

MOODY'S INVESTORS SERVICE

Credit Opinion: Sparebanken Oest

Global Credit Research - 19 Dec 2014

Drammen, Norway

Ratings

Category	Moody's Rating
Outlook	Negative(m)
Bank Deposits	Baa1/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]9-14	[3]12-13	[3]12-12	[3]12-11	[3]12-10	Avg.
Total Assets (NOK billion)	35.0	31.1	29.6	28.5	24.7	[4]9.0
Total Assets (EUR million)	4,308.9	3,717.5	4,039.4	3,678.3	3,173.6	[4]7.9
Total Assets (USD million)	5,443.2	5,122.5	5,325.5	4,775.0	4,257.5	[4]6.3
Tangible Common Equity (NOK billion)	2.4	2.2	2.1	1.8	1.8	[4]6.4
Tangible Common Equity (EUR million)	290.0	263.4	279.4	237.8	235.1	[4]5.4
Tangible Common Equity (USD million)	366.3	363.0	368.4	308.7	315.4	[4]3.8
Net Interest Margin (%)	1.8	1.9	1.8	1.7	1.9	[5]1.8
PPI / Average RWA (%)	2.4	2.7	2.7	1.9	3.1	[6]2.4
Net Income / Average RWA (%)	2.0	1.9	1.8	1.3	2.4	[6]2.0
(Market Funds - Liquid Assets) / Total Assets (%)	37.1	34.8	30.3	40.7	40.5	[5]36.7
Core Deposits / Average Gross Loans (%)	48.1	51.7	51.8	42.5	42.6	[5]47.3
Tier 1 Ratio (%)	14.4	15.8	14.8	14.2	15.4	[6]14.4
Tangible Common Equity / RWA (%)	13.3	14.2	13.9	13.2	15.2	[6]13.3
Cost / Income Ratio (%)	40.1	41.3	42.3	54.2	45.2	[5]44.6
Problem Loans / Gross Loans (%)	1.7	1.9	1.9	1.8	1.8	[5]1.8
Problem Loans / (Equity + Loan Loss Reserves) (%)	16.6	17.3	17.5	18.1	16.5	[5]17.2

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - 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 - transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Sparebanken Øst's C- standalone bank financial strength rating (BFSR), which is equivalent to a standalone credit assessment of baa2, primarily reflects the bank's retail focus, its success in recovering from its issues during the financial crisis, and its established regional franchise in the south-eastern Norway (encompassing the Greater Oslo area). Its rating is constrained by its high credit risk concentrations, reliance on market funding, and the strong competition in its home region in particular.

Sparebanken Øst's current global local currency (GLC) deposit rating of Baa1 receives a one-notch uplift from its baa2 standalone credit assessment. This is based on our assessment of a moderate probability of systemic support for the bank if necessary, in light of the Norwegian government's strong ability to extend support to the domestic financial sector and Sparebanken Øst's modest regional and limited national importance.

Rating Drivers

- Solid regional franchise in south-eastern Norway but marginal national market position
- Deposit increases continue although wholesale funding reliance remains
- Currently sound asset quality underpinned by retail focus and supportive macroeconomic environment. Risks stem from its sizeable exposure to the real estate sector and high borrower concentration
- Profitability helped by margin increases across the country. Intense competition in local market likely to make further margin increases difficult
- High capital ratios compared to its peer Norwegian rated savings banks

Rating Outlook

The negative outlook takes into account the recent adoption of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) regulation in the EU. In particular, this reflects that, with the legislation underlying the new resolution framework now in place and the explicit inclusion of burden-sharing with unsecured creditors as a means of reducing the public cost of bank resolutions, the balance of risk for banks' senior unsecured creditors has shifted to the downside. While not subject to the BRRD and SRM, we expect that Norway will look to introduce legislation or other tools that include mechanisms similar to those in the BRRD; our expectations are based on public comments as well as governments' track record of mirroring EU banking regulations. Although our support assumptions are unchanged for now, the probability has risen that they will be revised downwards to reflect the new framework. For further details, please refer to our Special Comment entitled "Reassessing Systemic Support for EU Banks," published on 29 May 2014.

What Could Change the Rating - Up

Upward pressure on the bank's ratings could arise from: (1) improved franchise strength in its home markets without a material increase in risk; (2) a continuation of the focus on core business; (3) a sustained improvement in profitability; and/or (4) maintaining the currently low problem loan level.

What Could Change the Rating - Down

The bank's standalone ratings could be negatively affected by a deterioration in financial flexibility, particularly adverse developments in asset quality. Erosion of the bank's market position, any increase in its overall risk profile or a deteriorating liquidity position could also exert downward pressure on the rating.

