

Credit Opinion: SpareBank 1 SR-Bank

Global Credit Research - 09 Jan 2012

Stavanger, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A1/P-1
Bank Financial Strength	C-
Baseline Credit Assessment	(Baa1)
Adjusted Baseline Credit Assessment	(Baa1)
Issuer Rating	A1
Senior Unsecured	A1
Subordinate	*A2
Jr Subordinate MTN	*(P)Baa2
Pref. Stock Non-cumulative	Ba1 (hyb)

* Placed under review for possible downgrade on November 29, 2011

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Key Indicators

SpareBank 1 SR-Bank (Consolidated Financials)[1]

	[2]9-11	[2]12-10	[2]12-09	[2]12-08	[2]12-07	Avg.
Total Assets (NOK billion)	133.0	134.8	124.9	125.8	103.1	[3]6.6
Total Assets (EUR million)	16,879.817	17,284.315	15,070.712	12,922.712	9,989.5	[3]6.8
Total Assets (USD million)	22,647.823	187.621	622.517	963.218	991.3	[3]4.5
Tangible Common Equity (NOK billion)	9.1	8.9	7.2	5.1	5.1	[3]15.8
Tangible Common Equity (EUR million)	1,155.3	1,144.1	871.4	527.9	638.4	[3]16.0
Tangible Common Equity (USD million)	1,550.1	1,534.8	1,250.3	733.8	933.4	[3]13.5
Net Interest Margin (%)	1.4	1.4	1.4	1.5	1.5	[4]1.4
PPI / Avg RWA (%)	1.4	1.7	1.8	1.1	1.5	[5]1.5
Net Income / Avg RWA (%)	1.1	1.4	1.3	0.3	1.5	[5]1.1
(Market Funds - Liquid Assets) / Total Assets (%)	38.1	41.8	44.7	41.0	36.8	[4]40.5
Core Deposits / Average Gross Loans (%)	60.9	61.7	56.4	56.1	60.7	[4]59.2

Tier 1 Ratio (%)	9.6	10.2	9.6	6.4	7.4 [5]	8.6
Tangible Common Equity / RWA (%)	9.2	9.6	8.5	5.8	7.4 [5]	8.1
Cost / Income Ratio (%)	57.2	51.5	50.5	62.2	56.0[4]	55.5
Problem Loans / Gross Loans (%)	1.2	1.1	1.2	1.6	0.8 [4]	1.2
Problem Loans / (Equity + Loan Loss Reserves) (%)	11.7	11.0	12.7	24.3	12.3[4]	14.4

Source: Moody's

[1] All 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 rates SpareBank 1 SR-Bank ASA A1/P-1/C-. The C- Bank Financial Strength Rating (BFSR), which maps to a Baseline Credit Assessment (BCA) of Baa1, reflects the bank's solid regional market position, good risk management and strengthened capital buffer. The key factor constraining the rating is SpareBank 1 SR-Bank's limited geographic outreach giving the bank a high credit risk concentration.

SpareBank 1 SR-Bank's global local currency (GLC) deposit rating of A1 receives a three-notch uplift from its Baa1 BCA. This is based on our assessment of a very high probability of systemic support for the bank in case of need, reflecting its position in the Norwegian market and also its membership of the SpareBank 1 Alliance, although we only factor in a low probability of support from SpareBank 1 Alliance.

In January 2012, SpareBank 1 SR-Bank was converted to a limited liability company (ASA) from an equity certificate company.

Credit Strengths

- Solid regional market position and brand recognition in south-western Norway
- Benefits of membership in the SpareBank 1 Alliance in terms of cross selling opportunities, shared operations and risk management practices
- Resilient earnings from core banking operations
- Improved capital position

Credit Challenges

- Asset quality vulnerable to potential house price falls or rising interest rates
- High credit risk concentration due to limited geographic reach and strong loan growth in 2006-08, especially in the corporate sector
- Pressure on core earnings in the competitive Norwegian banking market
- Heavy reliance on market funding

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

An upgrade of the banks' ratings could be triggered by a sustainable improvement in earnings without an increase in its risk profile. A reduction of loan concentrations may also result in upward pressure on the ratings.

What Could Change the Rating - Down

The BFSR could be negatively affected if credit quality weakens to a greater extent than envisaged in Moody's base-case stress scenario, which would exert pressure on the bank's capitalisation. SpareBank 1 SR-Bank's GLC deposit rating could be downgraded in the event of (i) the BCA being lowered to Baa2 or the BFSR being downgraded, and/or (ii) a decline in Moody's assessment of the probability of systemic and group support for the bank.

Recent Results

SpareBank 1 SR-Bank reported pre-tax income of NOK1,005 million in Q1-Q3 2011, down from NOK1,200 million in the corresponding period of 2010. The lower result was primarily driven by increased operating expenses and lower unrealised financial gains. Loan loss provisions were significantly lower in Q1-Q3 2011 totalling NOK94 million (down from NOK163 million in Q1-Q3 2010). Core banking income, net interest and commission income, increased by approximately 4%. Net interest income remains stable but the positive impact from volume growth and wider deposit margins is clearly hindered by higher funding costs. The bank's Tier 1 ratio stood at 9.6% (including 50% of the interim profit) at end-September 2011.

