



Moody's Investors Service

## Credit Opinion: SpareBank 1 SR-Bank

Global Credit Research - 05 Oct 2009

Stavanger, Norway

### Ratings

Category	Moody's Rating
Outlook	Negative
Bank Deposits	A1/P-1
Bank Financial Strength	C-
Issuer Rating	A1
Senior Unsecured	A1
Subordinate	A2
Jr Subordinate	A2
Preferred Stock	A3

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### Key Indicators

#### SpareBank 1 SR-Bank

	[1]2009	2008	[2]2007	2006	2005	[3]Avg.
Total assets (NOK billion)	<b>125.36</b>	<b>125.88</b>	<b>103.27</b>	<b>85.04</b>	<b>67.24</b>	[4]19.05
Total assets (EUR billion)	<b>13.89</b>	<b>12.93</b>	<b>13.01</b>	<b>10.36</b>	<b>8.42</b>	--
Total capital (NOK billion)	<b>9.41</b>	<b>10.14</b>	<b>8.67</b>	<b>7.29</b>	<b>6.17</b>	[4]16.68
Return on average assets	<b>0.61</b>	<b>0.43</b>	<b>1.09</b>	<b>1.23</b>	<b>1.36</b>	<b>1.04</b>
Recurring earnings power [5]	<b>1.01</b>	<b>0.69</b>	<b>1.12</b>	<b>1.17</b>	<b>1.43</b>	<b>1.20</b>
Net interest margin	<b>1.32</b>	<b>1.59</b>	<b>1.52</b>	<b>1.55</b>	<b>1.81</b>	<b>1.71</b>
Cost/income ratio (%)	<b>54.88</b>	<b>65.42</b>	<b>56.80</b>	<b>57.24</b>	<b>52.74</b>	<b>56.69</b>
Problem loans % gross loans	<b>1.39</b>	<b>1.62</b>	<b>0.84</b>	<b>0.42</b>	<b>0.75</b>	<b>0.94</b>
Tier 1 ratio (%)	<b>6.95</b>	<b>6.44</b>	<b>7.51</b>	<b>7.39</b>	<b>8.98</b>	<b>7.88</b>

[1] As of June 30. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate. [5] Preprovision income % average assets.

### Opinion

#### SUMMARY RATING RATIONALE

Moody's assigns a Bank Financial Strength Rating (BFSR) of C- to SpareBank 1 SR-Bank (formerly Sparebanken Rogaland), which maps to a Baseline Credit Assessment (BCA) of Baa1. The BFSR reflects the bank's solid regional market position, good risk management and satisfactory financial metrics. The key factor constraining the rating is SpareBank 1 SR-Bank's limited geographic outreach, which translates into a higher credit risk concentration.

SpareBank 1 SR-Bank is a leading savings bank operating in south-western Norway, with strong market shares in both retail and SME. The bank benefits from being a member of SpareBank 1 Alliance, created in 1996, which has provided member banks with a stronger brand, more sophisticated products provided by SpareBank 1 Gruppen (of which SpareBank 1 SR-Bank owns 19.5%) and cost synergies. Although the member banks have retained their local brandings, they continue to learn from each other's best practices. Ownership in SpareBank 1 Gruppen has resulted in volatility in the bank's earnings, particularly reflecting performance of the life insurance operations.

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 its membership of the SpareBank 1 Alliance, and a low probability of support from SpareBank 1 Alliance.

The A1 rating of SpareBank SR-Bank was confirmed on 8 September 2009. The outlook is negative. The confirmation reflects the bank's decision to apply for hybrid and preferred capital totalling NOK2.4 billion (EUR280 million) from the Norwegian State Finance Fund. Thereafter the bank has announced an offering of equity certificates as an alternative to the government capital injection. Moody's believes the capital increase could improve the bank's ability to absorb potential losses in light of potentially higher credit risk in the loan portfolio, given some risk concentrations and strong lending growth in the past few years, and could place it more appropriately at the current BFSR level (C-, mapping to a Baa1 BCA).

