

Global Credit Research - 24 Jun 2015

Drammen, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-2
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2

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Key Indicators

Sparebanken Oest (Consolidated Financials)[1]

	[2]3-15	[2]12-14	[3]12-13	[3]12-12	[3]12-11	Avg.
Total Assets (NOK billion)	34.0	35.0	31.2	29.6	28.5	[4]4.5
Total Assets (EUR million)	3,932.3	3,858.5	3,727.2	4,039.4	3,678.3	[4]1.7
Total Assets (USD million)	4,223.3	4,669.0	5,135.9	5,325.5	4,775.0	[4]-3.0
Tangible Common Equity (NOK billion)	2.6	2.6	2.3	2.1	1.7	[4]11.1
Tangible Common Equity (EUR million)	298.2	286.9	272.2	280.6	218.4	[4]8.1
Tangible Common Equity (USD million)	320.3	347.2	375.0	369.9	283.5	[4]3.1
Problem Loans / Gross Loans (%)	1.2	1.5	1.9	1.9	1.8	[5]1.7
Tangible Common Equity / Risk Weighted Assets (%)	14.9	14.6	14.7	14.0	12.1	[6]14.7
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	12.2	15.5	20.7	19.3	21.6	[5]17.9
Net Interest Margin (%)	1.7	1.8	1.9	1.8	1.7	[5]1.8
PPI / Average RWA (%)	1.9	2.3	2.7	2.7	1.8	[6]2.1
Net Income / Tangible Assets (%)	0.8	0.9	0.9	0.9	0.6	[5]0.8
Cost / Income Ratio (%)	47.2	41.7	41.9	43.0	55.3	[5]45.8
Market Funds / Tangible Banking Assets (%)	50.6	50.9	48.0	50.6	58.8	[5]51.8
Liquid Banking Assets / Tangible Banking Assets (%)	16.3	14.4	14.6	20.7	19.3	[5]17.1
Gross Loans / Total Deposits (%)	213.3	211.9	194.5	181.2	205.8	[5]201.3

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 11 May, we upgraded Sparebanken Øst's long-term deposit to A3 from Baa1, and affirmed the baseline credit assessment of baa2, adjusted BCA of baa2 and the Prime-2 short term obligation rating.

The affirmation of the baa2 BCA on Sparebanken Øst primarily reflects the bank's retail focus and its success in restoring profitability following the run off its portfolio of loans to Icelandic and Eastern European financial institutions. Furthermore, the bank has changed its focus to the retail mortgage sector from corporate lending, which Moody's considers a positive for its asset quality profile. Nevertheless, despite these improvements, credit risk concentrations, low problem-loan coverage compared to peers and strong competition in its home region continue to constrain the BCA at the current level.

The upgrade of the bank's deposit rating to A3 from Baa1 takes into account the Loss Given Failure (LGF) analysis of the bank's own volume of deposits and debt, and the volume of securities subordinated to them, which offsets the decrease in government support assumptions. Sparebanken Øst benefits from a large volume of deposits and substantial layers of subordination, resulting in very low loss given failure.

SPAREBANKEN ØST'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

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

Rating Drivers

- Improved capital ratios compare well with those of rated Norwegian savings banks peers
- Asset quality is underpinned by retail focus and supportive macroeconomic environment.
- Intense competition in local market is likely to pressure margins and profitability
- Deposit increases continue although wholesale funding reliance remains
- Large volume of deposits and junior debt resulting in deposit ratings benefiting from a very low loss-given-failure rate.

Rating Outlook

The stable outlooks on the bank's long-term senior debt and deposit ratings reflect our view that the bank's financials will remain broadly resilient in the face of a modest slowdown in Norway's still strong economic performance.

What Could Change the Rating - Up

Upward rating momentum could develop if Sparebanken Øst demonstrates (1) good asset quality in its retail and corporate books, including in the more volatile segments, (2) continued good access to capital markets and improved liquidity, and/or (3) stronger earnings generation without an increase in its risk profile.

