

MOODY'S

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Credit Opinion: Sydbank A/S

Global Credit Research - 30 May 2014

Aabenraa, Denmark

Ratings

Category	Moody's Rating
Outlook	Negative(m)
Bank Deposits	Baa1/P-2
Bank Financial Strength	C-
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Senior Unsecured	Baa1
Jr Subordinate MTN	(P)Ba1
Pref. Stock	Ba2 (hyb)
Other Short Term	(P)P-2

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Key Indicators

Sydbank A/S (Consolidated Financials)[1]

	[2]12-13	[2]12-12	[2]12-11	[2]12-10	[2]12-09	Avg.
Total Assets (DKK million)	147,892.0	152,713.0	153,441.0	150,843.0	157,821.0	[3]-1.6
Total Assets (EUR million)	19,823.8	20,468.4	20,645.1	20,241.7	21,209.9	[3]-1.7
Total Assets (USD million)	27,316.1	26,985.4	26,800.3	27,155.2	30,430.7	[3]-2.7
Tangible Common Equity (DKK million)	10,498.0	10,563.5	10,365.2	10,309.2	9,316.0	[3]3.0
Tangible Common Equity (EUR million)	1,407.2	1,415.8	1,394.6	1,383.4	1,252.0	[3]3.0
Tangible Common Equity (USD million)	1,939.0	1,866.6	1,810.4	1,855.9	1,796.3	[3]1.9
Net Interest Margin (%)	2.0	2.1	2.2	2.1	2.2	[4]2.1
PPI / Average RWA (%)	2.8	3.3	2.2	2.8	3.1	[5]2.8
Net Income / Average RWA (%)	0.3	0.7	0.3	0.6	1.0	[5]0.6
(Market Funds - Liquid Assets) / Total Assets (%)	-9.0	-2.9	-1.1	4.9	2.8	[4]-1.0
Core Deposits / Average Gross Loans (%)	91.9	85.9	81.4	75.9	75.5	[4]82.1
Tier 1 Ratio (%)	15.3	15.6	15.2	14.3	13.1	[5]14.7
Tangible Common Equity / RWA (%)	14.4	14.8	14.7	14.0	12.0	[5]14.0
Cost / Income Ratio (%)	56.3	52.0	62.7	56.0	53.8	[4]56.2
Problem Loans / Gross Loans (%)	9.1	7.0	4.0	3.5	3.5	[4]5.4
Problem Loans / (Equity + Loan Loss Reserves) (%)	45.1	39.2	25.5	24.8	27.9	[4]32.5

Source: Moody's

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

Opinion

SUMMARY RATING RATIONALE

Moody's rates Sydbank A/S Baa1/Prime-2/C-. The standalone C- bank financial strength rating (BFSR), which maps to a standalone baseline credit assessment (BCA) of baa2, reflects the Danish bank's strong regional franchise and satisfactory financial strength. However, the rating is constrained by Sydbank's high credit risk concentration and the continued weak economic outlook in Denmark. Although profitability did improve in 2012-2013, we note that the level of profitability remains low even with strong portfolio and trading income. The first 3 quarters of 2013 show a continued pressure on core income. Any material further improvement in profitability will in our view require a significant fall in loan loss provisions, which seems unlikely in the near term given the current economic environment.

The Baa1 long-term senior debt and deposit ratings incorporate the bank's baa2 standalone credit assessment as well as a one notch uplift from systemic support. As expected Sydbank was designated a Systemically Important Financial Institution (SIFI) with the political agreement on the SIFI regulations in October 2013

Rating Drivers

- Strong franchise in southern and central Jutland
- Falling core earnings reflect operating environment, but cost control remains strong
- Satisfactory liquidity profile
- Asset quality deterioration reflects challenging operating environment

Rating Outlook

The negative outlook on the supported ratings takes into account the recent adoption of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) regulation in the EU. In particular, this reflects that, with the legislation underlying the new resolution framework now in place and the explicit inclusion of burden-sharing with unsecured creditors as a means of reducing the public cost of bank resolutions, the balance of risk for banks' senior unsecured creditors has shifted to the downside. Although our support assumptions are unchanged for now, the probability has risen that they will be revised downwards to reflect the new framework. For further details, please refer to our Special Comment entitled "Reassessing Systemic Support for EU Banks," published on 29 May 2014.

What Could Change the Rating - Up

Upward rating momentum could develop if Sydbank demonstrates (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

While the current rating levels incorporate a degree of expected further performance deterioration, ratings may decline further if (1) Sydbank's financing conditions become more difficult, (2) its asset quality deteriorates more than we anticipate and/or (3) its risk profile increases, for example as a result of increased exposures to more volatile sectors or increased involvement in more risky operations such as capital market activities.