DETAILED RATING CONSIDERATIONS

Detailed considerations for SpareBank 1 SR-Bank's currently assigned ratings are as follows:

Bank Financial Strength Rating

The assigned BFSR is one notch lower than the outcome of Moody's bank financial strength scorecard. Based on Moody's loan loss expectations and given high credit risk concentration we believe that the bank's financial strength is more consistent with a C- BFSR.

Qualitative Factors (50% weighting)

Franchise Value

Trend: Neutral

SpareBank 1 SR-Bank has a sound franchise in the county of Rogaland, south-western Norway with 54 branch offices. Moody's estimates the bank has market shares of above 20% for lending and almost 30% for deposits in Rogaland. The bank is expanding into the neighbouring counties has a limited national market share at around 3-4%. The franchise value benefits from the bank's membership in the SpareBank 1 Alliance, which consists of 17 savings banks across Norway together representing one of the leading banking groups in Norway.

In January 2012, SpareBank 1 SR-Bank was converted to a limited liability company (ASA) from an equity certificate company. We do not expect any material change in the strategy as a result of the conversion. Moody's will continue to monitor the change and its effect on the Alliance.

Going forward we expect the bank to be able to maintain a leading position in south-western Norway but note that the Norwegian banking market is highly competitive and that savings banks generally lack pricing power against the two national market leaders. Additionally, the limited geographic diversification

constrains the overall score for the bank's franchise value to C-.

Risk Positioning

Trend: Neutral

SpareBank 1 SR-Bank's management practices and systems provide comprehensive guidelines and tools for risk-taking and also benefits from SpareBank 1 Alliance's focus on credit risk modelling. The quality of financial reporting is good when compared with that of its peers. The 20 largest owners held approximately 43% of the share capital at YE 2011 where the largest owner Gjensidige holds 16.3%.

The bank has limited appetite for market risk. Exposure to interest rate risk is limited to NOK60 million in relation to a 100 basis point parallel movement in interest rates. The bank's on-balance sheet shareholdings increased to NOK628 million at end-Q3 2011 (approximately 7% of Tier 1 capital).

Its overall risk profile is good, although risk concentrations remain a constraint on the C- score for risk positioning.

Operating Environment

Trend: Neutral

The score for operating environment takes into account the economic stability, integrity and corruption in the country as well as the legal system. The unadjusted score for Norway's operating environment is B and is constrained by a score of C for economic stability, primarily as a result of volatility in oil prices. To reflect the fact that offshore revenues are allocated to the Government Pension Fund and have a limited impact on the mainland economy, we calculate the score for economic stability as the average of the standard deviations of GDP growth both including (25% weight) and excluding offshore revenue (75% weight), which results in an adjusted score of B. Consequently, the adjusted score for operating environment is B+. For further discussion of the operating environment, please see Moody's latest Banking System Outlook on Norway.

Quantitative Factors (50% weighting)

Profitability

Trend: Weakening

Earnings from core banking activities at SpareBank 1 SR-Bank are showing a positive underlying trend. Net interest income, corresponding to more than 50% of income, of has increased slightly, partly due to loan growth, but remains constrained by increasing funding costs and strong competition. Commission income, contributing by 20% of income, has been growing in recent years partly due to cross-selling of the Alliance's products and also due to the fact that interest income on loans transferred to the Alliance's mortgage company, SpareBank 1 Boligkreditt, is reported as commissions instead of interest income. Net profitability has also been helped by an improving loan loss provision trend recently. SpareBank 1 SR-Bank's cost efficiency remained good in 2010, as reflected by a cost-to-income ratio of 50%.

The scorecard outcome is D+ and is constrained by the lower profitability levels in 2008. We recognise the improvement in overall profitability in 2009 and 2010 but note that the increase mainly came as a result of larger gains on financial investments and lower provisions. We assess the profitability trend as weakening going forward due to economic outlook uncertainties especially for the corporate sector.

Liquidity

Trend: Neutral

The bank's liquidity portfolio (corresponding to 15% of total assets at Q3 2011) consists mainly of covered bonds, financial institution, governments and municipality bonds and some domestic corporate bonds. Most of the portfolio is repo eligible. SpareBank 1 SR-Bank benefits from a good deposit base, which covers almost 60% of on-balance-sheet loans and 52% of non-equity liabilities. However, almost half of the bank's funding is in the form of domestic and international wholesale funding.

The bank has access to covered bonds, jointly with other members of the SpareBank 1 Alliance through SpareBank 1 Boligkreditt and also has the possibility to issue covered bonds backed by commercial mortgage loans from recently established SpareBank 1 Næringskreditt. Moody's cautions that extensive use of covered bond funding through these structures, whereby prime assets come off the bank's balance sheet, might result in the structural subordination of SpareBank 1 SR-Bank's unsecured creditors, including depositors. Any significant structural subordination might impact the bank's senior debt and deposit ratings.