What Could Change the Rating - Down

Future downward rating pressure would emerge if (1) Sparebanken Øst's asset quality deteriorates more than anticipated from current levels, (2) financing conditions become more difficult and/or (3) its risk profile increases, for example as a result of increased exposures to more volatile sectors and/or (4) macroeconomic environment deteriorates more than estimated, leading to adverse developments in the Norwegian real-estate market.

DETAILED RATING CONSIDERATIONS

IMPROVED CAPITAL RATIOS COMPARE WELL WITH THOSE OF NORWEGIAN SAVINGS BANKS PEERS

Sparebanken Øst benefits from a strong capital base which has been improving over the years and is a relative strength for the bank. At end-March 2015, Sparebanken Øst had a tangible common equity ratio of almost 15% under Basel III. These levels are above the average of Moody's-rated Norwegian banks and show an improvement from previous years in accordance with the increasing regulatory capital requirements. Our assigned

Capital Score reflects this strength as well as the bank's TCE/tangible banking assets ratio of almost 8% which is well within international standards.

ASSET QUALITY IS UNDERPINNED BY RETAIL FOCUS AND SUPPORTIVE MACROECONOMIC ENVIRONMENT

Our assigned Asset Risk score indicates that asset risk is a relative strength for Sparebanken Øst. Sparebanken Øst's loan book is characterized by a large and increasing proportion of retail loans, mostly in the form of mortgages, accounting for around 85% of total loans at end-December 2014 (of which 40% are part of Sparebanken Øst Boligkreditt's cover pool). This asset class has been more resilient historically, but we believe that its performance could be undermined by less favourable house price levels, especially given households' high indebtedness. At March-end 2015, the bank's problem loan ratio (impaired loans as a percentage of total loans) accounted for around 1.2% of gross loans, which is in line with levels reported by most other rated Norwegian savings banks, and reflects the generally supportive macroeconomic environment in Norway.

Risks to the bank's asset quality arise from significant industry concentration towards the property management and construction sectors, which accounted for around 10% of total loans at end-December 2014 compared to 16% in 2011, 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.

Sparebanken Øst's lending has increased at varying pace in the aftermath of the global financial crisis, but the bank is consistently focusing on the retail mortgage sector at the expense of corporate lending, which we consider positive for its asset risk profile. After brisk retail driven loan growth in 2010-11 (2011:+14%; 2010:+17%), growth in 2012 was much lower at 2% (including a 7% reduction in real estate exposure) whilst in 2013, lending to the corporate segment decreased further by 12% while retail loans grew by as much as 21%. In 2014, corporate lending decreased by 6.3%, while the retail portfolio increased by 15.0%. In the meantime, problem loans coverage has been declining over the years, and we view current levels as weak, especially when compared with those of peers.

While Sparebanken Øst's risk management practices lack the sophistication of many larger players in the Nordic region, the bank has made efforts to strengthen risk management, particularly in relation to investments, which we view positively.

INTENSE COMPETITION IN LOCAL MARKET IS LIKELY TO PRESSURE MARGINS AND PROFITABILITY

Sparebanken Øst's main source of income is net interest income, which, together with its increased retail focus adds to the stability and predictability of income and represented over 80% of its 2014 operating income. In the second half of 2014, we saw signs of renewed margin pressure across the Norwegian banking market, with most banks reducing mortgage rates, following a margin expansion over the recent years. Our assigned Profitability score reflects our expectations that the keen competition in Sparebanken Øst's main area of operation will add further pressure on margins and profitability in 2015, although they are currently at the higher end of the savings bank peer group.

During 2014, the bank's profitability was strong, with net income as a share of tangible assets standing at 0.92% (adjusted for non-recurring gains) above its three-year average of 0.8%. In 2014, the bank realised a gain in ordinary profit on the sale of Nets Holding AS (NOK134.7 million) and Frende Holding AS (NOK11.7 million). Fair value adjustments in the securities portfolio of NOK10.2 million contributed positively to revenue, though to a lesser extent than in previous years (2012: NOK62.3 million, 2013 NOK26.4 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 AS (Ba3 stable).

