from the corporate sector increased by 8.9% in the same period. Retail deposits have however grown significantly over the past years driven by the bank's alternative delivery channels, especially its website Topprente.no, which offers competitive savings rates to retail customers. It should nevertheless be noted that we view such deposits as more price-sensitive and therefore less sticky.

Exhibit 7

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



Note: Figures as of June 2017

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% (15.7% as of June 2017) 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, and its LCR ratio stands at 295.2% as of June 2017.

## Support and structural 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 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 A1(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	17.2%	aa2	← →	aa2	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.8%	baa1	← →	baa1	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				baa1		
Affiliate Support notching				0		
Adjusted BCA				baa1		

Balance Sheet	in-scope (NOK million)	% in-scope	at-failure (NOK million)	% at-failure
Other liabilities	12,156	33.2%	13,587	37.1%
Deposits	14,038	38.3%	12,606	34.4%
Preferred deposits	10,388	28.3%	9,869	26.9%
Junior Deposits	3,650	10.0%	2,737	7.5%
Senior unsecured bank debt	8,668	23.6%	8,668	23.6%
Dated subordinated bank debt	704	1.9%	704	1.9%
Equity	1,100	3.0%	1,100	3.0%
Total Tangible Banking Assets	36,665	100%	36,665	100%



Debt class	De Jure waterfall		De Facto waterfall		Notching		LGF	Assigned	Additional	Preliminary
	Instrument	Sub-ordination	Instrument	Sub-ordination	De Jure	De Facto	Notching Guidance vs. Adjusted BCA	LGF notching	notching	Rating Assessment
Counterparty Risk Assessment	36.0%	36.0%	36.0%	36.0%	3	3	3	3	0	a1 (cr)
Deposits	36.0%	4.9%	36.0%	28.6%	2	3	2	2	0	a2
Senior unsecured bank debt	36.0%	4.9%	28.6%	4.9%	2	2	2	2	0	a2
Instrument class	Loss Given		Additional		Preliminary Rating		Government		Local Currency	Foreign
	Failure notching		Notching		Assessment		Support notching		Rating	Currency Rating
Counterparty Risk Assessment	3		0		a1 (cr)		0		A1 (cr)	--
Deposits	2		0		a2		0		A2	A2
Senior unsecured bank debt	2		0		a2		0		A2	A2

Source: Moody's Financial Metrics

## Ratings

Exhibit 9

Category [Moody's Rating](#)

### SPAREBANKEN OEST

Outlook	Stable
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	A1(cr)/P-1(cr)
Issuer Rating	A2

Source: Moody's Investors Service

## Endnotes

- [1](#) 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.
- [2](#) The ratio increases to 17.6% when we include 50% of interim profit.
- [3](#) 9.3% when we include 50% of interim profit.

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