

MOODY'S

INVESTORS SERVICE

Credit Opinion: Sparebanken Oest

Global Credit Research - 02 Sep 2013

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]6-13	[2]12-12	[2]12-11	[2]12-10	[2]12-09	Avg.
Total Assets (NOK billion)	30.4	29.6	28.5	24.7	22.0	[3]8.4
Total Assets (EUR million)	3,826.1	4,039.4	3,678.3	3,173.6	2,650.4	[3]9.6
Total Assets (USD million)	4,973.3	5,325.5	4,775.0	4,257.5	3,802.7	[3]6.9
Tangible Common Equity (NOK billion)	2.1	2.1	1.8	1.8	1.6	[3]7.9
Tangible Common Equity (EUR million)	268.2	279.4	237.8	235.1	189.2	[3]9.1
Tangible Common Equity (USD million)	348.6	368.4	308.7	315.4	271.4	[3]6.5
Net Interest Margin (%)	1.8	1.8	1.7	1.9	2.1	[4]1.9
PPI / Average RWA (%)	2.7	2.7	1.9	3.1	3.5	[5]2.8
Net Income / Average RWA (%)	1.9	1.8	1.3	2.4	2.4	[5]2.0
(Market Funds - Liquid Assets) / Total Assets (%)	32.9	30.3	40.7	40.5	35.6	[4]36.0
Core Deposits / Average Gross Loans (%)	52.3	51.8	42.5	42.6	43.1	[4]46.5
Tier 1 Ratio (%)	14.3	14.8	14.2	15.4	14.2	[5]14.6
Tangible Common Equity / RWA (%)	13.9	13.9	13.2	15.2	13.4	[5]13.9
Cost / Income Ratio (%)	41.4	42.3	54.2	45.2	41.0	[4]44.8
Problem Loans / Gross Loans (%)	2.0	1.9	1.8	1.8	1.5	[4]1.8
Problem Loans / (Equity + Loan Loss Reserves) (%)	19.4	17.5	18.1	16.5	14.1	[4]17.1

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel II & 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 solid regional franchise in the south-eastern Norway (encompassing the Greater Oslo area), but is constrained by high credit risk concentrations, reliance on market funding as well as future profitability challenges arising from intense market competition.

Sparebanken Øst's current global local currency (GLC) deposit rating of A3 receives a two-notch uplift from its baa2 standalone credit assessment. This is based on our assessment of a high probability of systemic support for the bank if necessary and its importance to the Norwegian market.

Unless otherwise stated, all figures shown are from the bank's latest annual and interim financial reports.

Rating Drivers

- Sparebanken Øst benefits from a solid regional franchise in south-eastern Norway, but is undermined by a marginal market position nationally.
- Its funding profile benefits from a recent increase in deposits, although it remains geared towards market funding and some deposits may be less sticky due to their price sensitivity.
- The bank's asset quality is currently sound and is underpinned by its retail focus; however risks stem from its sizeable exposure to the real estate sector and high borrower concentration.
- It has successfully de-risked its balance-sheet by running off its investment portfolio.
- The bank's profitability will largely depend on its ability to improve margins in a competitive market.
- The bank exhibits relatively high capital ratios compared to its peer Norwegian rated savings banks.

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

Upward pressure on the bank's ratings could arise from (1) a continuation of the focus on core business and reduced asset allocation to the investment portfolio; (2) an improvement in profitability; and/or (3) sustaining the persistently low problem loan level.

What Could Change the Rating - Down

The ratings could be negatively affected by a deterioration in financial flexibility, particularly adverse developments in asset quality. 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 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

FRANCHISE VALUE - GOOD REGIONAL FRANCHISE IN SOUTH-EASTERN NORWAY, BUT MARGINAL MARKET POSITION NATIONALLY

Sparebanken Øst benefits from a good market position in the lower Buskerud county of south-eastern Norway. 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 collect deposits through Topprente.no.

The bank offers clients a wide product range via an open-architecture model: it is part owner of companies established with other independent savings banks, such as Frende (life and non-life insurance products) and Norne Securities (securities company). We view these initiatives positively as they increase cross-selling opportunities for Sparebanken Øst.

Overall, we positively view the bank's attempts 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.

LIQUIDITY- SOME RELIANCE ON LESS STABLE FUNDING SOURCES

Deposits comprised 44% of Sparebanken Øst's total funding at end-June 2013, compared to 34% at year-end 2011. The significant growth in deposits during 2012 (around +30%) is largely attributable to Sparebanken Øst's internet website Topprente.no which offers competitive savings rates to retail customers; whilst we positively view the increased deposit base, we caution that such deposits may be more price sensitive and therefore less sticky.