In addition, we believe that downward pressure could be exerted on the ratings due to external factors, such as less supportive macroeconomic environment and/or substantially adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

SOLID REGIONAL FRANCHISE IN SOUTH-EASTERN NORWAY BUT MARGINAL NATIONAL MARKET POSITION

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), this 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 many Norwegian banks are operational in the area. The bank's market share on a national basis is small at around 0.6% by loans. In recent years, the bank has increasingly used the internet as an additional distribution channel: it provides mortgages through DinBANK.no, targets young customers through YoungBank.no and collects deposits through Topprente.no, which are less concentrated on the bank's home county.

Overall, we positively view the bank's attempts to widen its operating area, but caution that the capital region remains highly competitive as large domestic and foreign banks are keen to gain and maintain their 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.

DEPOSIT INCREASES CONTINUE ALTHOUGH WHOLESALE FUNDING RELIANCE REMAINS

Deposits comprised about 42% of Sparebanken Øst's total funding at end-September 2014, a significant improvement on the end-2011 figure of 34%, but still at the lower end of our rated Norwegian savings banks. The 30% deposit growth rate seen over 2012 was not repeated during 2013 or so far in 2014, but at 7.9% for the first three quarters of 2014 was still meaningful and partly attributable to Sparebanken Øst's internet website Topprente.no, which offers competitive savings rates to retail customers. Whilst we view positively the increased deposit base, we caution that such deposits may be more price sensitive and therefore less sticky.

Constituting almost 58% of total funding at end-September 2014, Sparebanken Øst remains reliant on market funds, and therefore sensitive to fluctuations in investor sentiment. We note that funding with a maturity shorter than a year accounted for almost 16% of market funds as of third-quarter 2014, up from 11% at end-2013. A relatively large part of Sparebanken Øst's market funding consists of covered bonds issued via its wholly-owned covered bond company, Sparebanken Øst Boligkredit, with this source of funding representing 40% at end-September 2014, compared with 44% at year-end 2013, 35% at year-end 2012, 27% at year-end 2011 and just 10% at year-end 2010. Whilst we positively view the bank's access to the covered bond market, we caution that extensive use of covered bond funding causes structural subordination of Sparebanken Øst's unsecured creditors, including depositors.

Mitigating its high reliance on market funds, Sparebanken Øst holds a relatively large liquidity buffer. At September-end 2014, liquid assets increased to around NOK5.4 billion or around 16% of total assets and consisted of cash, government and government-related bonds and covered bonds.

CURRENTLY SOUND ASSET QUALITY UNDERPINNED BY RETAIL FOCUS AND SUPPORTIVE MACROECONOMIC ENVIRONMENT. RISKS STEM FROM ITS SIZEABLE EXPOSURE TO THE REAL ESTATE SECTOR AND HIGH BORROWER CONCENTRATION

At September-end 2014, problem loans (defined as gross loans in default and non-performing loans that are not in default) accounted for around 1.7% of gross loans, which is in line with levels reported by most other rated Norwegian savings banks, indicating the generally supportive macroeconomic environment in Norway.

Sparebanken Øst's loan book is underpinned by a large and increasing proportion of retail loans, mostly in the form of mortgages, accounting for around 85% of total loans at September-end 2014 (of which 40% are part of Sparebanken Øst Boligkredit's cover pool). This asset class has been more resilient historically but we believe that its performance could be undermined by less favourable interest rate and house price levels, especially given households' high indebtedness.

In our view a major risk to the bank's asset quality is the significant industry concentration towards the property management and construction sectors, which accounted for around 10% of total loans as of third-quarter 2014, although we view the reduction in these sectors positively. The bank's corporate loan book exhibits high borrower concentration, which could accelerate the extent and pace of any asset quality deterioration.

We also note that Sparebanken Øst experienced brisk loan growth in 2010-11 (2011:+14%; 2010:+17%) and we believe that rapid loan growth can be an indication of aggressive lending practices or overheating in some segments, although we note that the loan growth was driven largely by mortgage lending of which a large share was done at relatively low LTV levels. 2012 growth was much lower at 2% (including a 7% reduction in real estate exposure) whilst in 2013, lending to the corporate segment was further reduced by 12% and retail loans grew by 21%. During the nine months of 2014 the corporate loans were 7% down, while retail portfolio increased by 18%. We also note that the bank is increasing lending outside of the bank's main operating area.

Although risk management practices are adequate for the level and type of risk in the bank, they lack the sophistication of many larger players in the Nordic region. Over the most recent years the bank has made efforts to strengthen the risk management, in particular in relation to investments which we view positively. Sparebanken Øst's investment portfolio, which caused significant losses in 2008, has now been run.

