MOODY'S INVESTORS SERVICE

Credit Opinion: Sydbank A/S - DRAFT - In Progress or Approved Version

Global Credit Research

Aabenraa, Denmark

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-2
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Senior Unsecured	Baa1
Subordinate	Baa3
Jr Subordinate MTN	(P)Ba1
Pref. Stock Non-cumulative	Ba2
Other Short Term	(P)P-2

Contacts

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Key Indicators

Sydbank A/S (Consolidated Financials)[1]

	[2]**3-15**	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	**Avg.**
Total Assets (DKK million)	**155,662.0**	**152,316.0**	**147,892.0**	**152,713.0**	**153,441.0**	[4]**0.4**
Total Assets (EUR million)	**20,836.2**	**20,455.1**	**19,823.8**	**20,468.4**	**20,645.1**	[4]**0.2**
Total Assets (USD million)	**22,378.1**	**24,751.7**	**27,316.1**	**26,985.4**	**26,800.3**	[4]**-4.4**
Tangible Common Equity (DKK million)	**10,664.0**	**10,887.0**	**9,805.0**	**9,870.0**	**9,488.0**	[4]**3.0**
Tangible Common Equity (EUR million)	**1,427.4**	**1,462.1**	**1,314.3**	**1,322.9**	**1,276.6**	[4]**2.8**
Tangible Common Equity (USD million)	**1,533.1**	**1,769.2**	**1,811.0**	**1,744.1**	**1,657.2**	[4]**-1.9**
Problem Loans / Gross Loans (%)	**8.1**	**8.6**	**9.1**	**7.0**	**4.0**	[5]**7.3**
Tangible Common Equity / Risk Weighted Assets (%)	**15.2**	**15.0**	**13.5**	**13.9**	**13.4**	[6]**15.1**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**44.6**	**44.9**	**48.7**	**41.8**	**27.7**	[5]**41.5**
Net Interest Margin (%)	**1.7**	**1.9**	**1.9**	**2.1**	**2.2**	[5]**1.9**
PPI / Average RWA (%)	**2.9**	**2.8**	**2.8**	**3.3**	**2.2**	[6]**2.8**
Net Income / Tangible Assets (%)	**0.8**	**0.7**	**0.1**	**0.3**	**0.1**	[5]**0.4**
Cost / Income Ratio (%)	**57.5**	**57.4**	**56.5**	**52.1**	**63.0**	[5]**57.3**
Market Funds / Tangible Banking Assets (%)	**34.5**	**34.3**	**34.1**	**41.0**	**41.7**	[5]**37.1**
Liquid Banking Assets / Tangible Banking Assets (%)	**31.4**	**34.0**	**38.0**	**33.5**	**34.1**	[5]**34.2**
Gross Loans / Total Deposits (%)	**99.1**	**92.7**	**92.3**	**94.9**	**95.6**	[5]**94.9**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 17 June, we affirmed Sydbank's baa2 baseline credit assessment (BCA), upgraded its long-term deposit ratings to A3 from Baa1, and confirmed its Baa1 long-term senior unsecured debt and P-2 short deposit ratings.

Furthermore, we assigned a Counterparty Risk Assessment (CR Assessment) of A2(cr) / P-1(cr) to Sydbank.

The affirmation of Sydbank's standalone BCA of baa2 reflects a combination of a continued elevated level of problem loans and a relatively low, but improving, profitability since the start of the financial crisis. The bank's high level of capitalisation and good liquidity mitigate these challenges. The upgrade of the bank's deposit rating to A3 from Baa1 and the confirmation of senior unsecured debt ratings to Baa1 reflects the Advanced Loss Given Failure (LGF) analysis of the bank's own volume of debt and deposits and securities subordinated to them in our creditor hierarchy. Our Advanced LGF analysis for Sydbank suggests a very low loss given failure for depositors, and a low loss given failure for senior creditors, resulting in a two-notch uplift to the deposit ratings and one-notch uplift for long-term senior debt rating from the group's BCA.