#### **Credit Strengths**

- Solid regional market position and brand recognition in south-western Norway
- Benefits of membership in SpareBank 1 Alliance, reflected in the bank's franchise through shared operations and active benchmarking
- Comprehensive risk management practices
- Satisfactory core profitability of banking operations

#### **Credit Challenges**

- Increased problem loans and potential further impairments in the loan portfolio
- High credit risk concentration reflecting limited geographic reach and very strong loan growth, especially in the corporate sector
- Weaker capitalisation levels than those of its Norwegian peers, although we note that the bank has taken actions to improve capitalisation
- To improve risk-weighted earnings power
- High reliance on market funding
- Maintaining cost efficiency
- Earnings volatility resulting from ownership in SpareBank 1 Gruppen

#### **Rating Outlook**

The outlook on SpareBank 1 SR-Bank's ratings is negative.

The BFSR carries a negative outlook, reflecting transition risk that SpareBank 1 SR-Bank's financial strength could come under pressure under a more stressed scenario, according to Moody's scenario analysis, given its exposures to more volatile sectors, such as commercial real estate and shipping/offshore.

The negative outlook on the long-term debt and deposit ratings reflects the risk that, under a scenario of more severe stress than the rating agency anticipates, the bank could become more weakly positioned in the C- BFSR category, mapping to a BCA of Baa2 rather than Baa1, which would result in a downgrade of the long-term debt and deposit ratings.

We recently described the assumptions behind our scenario analysis in a Special Comment entitled "Moody's Approach to Estimating Nordic Banks' Credit Losses" published on 16 July 2009.

#### **What Could Change the Rating - Up**

An upward movement of the ratings is viewed as unlikely, as reflected in the fact that the BFSR and the long-term deposit and debt ratings carry a negative outlook.

#### **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 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 support for the bank.

#### **Recent Results**

SpareBank 1 SR-Bank announced on 25 September 2009 a NOK1.2 billion offering of equity certificates of which approximately NOK866 million is in the form of private placements to Gjensidige Forsikring BA (Gjensidige), a Norwegian insurance company. This would give Gjensidige an ownership of 17.3% in the bank and is subject to approvals from the authorities. The bank might therefore not use the option to issue hybrid and preference capital to the Norwegian State Finance Fund.

The pre-tax profit of SpareBank 1 SR-Bank decreased by 6% in H1 2009 compared to the same period in 2008. The main reason for lower profitability was an increase in loan loss provisions, which represented 30% of pre-provision income in H1 2009. Earnings were positively affected by gains on financial instruments, largely reflecting exchange gains on securities; net interest income was slightly lower than in the previous year, reflecting higher funding costs.

The problem loans accounted for 1.4% of gross loans at the end of H1 2009, down from 1.6% at YE2008. The loan growth has

slowed down significantly - in the first six months of 2009, gross lending to customers decreased by 2%, reflecting that fact that the bank continues to transfer retail mortgages to its partly-owned covered bond company, which is not consolidated.

In August 2009, SpareBank 1 SR-Bank announced that it will apply for hybrid and preferred capital from the Norwegian State Finance Fund, amounting to a maximum of NOK2.4 billion. This capital injection would have improved the Tier 1 ratio by around three percentage points at end-June 2009, when the bank reported a Tier 1 ratio of 7.0% (under Basel II transitional rules).

In December 2008, SpareBank 1 SR-Bank, together with the other banks in SpareBank 1 Alliance, acquired BNbank (previously known as Glitnir Bank) from Iceland's Glitnir banki for NOK300 million. BNbank reported a modest profit of NOK35 million in H1 2009, reflecting higher losses and lower operating income, of which NOK7 million is included in SpareBank 1 SR-Bank's earnings according to its 20% ownership.

### **Recent Events**

Although the performance of the Norwegian banking sector has been satisfactory so far in the downturn, the weaker economic environment has resulted in deteriorating asset quality, mainly in the corporate loan books. Financial investments have also resulted in volatility in earnings. Economic growth in Norway is expected to remain slow and unemployment will likely increase, albeit from low levels. A turnaround in the manufacturing and industry sectors is highly dependent on the economic recovery of Norway's trading partners. In addition, the household debt burden remains high, which could make some households vulnerable to higher unemployment and increasing interest rates.

