MOODY'S
INVESTORS SERVICE

Credit Opinion: Sparebanken Sogn og Fjordane

Global Credit Research - 19 May 2015

Norway

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1

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Key Indicators

Sparebanken Sogn og Fjordane (Consolidated Financials)[1]

	[2]**12-14**	[2]**12-13**	[2]**12-12**	[2]**12-11**	[2]**12-10**	**Avg.**
Total Assets (NOK billion)	**42.6**	**39.6**	**37.1**	**35.2**	**32.8**	[3]**6.8**
Total Assets (EUR million)	**4,700.6**	**4,734.2**	**5,061.5**	**4,546.5**	**4,205.3**	[3]**2.8**
Total Assets (USD million)	**5,688.0**	**6,523.5**	**6,673.0**	**5,902.0**	**5,641.6**	[3]**0.2**
Tangible Common Equity (NOK billion)	**3.2**	**2.9**	**2.6**	**2.3**	**2.3**	[3]**8.8**
Tangible Common Equity (EUR million)	**351.7**	**346.7**	**355.3**	**298.8**	**291.6**	[3]**4.8**
Tangible Common Equity (USD million)	**425.6**	**477.7**	**468.4**	**387.9**	**391.2**	[3]**2.1**
Problem Loans / Gross Loans (%)	**1.8**	**1.3**	**1.6**	**1.8**	**2.1**	[4]**1.7**
Tangible Common Equity / Risk Weighted Assets (%)	**13.7**	**13.0**	**12.4**	**11.2**	**10.9**	[5]**12.2**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**19.6**	**14.8**	**18.7**	**21.3**	**23.4**	[4]**19.6**
Net Interest Margin (%)	**1.8**	**1.7**	**1.7**	**1.6**	**1.7**	[4]**1.7**
PPI / Average RWA (%)	**2.3**	**2.4**	**2.4**	**1.4**	**2.2**	[5]**2.1**
Net Income / Tangible Assets (%)	**0.8**	**0.9**	**0.8**	**0.2**	**0.7**	[4]**0.7**
Cost / Income Ratio (%)	**40.5**	**39.5**	**40.4**	**55.2**	**38.0**	[4]**42.7**
Market Funds / Tangible Banking Assets (%)	**37.4**	**37.6**	**38.9**	**40.1**	**39.2**	[4]**38.6**
Liquid Banking Assets / Tangible Banking Assets (%)	**11.1**	**11.5**	**11.5**	**11.9**	**11.4**	[4]**11.5**
Gross Loans / Total Deposits (%)	**167.0**	**168.9**	**171.6**	**171.7**	**172.4**	[4]**170.3**

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

On 11 May, we upgraded Sparebanken Sogn og Fjordane's baseline credit assessment (BCA) and adjusted BCA to baa1 from baa2. We also upgraded the bank's long-term deposit rating to A2 from A3 and short-term deposit rating to Prime -1.

The increase in the bank's BCA to baa1 is primarily driven by improving asset quality and capital levels. We expect that the bank's problem ratio will decline significantly in the near term and lead to increased problem loan coverage in line with its peers. Our rating also incorporates the bank's high sector concentrations, which could result into some higher provision levels as the operating environment slows down. The upgrade to the bank's deposit and senior unsecured debt ratings takes into account the higher BCA and the Loss Given Failure (LGF) analysis of the bank's volume of deposits and debt, and the volume of securities subordinated to them, which offsets the decrease in government support assumptions.

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

As a purely domestic bank, Sparebanken Sogn og Fjordane 's operating environment is in Norway, and the bank's Macro Profile is thus 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 main risks to the system stem from a high level of household indebtedness and domestic banks' reliance on market funding. However, these risks are mitigated by the strength of households' ability to service debt, banks' adequate capitalisation and the relatively small size of the banking system compared with GDP.

RATING DRIVERS

-Capital levels are adequate

- Efficient operations support profitability, notwithstanding lower growth rate

- Asset quality currently weaker than its 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 stable outlook 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 Sogn og Fjordane 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 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

CAPITAL LEVELS ARE ADEQUATE

Sparebanken Sogn og Fjordane reported a Tangible Common Equity (TCE) ratio of 13.6% at end-March 2015 which we consider adequate. 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 TCE/ Tangible banking assets ratio of 8% which is higher than international standards.