DETAILED RATING CONSIDERATIONS

STRONG FRANCHISE IN CENTRAL AND SOUTHERN JUTLAND

Sydbank's franchise value is underpinned by its position as the fourth-largest banking group in Denmark, reportedly serving around 425,000 customers, including approximately 37,000 corporate clients. Of the retail customers a total of around 18,000 are a result of the Tonder Bank acquisition in November 2012. Its core business consists of corporate, investment and private banking, with a focus on private individuals and small and medium-sized enterprises (SMEs) through a network of 95 branches in Denmark. It also has five branches in northern Germany. While the bank has a national presence, its heartland is southern and central Jutland, Funen and the greater Copenhagen area, where most of its branch network is based. Sydbank reported a net inflow of customers in the first three quarters of 2013.

Moody's views Sydbank's well-established regional presence as an important factor underpinning its ratings. The bank reports a market share of 6-9% depending on customer segment and type of business, with the majority of its customers being based in Jutland.

The bank continues to subscribe to an open architecture model, providing its customers with alternatives across a full range of banking services and third party pension and life products. Co-operation agreements include the primary mortgage credit institutions Totalkredit, DLR Kredit and BFRKredit.

FALLING CORE EARNINGS REFLECT OPERATING ENVIRONMENT, BUT COST CONTROL REMAINS STRONG

The combination of limited lending demand, low interest rates, competitive margin pressure, continued high loan losses and an already lean cost base puts pressure on Sydbank's core earnings and profitability and makes the group increasingly sensitive to the more volatile investment portfolio income.

In 2012, Sydbank reported pre-tax profits of DKK 624 million, up from DKK 301 million in 2011. Core earnings excluding the return on the bank's investment portfolio fell to DKK 322 million from DKK 589 million in 2011 due to loan loss provisions increasing to DKK 1.7 billion from DKK 553 million. The fall in core earnings was mitigated by a DKK 412 million increase in investment portfolio earnings to DKK 397 million from a negative DKK 15 million in 2011. Risk-weighted recurring earnings power (pre-provision income in relation to average risk-weighted assets) increased to 3.30% against a three year average of 2.75%. The increase was mainly driven by the increase in investment portfolio earnings with risk weighted assets increasing 1.6%. Excluding the acquisition of Tonder Bank, risk weighted assets would have fallen around 2% mainly due to a fall in market risk.

The further fall in interest rates during 2012 to record low levels puts pressure on the bank's deposit margins and the lending rate increases implemented by Sydbank (along with many of the Danish peers) during 2011 and 2012 was offset by lower lending volumes, resulting in net interest income excluding interest on investment portfolios falling around 1%. Despite the takeover of Tonder Bank in November 2012 the loan balance at end-2012 was around 1% lower than end 2011. This was negatively impacted by around 1.5 percentage points from the closure of the Swiss operations during 2012 and positively impacted by around 2 percentage points by the acquisition of Tonder Bank. Falling interest rates did however have a positive impact on income especially from a higher mortgage and re-mortgaging activity. Customer related trading activities almost doubled income to DKK 323 million from DKK 167 million in 2011, contributing to the 3.7% increase in total core income to DKK 4.2 billion.

Moody's positively notes that operating costs remained stable for the fourth year as a result of tight cost control and a modest decline in staff despite taking over 56 employees from Tonder Bank and non-recurring costs mainly connected to the acquisition of DKK 69 million. The cost/ income ratio improved to 52% against a three year average of 57%.

Loan loss provisions increased 46% to DKK 1.7 billion in 2012. The increase was mainly a result of tightened impairment rules implemented by the Danish FSA, especially regarding loans secured against real property in commercial real estate lending and lending to retail clients.

With more than half of the group's pre-tax earnings driven by the investment portfolio, the return on this portfolio will have a significant impact on future earnings and income volatility. In terms of core earnings we expect total income in 2013 to reflect low bank credit demand and increased competition for the most attractive clients. Loan loss provisions are likely to fall from the high 2012 level, that was significantly impacted by the methodology change, but we expect the level to remain elevated compared to pre-crisis levels and to put continued pressure on the bank's profitability.

The results of the first three quarters of 2013 show a continued pressure on core income through a combination of falling margins, driven by falling lending margins, and largely stable lending balances. Costs remain stable and loan losses have fallen around 20% in the first three quarters of 2013 compared with 2012. The level of impaired loans has however continued to increase due to a combination of a continued challenging economic climate and a tighter impairment classification practise.

SATISFACTORY LIQUIDITY PROFILE

The bank's reliance on interbank funding continued to fall in recent years from around a quarter of all funding in 2006 to 12% at year-end 2012, and it has a decently sized securities portfolio, with liquid assets amounting to 42% of total assets as of year-end 2012. The bank's deposit base represented about 50% of total funding at year end 2012 and has been relatively stable in recent years.

In common with other regional and local banks, Sydbank funds its retail and commercial mortgage loans through Totalkredit/Nykredit Realkredit (Baa2, Negative) and DLR Kredit (unrated).

In addition, Sydbank announced in February 2012 a new funding tool allowing the bank to fund part of its new origination of private client bank loans through covered bonds issued by BRFKredit (unrated). The BRFKredit funding tool was only used to a relatively modest extent during 2012 and the first three quarters of 2013, but we still see this as a flexible long term funding alternative for Sydbank.

