

**Credit Opinion: Sparebanken Sogn og Fjordane**

Global Credit Research - 04 Apr 2016

Norway

**Ratings**

Category	Moody's Rating
Outlook	Negative
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

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**Key Indicators**

**Sparebanken Sogn og Fjordane (Consolidated Financials) [1]**

	[2]12-15	[2]12-14	[2]12-13	[2]12-12	[2]12-11	Avg.
Total Assets (NOK billion)	45.9	42.6	39.6	37.1	35.2	[3]6.9
Total Assets (EUR million)	4,777.4	4,700.6	4,734.2	5,061.5	4,546.5	[3]1.2
Total Assets (USD million)	5,189.7	5,688.0	6,523.5	6,673.0	5,902.0	[3]-3.2
Tangible Common Equity (NOK billion)	3.4	3.2	2.9	2.6	2.3	[3]10.3
Tangible Common Equity (EUR million)	355.8	351.7	346.7	354.1	298.8	[3]4.5
Tangible Common Equity (USD million)	386.5	425.6	477.7	466.8	387.9	[3]-0.1
Problem Loans / Gross Loans (%)	1.1	1.8	1.3	1.6	1.8	[4]1.5
Tangible Common Equity / Risk Weighted Assets (%)	13.5	13.7	13.0	12.4	11.2	[5]12.8
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	11.9	19.6	14.8	18.8	21.3	[4]17.3
Net Interest Margin (%)	1.7	1.8	1.7	1.7	1.6	[4]1.7
PPI / Average RWA (%)	1.8	2.3	2.4	2.4	1.4	[5]2.1
Net Income / Tangible Assets (%)	0.5	0.8	0.9	0.9	0.2	[4]0.6
Cost / Income Ratio (%)	46.7	40.6	39.4	40.4	55.2	[4]44.4
Market Funds / Tangible Banking Assets (%)	29.4	27.7	28.6	30.1	40.1	[4]31.2
Liquid Banking Assets / Tangible Banking Assets (%)	12.2	11.1	11.5	11.5	11.9	[4]11.6
Gross loans / Due to customers (%)	174.7	167.0	168.9	171.6	171.7	[4]170.8

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

Moody's assigns Sparebanken Sogn og Fjordane a baa1 baseline credit assessment (BCA), an A2 long-term issuer rating, an A2 long-term deposit rating, and a short-term obligation rating of Prime-1. We also assign a Counterparty Risk Assessment (CRA) of A1(cr) long-term and Prime-1 (cr) short-term.

Sparebanken Sogn og Fjordane's baa1 BCA reflects the bank's strong asset quality, and improving capital metrics, balanced against reliance on the domestic capital market. Our assessment also incorporates the bank's high sector concentrations, which could result in higher provisioning levels as the operating environment slows down. The deposit rating and issuer ratings take into account our Loss Given Failure (LGF) analysis of the bank's own volume of deposits and senior unsecured debt, as well as the volume of securities subordinated to them.

Sparebanken Sogn og Fjordane's deposit and debt ratings carry a negative outlook to capture downward pressure on earnings and increased asset risk on the bank's corporate book as a result of the slowdown in Norway's economic growth driven by a reduction in petroleum investments.

### Rating Drivers

- Sparebanken Sogn og Fjordane's BCA is supported by its Very Strong- Macro Profile
- Capital levels are adequate
- Profitability will continue to be challenged in 2016
- Asset quality currently weaker than peers but expected to normalise
- Market funding reliance renders the bank vulnerable to fluctuations in investor sentiment, but the deposit base remains strong
- Large volume of deposits and junior debt resulting in deposit ratings benefiting from a very low loss-given-failure rate and a two-notch uplift versus its BCA
- Low probability of government support likely resulting in no additional uplift versus BCA for debt and deposits

### Rating Outlook

The negative outlook on the Sparebanken Sogn og Fjordane's deposit and issuer ratings reflect our expectation that Norway's slowing growth resulting from reduced petroleum sector investments will have a negative impact on the bank's profitability and loan performance. Profitability weakened significantly during 2015 driven mainly by losses in the bank's liquidity book, in combination with renewed margin pressure and higher corporate loan losses, trends that we expect to continue in 2016. In addition we expect Sparebanken Sogn og Fjordane's exposure to the construction and real estate sector, which accounted for 13% of total loans at end 2015, to lead to further losses in the bank's portfolio.