EFFICIENT OPERATIONS SUPPORT PROFITABILITY, NOTWITHSTANDING LOWER GROWTH RATE

The bank's profitability is stable and comparable with other rated Norwegian banks. Net interest income is currently the largest component of the bank's income. However, the proportion of revenue from insurance sales could increase in the future, since the bank is now actively selling insurance products from the Frende insurance companies. Sparebanken Sogn og Fjordane stopped distributing Gjensidige's (a large Norwegian insurance company) insurance products in 2013, when the bank acquired a 10% stake in Frende (which is co-owned by other savings banks).

Sparebanken Sogn og Fjordane benefits from efficient operations, with a 41% cost-to-income ratio at year-end 2014. This low level reflects the bank's efforts to streamline costs by lowering headcount and collaborating with other banks on products including insurance, development projects and purchasing IT services. Loan loss provisions remain low, but increased to NOK73 million in 2014 from NOK43 million in 2013, as the bank made additional provisions in relation to an oil-related business as a result of lower oil prices.

In 2014 Sparebanken Sogn og Fjordane's profitability was strong. The bank's reported net profit increased by 16% year-on-year to NOK397 million in 2014. This mainly stems from an improvement in net interest income, primarily reflecting strong growth in deposits and lending. However, the bank announced a cut in interest rates in January 2015 which we expect will put downward pressure on margins. The annualized return on tangible assets was 0.97% in 2014, in line with the bank's three year average.

We expect growth in profitability to slow in 2015 as we do not expect continuation of margin increases. Our assigned Profitability score reflects our view that margins will come under pressure from lower interest rates and higher corporate loan losses, as the domestic banking operating economic environment is likely to be slightly tougher than in recent years.

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

Sparebanken Sogn og Fjordane reported problem loan ratio (impaired loans as a percentage of gross loans) increased to 1.7% at end-March 2015, from 1.33% in 2013. This increase is attributable the bank's corporate portfolio and is related to losses stemming from one corporate client, which we expect to be reversed over the coming months resulting in decrease in the problem loan ratio and increased coverage in line with peers.

The bank's exposure to the real estate and construction sectors stood at 13% of total loans at year-end 2014. Its overall exposure to oil-related business is low, at (1.6% 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

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 close to 60% of total funding at year-end 2014. 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.

However, the bank's reliance on market funding remains high, representing just over 37% of tangible assets at year-end 2014, 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 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 Sparebanken Sogn og Fjordane will have the capacity size-wise to undertake larger benchmark issuance, ultimately restricting its investor base. Our assessment of the bank's funding reflects that its overall funding profile remains a fundamental weakness. In addition, the extensive use of covered bond funding causes structural subordination of the bank's unsecured creditors, including depositors.

Liquid assets totalled 11% of tangible assets at the end of 2014. 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 due to concentration risk.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

We consider that Norway will seek to introduce legislation to implement the EU's Bank Resolution and Recovery Directive (BRRD). 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.

For Sparebanken Sogn og Fjordane's short-term and long-term deposit ratings, our upgrade considers the likely impact on the loss-given-failure result reflecting the combination of debt and deposit volumes and the amount of debt subordinated to these debt categories. This has result in a two-notch ratings uplift for the Preliminary Rating Assessment (PRA) above the BCA, reflecting a 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).

Therefore, we consider the probability of government support for debt and deposits to be low, which has resulted in no 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

Foreign currency deposit ratings are unconstrained, given that Norway has a country ceiling of Aaa. Sparebanken Sogn og Fjordane's foreign currency deposit rating is A2.).

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

SparebankenSognogFjordane

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						
Problem Loans / Gross Loans	1.8%	aa3	← →	baa2	Single name concentration	Sector concentration
Capital						
TCE / RWA	13.7%	a1	← →	a1	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.8%	baa1	← →	baa1	Return on assets	
Combined Solvency Score		a1		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	37.4%	ba2	← →	ba2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	11.1%	baa3	← →	baa3	Stock of liquid assets	
Combined Liquidity Score		ba1		ba1		

Financial Profile	**baa1**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	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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