ASSET QUALITY DETERIORATION REFLECTS CHALLENGING OPERATING ENVIRONMENT

During 2012, Sydbank's problem loans (measured as gross loans subject to individual impairments) increased to 7% of gross loans, an increase from 4% at year-end 2011. The increase reflected both the challenging operating environment and the tighter impairment rules imposed by the Danish FSA. Loan loss reserves as percentage of impaired loans remained largely stable at 51.4%. At year-end 2012 approximately 19% of problem loans were related to agriculture, hunting, forestry and fisheries, an increase from nearly 15% at year-end 2011 and 5% at year-end 2010. The continued increase illustrates the difficulties faced by the agricultural industry.

The first three quarters of 2013 showed a continued weak trend in problem loans reflecting both the general economic climate and tighter impairment definitions imposed by the Danish FSA.

Around 31% of Sydbank's loan portfolio is to retail customers (mortgage loans financed by Totalkredit/Nykredit, DLR do not appear on Sydbank's balance sheet). 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.

Danish mortgage loans tend to be originated by banks, but then transferred to specialist mortgage institutions - such as Nykredit Realkredit and DLR Kredit - in return for a periodic fee. This practice primarily reflects the funding advantage of mortgage credit institutions, due to their use of covered bond funding. As a result, mortgage institutions hold most lower-risk first-lien loans, whilst the banks, including Sydbank, tend to hold either second or sequential-lien loans.

Typical for Nordic, and in particular regional banks, Sydbank displays high credit risk concentration. To assess borrower concentration Moody's compares the sum of the top 20 largest exposures to the Tier 1 capital or pre-provision income - whichever provides the highest ratio. There is also some industry concentration in the loan book - property-related exposures account for 11% of loans and credit, and finance & insurance exposures for 17%. The exposure to agriculture accounts for around 7% of loans and guarantees. Overall, corporate lending accounts for around 68% of the loan portfolio.

The overall macroeconomic situation in Denmark remains weak, putting pressure on the corporate and retail sectors. This situation supports our expectation of a continued elevated loan loss level also in the coming years. In particular, we remain concerned about the continuing structural problems within the agricultural sector, as well as the corporate real estate market that has been severely affected by the falling housing prices since 2007. We also note that the prolonged period of virtually no economic growth in Denmark is increasingly putting pressure on sectors outside agriculture and corporate real estate.

At year-end 2012, Sydbank's Tier 1 and total capital ratios were 15.6% and 15.9%, respectively which is at similar levels as 2011. The individual solvency requirement for the bank is 8.9%, which as of year-end 2012 meant the bank had a capital cushion exceeding its individual requirement of around DKK 4.0 billion (equivalent to 6.7% of total loans and advances). The bank has a stated internal capital target of 13.9%.

Considering Sydbank's risk profile and internal capital-generation capability, we continue to view its economic capital as satisfactory. We expect the weaker macro-economic environment in Denmark to keep pressure on the bank's profitability and ultimately on capital adequacy. Given the continued challenges in Sydbank's operating environment it remains crucial for the bank to sustain a high capital buffer to mitigate any future asset deterioration

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a GLC deposit rating of Baa1 to Sydbank. The rating receives a one-notch uplift from the baa2 BCA, based on Moody's assessment of a moderate probability of systemic support in the event of a stress situation and the Aaa local currency deposit ceiling of Denmark.

Notching Considerations

Sydbank's junior subordinated debt and preferred stock are rated (P)Ba1 and Ba2(hyb), respectively. These ratings are two and three notches, respectively, below Sydbank's baa2 adjusted standalone credit assessment (which is the same as its standalone credit assessment). The ratings do not include systemic support uplifts, reflecting Moody's view that systemic support for subordinated debt may no longer be sufficiently predictable or reliable to be a sound basis for incorporating uplift into Moody's ratings.

Foreign Currency Deposit Rating

Sydbank's Baa2 foreign currency deposit rating is unconstrained given that Denmark has a country ceiling of Aaa.

Foreign Currency Debt Rating

Sydbank's Baa2 foreign currency debt rating) is unconstrained given that Denmark 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

Sydbank A/S

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				x			
- 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						C	Neutral
PPI % Average RWA (Basel II)		2.75%					
Net Income % Average RWA (Basel II)				0.51%			

Factor: Liquidity						C	Neutral
(Market Funds - Liquid Assets) % Total Assets			0.32%				
Liquidity Management			x				
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	15.03%						
Tangible Common Equity % RWA (Basel II)	14.50%						
Factor: Efficiency						C	Neutral
Cost / Income Ratio			56.88%				
Factor: Asset Quality						C	Weakening
Problem Loans % Gross Loans			4.84%				
Problem Loans % (Equity + LLR)			29.83%				
Lowest Combined Financial Factor Score (15%)						C	
<i>Economic Insolvency Override</i>						Neutral	
Aggregate BFSR Score						C	
Aggregate BCA Score						a3	
Assigned BFSR						C-	
Assigned BCA						baa2	

[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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