In 2011 SpareBank 1 SR-Bank issued NOK2 billion senior unsecured funding with maturities ranging between 3-5 years. During 2011 NOK19 billion were transferred to Sparebank 1 Boligkreditt, the mortgage company of the Sparebank 1 Alliance.

The D+ score for liquidity, although lower than that of European counterparts, is in line with that of other Norwegian banks. It reflects SpareBank 1 SR-Bank's reliance on market funding, although we note the positive impact of the bank's liquidity management as well as its access to covered bonds.

Capital Adequacy

Trend: Neutral

At end Q3 2011, the bank's Tier 1 and total capital ratios - calculated in accordance with the transitional rules towards Basel II - stood at 9.6% and 11.2%, respectively. These levels exceed the board's minimum Tier 1 ratio target of 9.0%. SpareBank 1 SR-Bank was converted into a limited liability company from an equity certificate company in January 2012. The key rationale is to broaden the investor base. The conversion should not have a significant impact on the bank's capital levels; however, should it be paired with less prudent growth or an increase in risk taking, it could jeopardize the bank's solidity.

The score for capital adequacy is B+. We view the current capital levels as an adequate buffer to absorb expected further losses and hence view the trend as neutral.

Asset Quality

Trend: Weakening

SpareBank 1 SR-Bank's loan portfolio is relatively well diversified, with around half of lending being to retail customers as at end Q3 2011 (over 60% including loans transferred to SpareBank 1 Boligkreditt), mostly in the form of mortgages. As most Nordic peers, SpareBank 1 SR-Bank has a high borrower concentration as measured by the 20 largest exposures in relation to Tier 1 capital where commercial real estate is the most notable sector representing 20% of total loans. Loan growth has been rapid in the past years and has resulted in a less well-seasoned loan portfolio.

Overall, the bank reported a moderate weakening in credit quality through the global economic downturn. Problem loans have now decreased to 1% of gross loans in Q3 2011. Coverage of problem loans by loan loss reserves increased to around 60% at YE 2010, a level which we view as satisfactory.

The score for asset quality is B. The current strong asset quality may however not be sustainable across the economic cycle given the still fragile economic recovery which justifies a weakening asset quality trend particularly related to the corporate sector. According to Moody's SpareBank 1 SR-Bank's loan book concentration and exposure to commercial real estate and shipping are vulnerable to an economic

downturn and could result in severe balance sheet and profitability stress on the bank.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of A1 to SpareBank 1 SR-Bank. Under Moody's Joint Default Analysis, the rating receives a three-notch uplift from the Baa1 BCA. As a result of SpareBank 1 SR-Bank's importance to the region and the region's importance to the national economy of Norway (local currency deposit ceiling of Aaa), Moody's assesses a very high probability of systemic support for the bank from Norway in the event of a stress situation. We are however likely to gradually reduce such unusual support uplift as such support mechanisms are phased out, as banks' stand-alone profiles improve, and as regulators globally consider implementing bank resolution regimes. Furthermore, SpareBank 1 SR-Bank also benefits from a low probability of support from SpareBank 1 Alliance. The dependence between SpareBank 1 SR-Bank and SpareBank 1 Alliance is high due to the substantial degree of integration between the alliance banks and shared products.

Notching Considerations

The ratings for the Bank's hybrid obligations are notched off the BCA according to "Moody's Guidelines for Rating Bank Hybrid Securities and Subordinated Debt" released on 17 November 2009. On 28 November 2011, Moody's placed under review for downgrade all subordinated and junior subordinated debt for rated Norwegian banks. This reflects Moody's belief that the probability of subordinated bank debt in Europe benefiting from systemic support will be lower than assumed in the past, further to possible legislative changes, including the European Commission's proposed framework on resolution regimes, which would allow the imposition of losses on subordinated debt holders outside a bankruptcy. Moody's notes that Norway typically implements EU legislation.

Foreign Currency Deposit Rating

SpareBank 1 SR-Bank's foreign currency deposit rating of A1 is unconstrained given that Norway has a country ceiling of Aaa.

Foreign Currency Debt Rating

SpareBank 1 SR-Bank's foreign currency debt rating of A1 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 honor 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 recognize 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. A 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

SpareBank 1 SR-Bank

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						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						
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						B+	Neutral
Economic Stability		x					
Integrity and Corruption		x					
Legal System	x						
Financial Factors (50%)						C	
Factor: Profitability						D+	Weakening
PPI / Average RWA - Basel II			1.56%				
Net Income / Average RWA - Basel II				0.99%			
Factor: Liquidity						D+	Neutral
(Mkt funds-Liquid Assets) / Total Assets					42.48%		
Liquidity Management			x				
Factor: Capital Adequacy						B+	Neutral
Tier 1 Ratio - Basel II		8.75%					
Tangible Common Equity / RWA - Basel II	8.01%						
Factor: Efficiency						B	Neutral
Cost / Income Ratio		54.73%					
Factor: Asset Quality						B	Weakening
Problem Loans / Gross Loans		1.33%					

Problem Loans / (Equity + LLR)	16.02%					
Lowest Combined Score (15%)						D+
Economic Insolvency Override						Neutral
Aggregate Score						C
Assigned BFSR						C-

[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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