The Norwegian government has introduced measures to support the domestic banking sector in terms of liquidity and capital. In February 2009, the government announced that it will establish two funds - a Norwegian State Finance Fund to provide core capital to Norwegian banks and a Norwegian State Bond Fund to invest in fixed-income securities issued by Norwegian banks and other corporates. The banks have until end-September 2009 to apply for capital from the State Finance Fund; SpareBank 1 SR-Bank has decided to apply for up to NOK1.6 billion in hybrid capital and NOK0.8 billion in preferred capital. The government's earlier initiative in October 2008 established a swap arrangement whereby banks could swap covered bonds to government bonds to support liquidity. The swap arrangement amounts to NOK350 billion with maturities up to five years. At end-June 2009, SpareBank 1 SR-Bank had used NOK6.7 billion of the facility.

### **DETAILED RATING CONSIDERATIONS**

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

#### **Bank Financial Strength Rating**

Moody's C- BFSR for SpareBank 1 SR-Bank reflects the bank's strong regional market position and brand recognition in south-western Norway, and the benefits it derives from membership of SpareBank 1 Alliance. The key factors constraining the BFSR are the bank's operations in a limited geographic area and a high credit risk concentration. Furthermore, the bank's liquidity remains stretched by international standards and risk-adjusted profitability deteriorated in 2008 and is likely to remain under pressure in 2009.

As a point of reference, the assigned BFSR is one notch lower than the outcome of Moody's bank financial strength scorecard. Based on Moody's loss expectations for SpareBank 1 SR-Bank's loan portfolio as well as high credit risk concentration, we believe that the bank's financial strength is more consistent with a C- BFSR.

Qualitative Factors (50% weighting)

Factor 1: Franchise Value

Trend: Neutral

SpareBank 1 SR-Bank has a sound, defensible franchise in south-western Norway, characterised by a loyal customer base, high regional market share in the county of Rogaland and a stable core earnings base. The bank has 53 branches, with over 200,000 customers. According to the bank, it has market share of around 40% in the retail market in Rogaland when measured by the number of customers. In the corporate lending sector, it reports a market share of over 25% in its main market of Rogaland. In addition, the bank has been expanding into the neighbouring counties of Adger and Hordaland, with market shares in corporate lending of around 8% and 4%, respectively.

In autumn 2008, the banks in SpareBank 1 Alliance acquired BNbank, which is a relatively small bank, with a market share of less than 2% in lending and deposits in Norway. In the longer run, we expect the acquisition to strengthen the overall franchise of the Alliance, but the direct impact on SpareBank 1 SR-Bank's franchise is not large given that BNbank's strongest presence is in central Norway (corporate) and the Oslo area (retail). SpareBank 1 SR-Bank owns 20% of BNbank and has entered into an agreement to acquire an additional 3.5% of the shares subject to approval from the authorities.

Around 50% of the bank's lending on-balance sheet is to retail customers (not including loans transferred to SpareBank 1 Boligkreditt, the covered bond company of the Alliance), mostly in the form of mortgages. Recently, corporate lending has been growing more rapidly than retail lending. In recent years, the bank has also increased its focus on cross-selling and, as a result, fee and commission income now represents around 25% of operating income compared with less than 20% in 2005. This also includes commission income received from the covered bond company, which is expected to increase, as the bank has transferred more loans to the company. Over 50% of the bank's income was derived from more stable income sources in 2008, including retail banking and asset management.

SpareBank 1 SR-Bank's franchise value is positively affected by its membership of SpareBank 1 Alliance, which was established in 1996 in response to increasing competitive pressures in the Norwegian banking sector. Currently, the Alliance has 22 saving banks as members and includes joint product companies (including fund management, life and non-life insurance companies), joint marketing and the development of common IT and Internet platforms. Therefore, belonging to the Alliance allows cost sharing, economies of

scale and critical mass among members. The sales strategy remains decentralised to safeguard close customer relationships.