PROFITABILITY HELPED BY MARGIN INCREASES ACROSS THE COUNTRY. INTENSE COMPETITION IN LOCAL MARKET LIKELY TO MAKE FURTHER MARGIN INCREASES DIFFICULT

Sparebanken Øst's main source of income is net interest income, which represented over 80% of its 2013 operating income. In 2013 this source of income was supported by strong loan volume growth as well as improved lending margins across the banking system. We see signs of renewed margin pressure across the Norwegian banking market, with mortgage rates having been reduced by most larger banks in the second half of 2014. This follows the margin expansion seen over the recent years. The keen competition in Sparebanken Øst's main area of operation, means that we expect Sparebanken Øst to see its margins and profitability under pressure in the coming period, although we note that Sparebanken Øst's current profitability is at the higher end of the savings bank peer group. We also expect deposit margins will continue to be squeezed and weigh on the bank's top-line profitability.

Fair value adjustments in the securities portfolio of NOK26.4 million contributed positively to revenue in 2013 (2012: NOK62.3 million). Whilst the successful run-off of Sparebanken Øst's investment portfolio will limit the volatility going forward, we note that a sizeable part of the value changes in the two past years were related to Sparebanken Øst's stake in Eksportfinans (Ba3 negative).

Loan loss provisions remained contained at NOK16 million in 2013 (2012: NOK25 million). While we believe future developments are uncertain, we do not foresee levels as elevated as in 2008 (NOK245 million), especially as the bank has now run off its portfolio of loans to Icelandic and Eastern Europe financial institutions.

Although we acknowledge the bank's cost efficiency is good (2013 cost-to-income: 41%), partly because it avoids the fixed costs of product manufacturing through taking minority shares in its product development companies, we believe that cost containment might prove to be more difficult as an independent bank going forward.

During 2014 the bank's profitability remained strong with pre-provision income as a proportion of average risk weighted assets of around 2.4% for nine-months 2014 (adjusted for non-recurring gains). Sparebanken Øst's lending margins decreased to 1.83% in 2014 compared to 1.91% in 2013. In 2014 the Bank has recognised gain on the sale of Nets Holding AS (NOK134.7 million) and Frende Holding AS (NOK11.7 million) recording a realised gain in ordinary profit.

HIGH CAPITAL RATIOS COMPARED TO ITS PEER NORWEGIAN RATED SAVINGS BANKS

At end-September 2014 Sparebanken Øst reported Tier 1 and total capital ratios of 14.4% and 16.7%, respectively (under Basel III). These levels are among the highest within Moody's-rated Norwegian banks and show an improvement compared to the previous years primarily due to issuance of a subordinated loan of NOK150 million and fund notes NOK200 million in October 2013 and a further NOK150 million in September 2014.

NOTE ON DATA

Unless noted otherwise, data in this report is sourced from company reports and our Banking Financial Metrics. All figures are based on our own chart of account, and are adjusted for analytical purposes. Please refer to the documents entitled "Financial Statement Adjustments in the Analysis of Financial Institutions" published on 19 December 2013.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of Baa1 to Sparebanken Øst. The rating is supported by the bank's baa2 standalone credit assessment 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, we assess a moderate probability of systemic support for the bank in the event of a stress situation. Consequently, there is a one-notch uplift for the GLC deposit rating from the bank's standalone credit assessment. We are however likely to gradually reduce systemic support uplift as regulators globally consider implementing bank resolution regimes.

Foreign Currency Deposit Rating

The Baa1 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. An 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	x		
Geographical diversification			x				
Earnings stability							
Earnings Diversification [2]						C-	Neutral
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	x				
Financial Reporting Transparency		x	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						A-	Neutral
Economic Stability		x					
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						C-	
Factor: Profitability						C	Neutral
PPI % Average RWA (Basel II)			2.44%				
Net Income % Average RWA (Basel II)			1.66%				
Factor: Liquidity						E	Neutral
(Market Funds - Liquid Assets) % Total Assets					35.29%		
Liquidity Management					x		
Factor: Capital Adequacy						A	Improving
Tier 1 Ratio (%) (Basel II)	14.94%						
Tangible Common Equity % RWA (Basel II)	13.78%						
Factor: Efficiency						B	Neutral
Cost / Income Ratio		45.97%					
Factor: Asset Quality						B	Weakening
Problem Loans % Gross Loans		1.85%					

Problem Loans % (Equity + LLR)	17.65%				
Lowest Combined Financial Factor Score (15%)					E
Economic Insolvency Override					Neutral
Aggregate BFSR Score					C-
Aggregate BCA Score					baa1/baa2
Assigned BFSR					C-
Assigned BCA					baa2

[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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