SYDBANK'S BCA IS SUPPORTED BY ITS "VERY STRONG-" MACRO PROFILE

Sydbank is almost purely active in Denmark, meaning that the bank's operating environment and hence its macro profile is aligned with that of Denmark at "Strong +". Danish banks and mortgage credit institutions benefit from an improving operating environment and a strong institutional and legal framework. Our assessment, however, also factors in the bank's large stock of problem loans that date back to the financial crisis, and high household debt. The financial sector has considerable wholesale funding needs, which - though reducing - creates some susceptibility to adverse events, while the relatively fragmented structure of the banking industry and strong competition constrain profitability.

Rating Drivers

- Asset quality reflects challenging operating environment - but positive trend

- Satisfactory capital position

- Improving core earnings but challenges remain

- Improving funding structure

- Satisfactory liquidity profile

- Large volume of deposits resulting in deposit ratings benefiting from a very low loss-given-failure rate and two-notch uplift from BCA. For senior unsecured debt, our LGF analysis indicates a one-notch uplift from the BCA

Rating Outlook

Sydbank's ratings carry a stable outlook

What Could Change the Rating - Up

Upward pressure on Sydbank's ratings could develop from (1) a sustained increase in profitability from core operations without an increase in its risk profile; and/or (2) improved asset-quality metrics, especially in relation to more volatile segments such as agriculture and commercial real estate.

What Could Change the Rating - Down

Downward pressure on Sydbank's ratings could emerge if (1) its asset quality deteriorates from the current levels; (2) its risk profile increases (e.g., as a result of increased exposures to more volatile assets); and (3) the bank shows weakened profitability from core earnings.

DETAILED RATING CONSIDERATIONS

ASSET QUALITY REFLECTS CHALLENGING OPERATING ENVIRONMENT - BUT POSITIVE TREND

Our assigned Asset Risk score indicates that overall, asset risk remains a relative weakness for Sydbank.

Following a weakening in asset quality during the financial crisis and the low-growth period that followed, Sydbank's asset-quality challenges are easing. At end-March 2015, Sydbank's problem loans (measured as gross loans subject to individual impairments) amounted to 8.1% of gross loans, down from 8.6% at year-end 2014. Problem loans remain elevated both relative to the pre-crisis level (2% at end-December 2008) and to many Nordic and European peers. We expect the more positive recent trend to continue, reflecting the more benign Danish macro environment.

In parallel with the positive trend in problem loans and an already adequate level of balance sheet reserves against these, Sydbank's loan loss provisioning has declined significantly in recent years, resulting in a material increase in the group's profitability.

The continued elevated level of problem loans reflects the relatively high impact of the financial crisis on Denmark's economy and prolonged weak economic growth following the start of the crisis, which only recently started to improve and the tighter impairment rules imposed by the Danish FSA in recent years with respect to the treatment and valuation of collateral.

At year-end 2014, approximately 28% of problems loans were related to agriculture, hunting, forestry and fisheries, an increase from 24% at year-end 2013. The continued elevated level of problem loans illustrates partly the difficulties faced especially by the Danish agricultural industry, which we expect to persist in the coming years.

Sydbank's gross problem loan number remains high compared with those of peers, but we note that the relatively high provision coverage of 64% at December 2014 and the Danish FSA asset-quality review performed in the second half of 2014 suggest that problems in the current loan book have been identified and adequately provided for, indicating that the risk relating to this portfolio going forward is lower than suggested by the gross number.

Around 33% of Sydbank's loan portfolio is to retail customers. As mortgage loans financed by Totalkredit/Nykredit and DLR do not appear on Sydbank's balance sheet, many on-balance-sheet loans benefit from second liens on collateral. Sydbank provides a guarantee on losses on loans transferred to DLR Kredit, whereas losses on loans transferred to Totalkredit/Nykredit are deducted from the fees paid by these mortgage credit institutions.

The overall macroeconomic situation in Denmark is improving, and the likelihood of new spikes in loan write-downs in the near term has reduced because of the more favourable operating environment with improving house prices and consumer sentiment. While the expected GDP growth in the coming years remains below pre-crisis levels, it is still significantly above the weak growth levels seen in recent years. As an open export-oriented economy, the economic outlook for Denmark will to depend largely on economic growth in key export markets. However, with general economic growth looking more robust, we believe the risk of a new correction in property prices has reduced and expect the trend in consumer confidence and hence consumer spending to remain positive. That said, we remain cautious with regards to the agricultural sector in Denmark, which remains under more structural pressure resulting partly from high debt levels in the industry.