We expect the bank to be able to maintain a leading position in the region due to close relationships with its clients, a broad product offering and synergies related to its membership of SpareBank 1 Alliance. Nevertheless, the bank operates in a limited geographic area, which constrains the overall C score for franchise value. We also note that the competition in south-western Norway has remained strong despite the economic downturn.

#### Factor 2: Risk Positioning

Trend: Neutral

SpareBank 1 SR-Bank's management practices and systems provide comprehensive guidelines and tools for risk-taking. Over time, this approach has come to characterise the risk culture of the organisation. The bank also benefits from SpareBank 1 Alliance's focus on credit risk modelling. Its overall risk profile is good, although the risk concentrations remain a constraint on our assessment of its risk management.

The largest owner, Coil Investment Group AS, had 5.1% of equity certificates (EC) and the 20 largest owners had 25% at H1 2009. However, if the private placements to Gjensidige is approved by the authorities, the insurance company will become the largest owner in the bank with about 17% of ECs. The main difference between ECs and shares is that ECs give ownership rights to specific parts of a bank's capital. In addition, the governing bodies of a savings bank have a broader representation than a commercial bank. The ECs of SpareBank 1 SR-Bank are listed on the Oslo Stock Exchange. The board consists of seven members, one of whom represents employees. We do not view SpareBank 1 SR-Bank as having any corporate governance problems.

SpareBank 1 SR-Bank reports according to IFRS and its accounts are audited by PricewaterhouseCoopers. In our view, the quality of financial reporting is good when compared with that of its peers.

Operating in and being supportive to a small geographic region results in large customer exposures for SpareBank 1 SR-Bank. Therefore, it exhibits high borrower concentration as measured by the 20 largest exposures in relation to Tier 1 capital or pre-provision profit. The bank also has relatively high industry concentration, with the largest sector being real estate business (mainly the letting of commercial property), which represents over 20% of total loans (excluding loans transferred to SpareBank 1 Boligkreditt). We also note that exposure to foreign trade shipping, pipeline and other transport services has grown rapidly, representing around 6% of the total loan portfolio and mostly related to offshore supply vessels. Lending to both the real estate and shipping/offshore sectors has been a significant contributor to loan growth over the past few years. These sectors represent a possible source of vulnerability in the event that economic conditions continue to weaken. Petroleum investments are still high and support the corporate sector in the region, but we are cautious about a lagging impact from the global slowdown and slow recovery, which could negatively impact the order books in the coming years.

Liquid assets on-balance sheet have notably increased in 2009 - liquid assets amounted to 16% of total assets at H1 2009, compared with 12% at YE2008 and below 10% in the previous years. This is partly reflecting the use of the government swap facility for covered bonds. The bank's liquidity portfolio consists mainly of covered bonds and also includes bonds issued by domestic or international financial institutions, governments and municipalities, and some domestic corporate bonds. The portfolio does not include structured products other than covered bonds. The majority of the portfolio is repo eligible.

SpareBank 1 SR-Bank has access to the covered bond market via its partly-owned covered bond company SpareBank 1 Boligkreditt, which started to issue covered bonds backed by retail mortgage loans in 2007. By [the end of H1 2009, SpareBank 1 SR-Bank had transferred retail mortgages worth NOK18 billion to the covered bond company (around 16% of the loan portfolio). SpareBank 1 banks have also established SpareBank 1 Naeringskreditt, which issues covered bonds backed by commercial mortgage loans.

On the funding side, SpareBank 1 SR-Bank benefits from a good deposit base. However, customer deposits increased by less than 3% in the first six months of 2009 and corporate deposits have been declining. The deposit-to-loan ratio was 56% at H1 2009 and over half of the deposits are from the corporate sector. Less than 50% of total funding consists of deposits and the rest consists of market funds. The bank has a euro medium-term note programme and also issues bonds in the local market. The maturity profile of long-term funding is relatively diversified for the next five years: around NOK3 billion matures in September-December 2009 and around NOK7 billion in 2010.