The bank contained loan loss provisions at NOK23.6 million in 2014 (2013: NOK16.0 million), but problem loan coverage is low at 32.4%. Going forward we expect loan loss provisions to increase in order to improve problem loan coverage as macroeconomic growth weakens in the low oil price environment. Nevertheless, we do not foresee the bank's provisioning to return to the elevated levels it booked in 2008 (NOK245 million), especially as the bank has now run off its portfolio of loans to Icelandic and Eastern European financial institutions. The bank's efficiency compares well with Norwegian rated peers and cost-to-income ratio was at 42% in 2014, which has been stable over the last years.

DEPOSIT INCREASES CONTINUE ALTHOUGH WHOLESALE FUNDING RELIANCE REMAINS

Constituting just over 50% of the bank's tangible assets at end-December 2014, Sparebanken Øst remains reliant

on market funds, and therefore sensitive to fluctuations in investor sentiment.

Deposits accounted for about 42% of Sparebanken Øst's total funding at end-December 2014, a significant improvement from the end-2011 figure of 34% but still at the lower end of levels among rated Norwegian savings banks. The 30% deposit growth rate seen in 2012 was not repeated during 2013, but at 6.8% in 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 price-sensitive and therefore less sticky.

A relatively large part of Sparebanken Øst's market funding consists of covered bonds issued via its wholly owned covered bond company, Sparebanken Øst Boligkreditt, with this source of funding representing 40% at end-December 2014. Under our methodology, we globally reflect the stability of covered bonds relative to unsecured market funding through a standard adjustment in our scorecard. However, we do not expect that, size wise, Sparebanken Øst will have the capacity to make larger benchmark issuance, which ultimately restricts its investor base. The bank's Funding score reflects that its overall funding profile remains a fundamental weakness for Sparebanken Øst. In addition, 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 end-December 2014, liquid assets increased to NOK4.9 billion or around 14% of tangible banking assets 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 AND ADDITIONAL NOTCHING

We expect that Norway will seek to introduce legislation to implement the EU Bank Resolution and Recovery Directive (BRRD). In our LGF analysis we assume residual tangible common equity of 3%, losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, as well as a 5% run-off in preferred deposits. We assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

For Sparebanken Øst's long-term deposit ratings, our ratings have considered the likely impact on loss-given-failure of the volume of deposits and the amount of debt subordinated to them. This has resulted in a Preliminary Rating Assessment of two notches above the BCA, reflecting very low loss-given-failure.

GOVERNMENT SUPPORT

The expected implementation of resolution legislation has caused us to reconsider the probability that government support would benefit certain creditors.

Sparebanken Øst benefits from a well-established market position in the lower Buskerud County of southeastern 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. The bank's market share on a national basis is small at around 0.6% by loans.

Therefore, we consider the probability of government support for debt and deposits as low, resulting in zero notches of uplift.

COUNTERPARTY RISK ASSESSMENT

We also assigned a long-term and short term CR assessment of A2(cr) and P-1(cr) respectively.

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.

Foreign Currency Deposit Rating

The A3 foreign currency deposit rating is not constrained given that Norway has a country ceiling of Aaa.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard 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

Macro Factors	
Weighted Macro Profile	Very Strong -

Financial Profile						
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
<i>Problem Loans / Gross Loans</i>	1.6%	aa3	← →	baa1	Geographical concentration	Sector concentration
Capital						
<i>TCE / RWA</i>	14.9%	aa3	← →	aa3	Risk-weighted capitalisation	
Profitability						
<i>Net Income / Tangible Assets</i>	0.8%	baa1	↓	baa2	Expected trend	
Combined Solvency Score		a1		a3		
Liquidity						
Funding Structure						
<i>Market Funds / Tangible Banking Assets</i>	50.9%	b2	← →	b2	Market funding quality	
Liquid Resources						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	14.4%	baa3	← →	baa3	Stock of liquid assets	
Combined Liquidity Score		ba3		ba3		

Financial Profile

baa2

Qualitative Adjustments

Business Diversification
Opacity and Complexity
Corporate Behavior

Adjustment

0

0

0

0

Sovereign or Affiliate constraint

Aaa

Scorecard Calculated BCA range	baa1 - baa3
Assigned BCA	baa2
Affiliate Support notching	0
Adjusted BCA	baa2

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	2	0	a3	0	A3	A3

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