### What Could Change the Rating - Up

Upward rating momentum is currently unlikely given the negative outlook. Over time, upward pressure could develop if the bank demonstrates: (1) sustained good asset quality in its retail and corporate loan 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 Sogn og Fjordane's problem loan ratio increases above our system-wide expectation of approximately 2%; (2) financing conditions become more difficult; (3) its risk profile increases, for example as a result of increased exposures to more volatile sectors; (4) net profitability weakens, falling below 0.4% of tangible assets; and/or (5) the macroeconomic environment deteriorates more than estimated, leading to a lower Macro Profile. Also, a reduction in uplift as a result of our LGF analysis could lead to downward rating pressure.

## DETAILED RATING CONSIDERATIONS

SPAREBANKEN SOGN OG FJORDANE'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO

## PROFILE

As a purely domestic bank, Sparebanken Sogn og Fjordane's Macro Profile is aligned with that of Norway at Very Strong-. Norwegian banks benefit from operating in an affluent and developed country with very high economic, institutional and government financial strength as well as low susceptibility to event risk. The country's economy is growing and well diversified, and has demonstrated resilience to the ongoing weakness in the oil sector. The main risks to the system stem from the high level of household indebtedness, elevated real estate prices and domestic banks' extensive use of market funding. However, these risks are offset by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared with GDP.

### CAPITAL LEVELS ARE ADEQUATE

Sparebanken Sogn og Fjordane reported a core tier 1 capital adequacy ratio of 13.7% at end-December 2015, already in excess of the 11.5% minimum requirement that will come into force 1 July 2016. The bank's capital levels compare well with those of its Norwegian peers, having improved from previous years in accordance with increasing regulatory requirements, reflecting stable profitability. Our assigned Capital score reflects this strength, as well as the bank's tangible common equity / tangible banking assets ratio of 7.5%, which is higher than international standards.

### PROFITABILITY WILL CONTINUE TO BE CHALLENGED IN 2016

Sparebanken Sogn og Fjordane's profitability weakened significantly during 2015 driven mainly by losses in the bank's liquidity book, in combination with renewed margin pressure and higher corporate loan losses, trends that we expect to continue in 2016.

Net interest income, which was the largest contributor to operating income (93% in 2015), increased by 3.8% year-on-year in 2015 while the net interest margin decline to 1.7% from 1.75% in 2014 due to lower margins on loans driven by continuous interest rate cuts by the Norwegian Central Bank. Loan loss provisions increased in 2015, with the cost of risk at 0.25% at end-December 2015, preceded by 0.20% in 2014 and 0.13% in 2013, mainly related to a particular exposure in the oil industry. In addition higher spreads in the wholesale market during the third and fourth quarters of 2015 led to losses on the investment securities held in the bank's liquidity portfolio. These pressures, combined with negative results from the investment portfolio of the bank led to a decline in the net income by 32.5% in 2015 compared to 2014.

The annualised return on tangible assets was 0.5% at end-December 2015, significantly lower compared to 0.8% at end 2014 and the bank's three-year average. Our assigned Profitability score reflects our view that the more challenging operating environment in 2016 will continue to put pressure on the bank's financial performance, through a combination of 1) lower margins as interest rates continue to decline and wholesale funding costs remain high, 2) higher loan loss provisions driven by the bank's corporate portfolio and 3) further losses on securities held in the bank's liquidity book.

### ASSET QUALITY CURRENTLY WEAKER THAN PEERS, BUT EXPECTED TO NORMALISE

Sparebanken Sogn og Fjordane's asset quality has improved significantly over the past years supported by a strong operating environment. The bank's problem loan ratio (impaired loans as a percentage of gross loans) decreased to 1.1% at end-December 2015, from 1.8% at year-end 2014, 1.3% in 2013. This decrease was attributable to the reversal of losses stemming from one corporate client, leading to increased loan loss coverage to a degree in line with peers. Furthermore, the bank increased its non-performing loan coverage ratio to 65.2% from 28.7% in 2014.

The bank's exposure to the real-estate and construction sectors stood at 13% of total loans at year-end 2015. Its overall exposure to oil-related business is low, at 1.5% of total loans. Similar to most of its Nordic peers, the bank exhibits high single-name concentration, which could heighten the pace and the extent of any deterioration in asset quality, which is reflected in our assigned Asset Risk.

We expect that the slowdown in economic growth in Norway will translate into asset quality pressures over the loan book of the bank. As a result, we anticipate that we could see some moderate asset quality deterioration in the near to medium term.