The bank has limited appetite for market risk, although it established a capital markets division in 2007, which is also involved in proprietary trading. Exposure to interest rate risk is limited to NOK30 million in relation to a 100 basis point parallel movement in interest rates. The bank's shareholdings on-balance sheet decreased to NOK255 million at the end of H1 2009 (less than 5% of Tier 1 capital). The portfolio mainly consists of shares in Norwegian companies, including both listed and unlisted companies. In addition, SpareBank 1 SR-Bank's currency position is limited. The bank also has some indirect exposure to market volatility via its shareholding in SpareBank 1 Gruppen.

As regards risks related to the ownership in BNbank, we note that it has high credit risk concentration both in terms of borrowers and industries (around 50% of its loan portfolio is made up of commercial real estate). However, the retail mortgage book and the fact that ownership is split between the banks in the alliance are seen as mitigating factors.

A high credit risk concentration constrains the overall score for risk positioning at C-.

#### Factor 3: Regulatory Environment

For a discussion of the regulatory environment, please see Moody's latest Banking System Outlook on Norway, published in November 2008.

#### Factor 4: Operating Environment

Trend: Neutral

The score for the operating environment takes into account the economic stability, integrity and corruption in the country, as well as the legal system. The score for Norway's operating environment is B+. For a further discussion of the operating environment, please see Moody's latest Banking System Outlook on Norway, published in November 2008.

#### Quantitative Factors (50% weighting)

##### Factor 5: Profitability

Trend: Weakening

SpareBank 1 SR-Bank is reliant on net interest income, which represents over 70% of its operating income. The net interest margin on average earning assets decreased in H1 2009 to 1.3% from 1.6% in 2008 reflecting higher funding and liquidity related costs, downward pressure on deposit margins and low interest rates. Commission income represents over 20% of operating income and is mainly related to payment services, securities trading and insurance products. It also includes commissions received from mortgages transferred to SpareBank 1 Boligkreditt. Over the past few years, the bank has been successful in cross-selling, which has increased the commission income; however, after several years of double-digit growth, fee and commission income decreased in 2008 and the growth was slow in the first six months of 2009.

Trading income has historically comprised less than 10% of operating income and, in 2008, unrealised losses significantly affected profitability. Going forward, the reclassification of part of the bank's financial assets to the "held-to-maturity" and "loans and receivables" categories should limit the impact of the securities holding on earnings, although some volatility remains. The performance of SpareBank 1 Gruppen, of which SpareBank 1 SR-Bank owns 19.5%, has resulted in volatility in the bank's profitability. In addition, the bank recognised significant "badwill" profit in 2008 following the takeover of BNbank by the banks of SpareBank 1 Alliance. In H1 2009, SpareBank 1 SR-Bank's share of the profit of BNbank was NOK7 million.

The net result in 2008 and H1 2009 was also negatively affected by increased loan loss provisions. Overall, we note that risk-weighted profitability has deteriorated, with a slight recovery so far in 2009: pre-provision income in relation to average risk-weighted assets was to 1.0% in 2008 and 1.5% in H1 2009.

The profitability score on Moody's scorecard reflects risk-adjusted profitability under Basel II (transitional rules) and therefore only includes the profitability ratios for 2008. The scorecard outcome is D, even when adjusting for the reclassification of financial assets permitted by the amendment of IAS39. The profitability trend is weakening given the more challenging economic outlook, especially for the corporate sector, which is likely to result in further loan loss provisions.

##### Factor 6: Liquidity

Trend: Neutral

As mentioned above, the bank is reliant on domestic and international wholesale funding, and also benefits from a good deposit base. Retail deposits have been growing, but corporate deposits have been on a declining trend: overall deposit growth was below 3% in January-June 2009. In addition, SpareBank 1 SR-Bank has started to issue covered bonds jointly with other members of SpareBank 1 Alliance, which should have a positive effect on liquidity. Covered bonds could also be used under the government's swap arrangement in exchange for Norwegian government securities. So far, the bank has used covered bonds worth NOK6.7 billion in this scheme.