Sydbank participated in the 2014 asset-quality review conducted by the Danish FSA according to the European Central Bank's guidelines. The Danish FSA established a relatively modest need for additional impairment charges of DKK75 million, which have already been included in the results for the first three quarters of 2014.

SATISFACTORY CAPITAL POSITION

Our assigned Capital score reflects Sydbank's satisfactory capital position and is a relative strength in the assessment of the bank's standalone strength.

We continue to view Sydbank's economic capital as substantial. As of March 2015, Sydbank's Tier 1 and total capital ratios were 16% and 17.6%, respectively, compared with an individual solvency requirement according to the Danish FSA calculation of 10.3%. (At December 2014, Sydbank's Tier 1 and total capital ratios were 15.5% and 16.0%, respectively.)

Considering Sydbank's risk profile and internal capital-generation capability, we continue to view its economic capital as satisfactory. In addition to participating in the asset-quality review conducted by the Danish FSA, Sydbank participated in the EU-wide stress test and came out with an ample margin with a Common Equity Tier 1 ratio of 12.9% in the adverse scenario, best among the participating Danish banks.

IMPROVING CORE EARNINGS, BUT CHALLENGES REMAIN

Net income increased to 0.8% of tangible assets at end-March 2015 from 0.7% at end-December 2014. The impact on the bank's earnings of the currently very low Danish interest rates and continued high uncertainty relating to the future provisioning need towards Danish agriculture present some risk to the profitability outlook.

Sydbank's main source of income is net interest income, which accounts for on average around two thirds of operating income, but margins in the Danish banking market are under pressure because of generally low credit demand, the low interest rate environment and high competition in the Danish banking sector. Net fee and commission income accounts for around a quarter of operating income. The remaining income consists mainly of trading income.

Based on 2014 full-year numbers, Sydbank's pre-provision income (PPI) - as measured by PPI/average risk-weighted assets - of 2.87% compares relatively well with the average of 1.86% for Danish banks. Net income - measured by net income/average risk-weighted assets - of 1.50% is positive in relation to the Danish average of 0.89%. Sydbank's net income/tangible assets ratio of 0.76% is also above the average of 0.52% for Danish banks. Impairment charges have been high in the last few years because of the challenging operating environment in Denmark, but also because of stricter impairment guidelines from the Danish FSA. We note that impairment charges on average made up nearly three quarters of PPI for the last five years; however, the development during 2014 was positive, with impairments making up just over 34% of PPI.

Cost control remains a key focus for Sydbank. Costs have increased somewhat following the acquisition of DiBa in December 2013, but a cost reduction programme running until 2016 is aimed at mitigating any further pressures on profitability. Sydbank's three-year average cost-to-income ratio was 55%, in line with the Danish average for our rated banks. We positively note that operating costs remained stable for the fifth year as a result of tight cost control.

During 2014, Sydbank reported a pre-tax profit of DKK1.3 billion, up from DKK171.0 million in 2013. The improved result was due mainly to a rise in net fee and commission income, significantly lower loan impairment charges and a one-off gain from the sale of the shares in Nets (DKK148 million). Impairment charges fell by 62% compared with FY 2013 to DKK707 million, significantly lower than in 2013 (DKK1.86 billion) and 2012 (DKK1.75 billion). Despite the general low-growth environment in Denmark, Sydbank has been one of the few banks generating an influx of new customers: The bank grew its loan book by 5.2% year over year in 2014. Sydbank's 2014 return on equity reached 10%, significantly better than those of the biggest banks in Denmark. We note that income from the group's investment portfolio in 2014 accounted for a smaller proportion of pre-tax earnings (-1.8%) compared with the full year 2013 where return on the group's investment portfolio was more than the group's pre-tax profit, making Sydbank less dependent on this source of income.