### MARKET FUNDING RELIANCE RENDERS THE BANK VULNERABLE TO FLUCTUATIONS IN INVESTOR SENTIMENT, BUT ITS DEPOSIT BASE REMAINS STRONG

Sparebanken Sogn og Fjordane's funding profile benefits from a sizeable deposit base, constituting 63.5% of total funding at year-end 2015. While more than half of the bank's deposits come from retail customers, while corporate deposits are spread over many sectors, of which the largest is public sector deposits, the bank is more vulnerable to changes in investor sentiment due to its full dependency on the concentrated domestic market.

The bank's reliance on market funding remains high, representing 40% of tangible assets at year-end 2015, rendering it vulnerable to swings in investor sentiment. In particular, the bank has been using covered bond funding actively since 2009, when the bank's wholly-owned covered bond company (Bustadkreditt Sogn og Fjordane AS) was established. Under our methodology, we reflect on a global level the stability of covered bonds relative to unsecured market funding through a standard adjustment in our Scorecard. However, we do not expect that Sparebanken Sogn og Fjordane will have the capacity, in terms of size, to undertake larger benchmark issuance, ultimately restricting its investor base. As such, our assessment considers the bank's overall funding profile as a relative weakness.

Liquid assets totalled 12% of tangible assets at the end of 2015. They comprised cash and deposits with the central bank and a securities portfolio, which mainly included covered bonds, government and semi-government bonds, as well as other bonds, commercial paper and a limited amount of equity investments. We note that the bank's holdings are concentrated in Norwegian securities, which could be a source of vulnerability owing to concentration risk.

## **Notching Considerations**

### **LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING**

We expect that Norway will look to introduce the EU's Bank Resolution and Recovery Directive in 2017. In our LGF analysis we assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These metrics are in line with our standard assumptions.

Sparebanken Sogn og Fjordane's long-term deposit and issuer ratings include our considerations of the likely impact on loss-given-failure of the of the bank's own volume of deposits and senior unsecured debt, as well as the volume of securities subordinated to them. This results 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 potential for government support to benefit certain creditors. Sparebanken Sogn og Fjordane is a regional savings bank with a strong market position in the county of Sogn og Fjordane (Western Norway), where we estimate that it commands a 51% market share for lending and about 45% for deposits. Despite its dominant local position, the bank lacks geographical diversification and its national franchise is limited by a national market share of less than 2% (based on total lending nationwide, using Statistics Norway data). We therefore consider the probability of government support for Sparebanken Sogn og Fjordane's debt and deposits to be low, which results in no ratings uplift.

### **COUNTERPARTY RISK ASSESSMENT**

We assign a long-term and short-term CR assessment of A1(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**

Sparebanken Sogn og Fjordane's foreign-currency deposit rating of A2 is unconstrained given that Norway has a country ceiling of Aaa.

## Rating Factors

Sparebanken Sogn og Fjordane

<b>Macro Factors</b>	
<b>Weighted Macro Profile</b>	<b>Very Strong</b>

<b>Financial Profile</b>						
<b>Factor</b>	<b>Historic Ratio</b>	<b>Macro Adjusted Score</b>	<b>Credit Trend</b>	<b>Assigned Score</b>	<b>Key driver #1</b>	<b>Key driver #2</b>
<b>Solvency</b>						
<b>Asset Risk</b>						
<i>Problem Loans / Gross Loans</i>	1.4%	aa2	← →	baa2	Single name concentration	Sector concentration
<b>Capital</b>						
<i>TCE / RWA</i>	13.9%	a1	← →	a1	Risk-weighted capitalisation	
<b>Profitability</b>						
<i>Net Income / Tangible Assets</i>	0.7%	baa2	↑	baa2	Return on assets	
<b>Combined Solvency Score</b>		a1		a3		
<b>Liquidity</b>						
<b>Funding Structure</b>						
<i>Market Funds / Tangible Banking Assets</i>	37.4%	ba2	← →	ba2	Extent of market funding reliance	
<b>Liquid Resources</b>						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	11.1%	baa3	← →	baa3	Stock of liquid assets	
<b>Combined Liquidity Score</b>		ba1		ba1		

**Financial Profile**

**baa1**

**Qualitative Adjustments**

**Adjustment**

Business Diversification  
Opacity and Complexity  
Corporate Behavior

0

0

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

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	2	0	a2	0	A2	A2

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