The D+ score for liquidity, although lower than that of European counterparts, is in line with the liquidity scores of other Norwegian banks. It reflects reliance on market funding, but we positively note the bank's good liquidity management as well as access to covered bonds.

##### Factor 7: Capital Adequacy

Trend: Neutral

Moody's expects that Norwegian banks will experience deterioration in asset quality over the coming quarters which is likely to lead to higher credit-related write-downs, exerting adverse pressure on banks' capitalisation. The anticipated deterioration in asset quality mainly relates to the more challenging outlook for the Norwegian corporate sector and exposures to volatile sectors such as commercial real estate and shipping-related industries. To reflect these expectations, we perform scenario analysis to capture the potential impact on capital. The assumptions behind our scenario analysis are described in more detail in a Special Comment entitled "Moody's Approach to Estimating Nordic Banks' Credit Losses" published on 16 July 2009.

SpareBank 1 SR-Bank has reported lower capital levels than its Norwegian and Nordic peers in the past few years. To improve its capitalisation, the bank announced in August 2009 that it will apply for government hybrid and preference capital totalling NOK2.4 billion. This capital would have improved the Tier 1 ratio to around 10% at the end of H1 2009. In September 2009, the bank announced that as an alternative to the government capital injection it would issue equity certificates amounting to NOK1.2 billion and also considers issuing hybrid instruments to the market (depending on the market conditions). We view these efforts to increase capital as a positive development that is reflected in our confirmation of the bank's long-term ratings with negative outlook. The capital increase would improve the bank's ability to absorb potential losses in light of potentially higher credit risk in the loan portfolio, and place it more appropriately at the current rating level. We also note that from the quality of capital point of view pure equity would be better than hybrid capital. The bank's board has recently increased its target for core capital level and now targets at a Tier 1 ratio at minimum of 9%.

At the end of H1 2009, the bank's Tier 1 and total capital ratios calculated in accordance with the transitional rules towards Basel II stood at 7.0% and 9.5%, respectively, largely reflecting strong loan growth. The bank's Tier 1 capital includes a US\$75 million hybrid instrument to which Moody's has assigned a basket B (i.e. 25% equity credit).

For Basel II purposes, SpareBank 1 SR-Bank applies the internal ratings-based foundation approach for corporate credit risk and the advanced approach for retail credit risk. Given the bank's large retail loan book, the capital requirement is estimated to decrease

under Pillar 1. However, due to some concentration issues as well as the more challenging economic environment, we do not expect the bank to release capital.

The score for capital adequacy is C+. We expect that weakening credit quality will put pressure on capitalisation, but the capital increase could provide additional buffer. Therefore, the trend is viewed as neutral.

#### Factor 8: Efficiency

Trend: Neutral

The bank's cost efficiency improved in H1 2009, as reflected by the cost-to-income ratio of 55%, compared with 65% in 2008. The positive development reflects improved operating earnings, which more than compensated for higher personnel costs. On the one hand, we continue to see pressure on expenses due to increased funding costs and strong competition. On the other hand, SpareBank 1 SR-Bank should benefit from cost improvements related to SpareBank 1 Alliance. In 2008, cost efficiency was negatively affected by losses on financial instruments and higher operating costs, especially related to marketing. The number of employees increased by 9% in 2008, but is expected to be reduced by around 80 in 2009, reflecting more restrictive policies in terms of hiring.

In a competitive market such as Norway, we continue to see efficiency as key for the financial flexibility of SpareBank 1 SR-Bank.

The bank scores C for efficiency.

#### Factor 9: Asset Quality

Trend: Weakening

Problem loans (non-performing and problem commitments) have increased from the record low levels in 2006. At the end of H1 2008, problem loans accounted for 1.4% of gross loans compared with 1.6% at YE2008 and 0.4% at YE2006. Overall, the bank reports moderate weakening in the credit quality. Therefore, loan loss provisions continued on a negative trend and represented around 30% of pre-provision income in H1 2009. Furthermore, the bank announced additional provisioning needs in relation to one of its shipping exposures in early 2009.