We expect total income in 2015 to reflect continued subdued credit demand, intense competition and record-low interest rates. Owing to the continued strong cost focus in the bank, we expect the cost-to-income ratio to show a further improvement in 2015. The ratio stood at 57.5% at end-March 2015 (57.4% at end-December 2014). The level of loan loss provisions relative to total gross loans has also been closer to the longer-term average in recent quarters, and we expect the level to stabilise at this lower level going forward, partly reflecting improving operating conditions in Denmark.

IMPROVING FUNDING STRUCTURE

Our Funding Structure score reflects our view that Sydbank's overall funding profile remains a fundamental weakness, although we note the improvements over recent years.

Sydbank's deposit base represented over 56% of total funding at end-December 2014 and has shown an increasing trend in recent years, while the bank's reliance on short interbank funding has continued to fall from more than 20% of total funding in 2007 to 10% at end-December 2014.

In common with other regional and local banks, Sydbank funds its retail and commercial mortgage loans off balance sheet through mainly Totalkredit/Nykredit Realkredit and to a lesser extent DLR Kredit (unrated).

The April 2014 acquisition of BRFKredit (unrated) by Jyske Bank (long-term deposit rating of A3) means that Sydbank no longer uses BRFKredit to fund mortgages, but has become the largest distribution partner for Nykredit/Totalkredit, which has strengthened its position in this relationship, a credit positive.

SATISFACTORY LIQUIDITY PROFILE

At end-March, liquid banking assets accounted for 31% of total banking assets (around 34% at end-December 2014) which is a similar level to the recent years. The ratio compares well with those of peers, and the bank's liquidity is high relative to the Danish requirement. Our Liquid Resources score reflects our view that liquidity is a relative strength for Sydbank's standalone credit assessment.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

Sydbank is subject to the EU Bank Resolution and Recovery Directive, which we consider to be an Operational Resolution Regime. 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 are in line with our standard assumptions.

The upgrade of the bank's deposit rating to A3 from Baa1 and the confirmation of senior unsecured debt ratings to Baa1 takes into account the LGF analysis of the bank's own volume of debt and deposits and securities subordinated to them in our creditor hierarchy. Our advanced LGF analysis for Sydbank suggests a very low loss given failure for depositors, and a low loss given failure for senior creditors, resulting in a two-notch uplift to the deposit ratings and one-notch uplift for long-term senior debt rating from the group's BCA.

GOVERNMENT SUPPORT

The implementation of the Bank Resolution and Recovery Directive has caused us to reconsider the potential for government support to benefit certain creditors. Within the EU, we now assess the probability of government support to be moderate only for the largest and most complex institutions. For Sydbank, we assess the probability of government support to be low, meaning that the bank's debt and deposit ratings no longer benefit from rating uplift from government support.

COUNTERPARTY RISK ASSESSMENT

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 both 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.

Sydbank's CR Assessment is positioned at A2(cr)/Prime-1(cr). The CR Assessment is positioned three notches above the adjusted BCA of baa2, based on the substantial cushion against default provided to the senior obligations represented by the CR Assessment by subordinated instruments. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, thereby focusing purely on subordination and taking no account of the volume of the instrument class.

ABOUT MOODY'S BANK RATINGS

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

Sydbank A/S

Macro Factors	
Weighted Macro Profile	**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	8.2%	ba2	↑	ba1	Expected trend	
Capital						
TCE / RWA	15.2%	aa3	←→	aa3	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.5%	ba1	←→	ba2	Earnings quality	
Combined Solvency Score		baa2		baa2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	34.3%	ba1	←→	ba1	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	34.0%	a2	←→	a2	Stock of liquid assets	
Combined Liquidity Score		baa2		baa2		

Financial Profile	**baa2**
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	**baa1 - baa3**
Assigned BCA	**baa2**
Affiliate Support notching	**0**
Adjusted BCA	**baa2**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**

Deposits	2	0	a3	0	A3	A3
Senior unsecured bank debt	1	0	baa1	0		Baa1
Dated subordinated bank debt	-1	-1	ba1	0		Baa3
Junior subordinated bank debt	-1	-1	ba1	0		(P)Ba1
Non-cumulative bank preference shares	-1	-2	ba2	0		Ba2(hyb)