Despite the growth in deposits, Sparebanken Øst remains reliant on market funds, which constituted close to 60% of total funding at end-June 2013; we note that this type of funds is typically sensitive to fluctuations in investor sentiment. In addition, we note that funding with a maturity shorter than a year accounted for 16% of market funds at end-June 2013 (year-end 2012: 12%). A relatively large and growing part of Sparebanken Øst's market funding consists of covered bonds issued via its wholly-owned covered bond company, Sparebanken Øst Boligkreditt; this source of funding represented 41% at end-June 2013, compared with 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 end-June 2013, liquid assets increased to around NOK3.9 billion or 13% of total assets and consisted of cash, government and government-related bonds and covered bonds.

ASSET QUALITY - UNDERPINNED BY STRONG RETAIL FOCUS BUT RISKS STEM FROM IT SIZEABLE EXPOSURE TO THE REAL ESTATE SECTOR AND HIGH BORROWER CONCENTRATION

At end-June 2013, problem loans (defined as gross loans in default and non-performing loans that are not in default) accounted for around 2% of gross loans, which is in line with levels reported by most other rated Norwegian savings banks.

Sparebanken Øst's loan book is underpinned by a large portion of retail loans, mostly in the form of mortgages, accounting for around 80% of total loans at end-June 2013 (of which around half 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 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 14% of total loans at end-June 2013. The bank's corporate loan book also 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. Nevertheless loan growth in 2012 was much more contained at 2%; in particular Sparebanken Øst reduced its exposure to real estate by 7%. In H1 2013, while lending to the real estate segment was further reduced (-3%), retail loans grew by 10%. We also note that during the period there was a 23% increase in loans outside of the bank's main operating area.

SUCCESSFUL DE-RISKING OF ITS BALANCE-SHEET BY RUNNING OFF ITS INVESTMENT PORTFOLIO

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, and also de-risking the bank. Sparebanken Øst's investment portfolio, which caused significant losses in 2008, has now been run off and at year-end 2012 no financial investments were classified within the high risk category (year-end 2011: NOK53 million; year-end 2010: NOK187 million).

PROFITABILITY - LARGELY DEPENDANT ON ITS ABILITY TO IMPROVE MARGINS IN A COMPETITIVE MARKET

Sparebanken Øst's main source of income is net interest income, which represented over 75% of its 2012 operating income. In 2012 this source of income was supported by strong loan volume growth in 2011 as well as improved lending margins. We expect that keen competition in Sparebanken Øst's area of operation will continue

to constrain margins, although margin pressure will likely be alleviated by the ongoing general repricing movement in the Norwegian banking market in light of expected increase in regulatory capital requirements. 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 contributed positively to revenue in 2012 (+NOK62.3 million), compared to 2011 (-NOK32.8 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 NOK25 million in 2012 (2011: NOK18 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 (2012 cost-to-income: 42%), 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.

In H1 2013, Sparebanken Øst reported pre-tax income of NOK189 million, up from NOK171 million in H1 2012 primarily supported by increased net interest income and lower operating cost, which more than offset lower income from commissions and financial investments. Loan loss provisions remained low, albeit up to NOK6.7 million from NOK5.3 million in H1 2012.

CAPITAL - AT GOOD LEVELS

At end-June 2013 Sparebanken Øst reported Tier 1 and total capital ratios of 14.3% and 15.1%, respectively (standardised approach). Whilst these levels show a marginal improvement compared to the previous year primarily due to retained earnings in 2012, we note that the bank's equity has grown somewhat slower than assets over the past two years (year-end 2012: 7.7% of total assets; year-end 2010: 8.1%). Nevertheless, these levels are among the highest among Moody's-rated Norwegian banks.

NOTE ON DATA

Unless noted otherwise, all figures shown in this report are sourced from the bank's latest annual and interim financial reports and our Banking Financial Metrics. These metrics are based on our own chart of account, and are adjusted for analytical purposes. Please refer to the documents entitled "Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies" and "Frequently Asked Questions: Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies", both published on 19 July 2012.

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 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 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 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 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. 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			
Geographical diversification					x		
Earnings stability			x				
Earnings Diversification [2]							
Factor: Risk Positioning						D	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						A-	Neutral
Economic Stability		x					
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						C-	
Factor: Profitability						B	Neutral
PPI % Average RWA (Basel II)		2.56%					
Net Income % Average RWA (Basel II)		1.84%					
Factor: Liquidity						E	Weakening
(Market Funds - Liquid Assets) % Total Assets					37.17%		
Liquidity Management					x		
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	14.82%						
Tangible Common Equity % RWA (Basel II)	14.11%						
Factor: Efficiency						B	Neutral
Cost / Income Ratio		47.23%					
Factor: Asset Quality						B	Weakening
Problem Loans % Gross Loans		1.82%					
Problem Loans % (Equity + LLR)		17.37%					
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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