In addition to risks related to borrower and industry concentration, lending growth has been rapid in recent years, resulting in a less seasoned loan portfolio: corporate lending increased by 30% in 2008 and total lending increased by 20% (including loans transferred to SpareBank 1 Boligkreditt). Loan loss coverage increased close to 70% at the end of H1 2009 compared with below 30% at YE2007, which Moody's views as a positive development. In the mortgage loan portfolio, average LTV is around 70% when excluding SpareBank 1 Boligkreditt.

The Norwegian economic environment is satisfactory and has been more resilient to the global downturn than other Nordic countries; however, we caution that a turnaround for export-related sectors is highly dependent on the economic recovery of the trading partners. We view the commercial real estate, construction, fishing and shipping-related sectors as more volatile sectors and potential sources of increased credit risk. In the retail sector, the credit risk is lower and Norwegian banks, including SpareBank 1 SR-Bank, generally have a limited amount of unsecured lending. As supporting factors, we note that low unemployment and low interest rates should be helpful in terms of ability to service loans, since the majority of loans have floating rates. However, the debt burden of households has been rising and unemployment is likely to increase from the current low levels. As a mitigating factor, we note that mortgage loans are secured both by property and personal liability.

The score for asset quality is B. We do not expect the current asset quality to be sustainable across the economic cycle given the weaker outlook for the Norwegian economy. Therefore, we see a weakening trend for this factor.

#### **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. 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 of SpareBank 1 SR-Bank's junior obligations are currently notched from the fully supported deposit rating.

Moody's cautions, however, that it released a Request for Comment entitled, "Moody's Proposed Changes to Bank Subordinated Capital Ratings" on 16 June 2009 requesting market feedback on potential changes to its bank hybrid rating methodology. Should Moody's implement this revised methodology as proposed, the ratings of the hybrid securities could potentially be subject to a multi-notch downgrade.

#### **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						C	Neutral
Market Share and Sustainability	x						
Geographical Diversification					x		
Earnings Stability			x				

<b>Earnings Diversification [2]</b>							
<b>Factor: Risk Positioning</b>						<b>C-</b>	<b>Neutral</b>
<b>Corporate Governance [2]</b>							
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
<b>Controls and Risk Management</b>		<b>x</b>					
- Risk Management			x				
- Controls	x						
<b>Financial Reporting Transparency</b>		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
<b>Credit Risk Concentration</b>	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
<b>Liquidity Management</b>			<b>x</b>				
<b>Market Risk Appetite</b>		<b>x</b>					
<b>Factor: Operating Environment</b>						<b>B+</b>	<b>Neutral</b>
<b>Economic Stability</b>			<b>x</b>				
<b>Integrity and Corruption</b>	<b>x</b>						
<b>Legal System</b>	<b>x</b>						
<b>Financial Factors (50%)</b>						<b>C-</b>	
<b>Factor: Profitability</b>						<b>D</b>	<b>Weakening</b>
PPP % Avg RWA - Basel II				1.02%			
Net Income % Avg RWA - Basel II				0.63%			
<b>Factor: Liquidity</b>						<b>D+</b>	<b>Neutral</b>
(Mkt funds-Liquid Assets) % Total Assets					33.56%		
<b>Liquidity Management</b>			<b>x</b>				
<b>Factor: Capital Adequacy</b>						<b>C+</b>	<b>Neutral</b>
Tier 1 ratio (%) - Basel II			6.98%				
Tangible Common Equity / RWA - Basel II		6.53%					
<b>Factor: Efficiency</b>						<b>C</b>	<b>Neutral</b>
Cost/income ratio			59.82%				
<b>Factor: Asset Quality</b>						<b>B</b>	<b>Weakening</b>
Problem Loans % Gross Loans		0.96%					
Problem Loans % (Equity + LLR)		14.75%					
<b>Lowest Combined Score (15%)</b>						<b>D+</b>	
<b>Economic Insolvency Override</b>						<b>Neutral</b>	
<b>Aggregate Score</b>						<b>C</b>	
<b>Assigned BFSR</b>						<b>C-</b>	

[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



Moody's Investors Service

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