

## CREDIT OPINION

6 June 2017

Update

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### RATINGS

#### Sydbank A/S

Domicile	Denmark
Long Term Debt	Baa1
Type	Senior Unsecured - Fgn Curr
Outlook	Stable
Long Term Deposit	A3
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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## Sydbank A/S

### Update to Discussion of Key Credit Factors

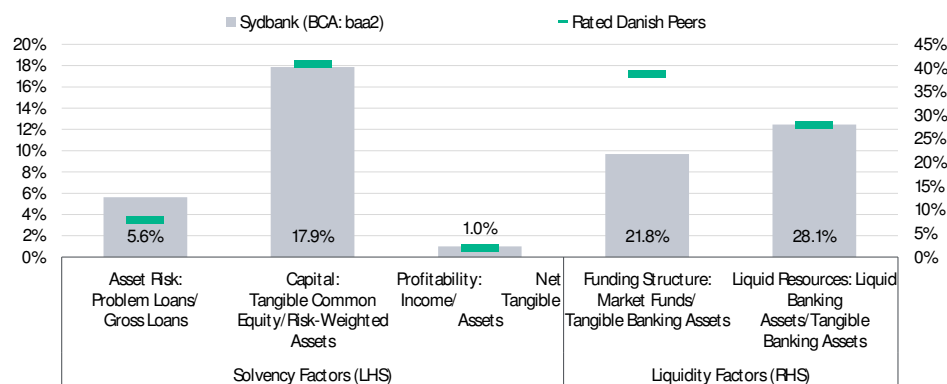
#### Summary Rating Rationale

Sydbank A/S's long- and short-term deposit ratings are A3/Prime-2 and its long-term senior unsecured debt rating is Baa1. We also assign a standalone baa2 baseline credit assessment (BCA) and Adjusted BCA to Sydbank, as well as A2(cr)/Prime-1(cr) long-term and short-term counterparty risk assessments (CRA).

Sydbank's standalone BCA of baa2 reflects a combination of elevated but improving level of problem loans and relatively low, but also improving, profitability. The bank's high level of capitalisation and solid liquidity mitigate these challenges. The bank's deposit rating of A3 and the senior unsecured debt ratings of Baa1 reflect 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. The bank's ratings do not benefit from any government support uplift.

Exhibit 1

#### Rating Scorecard - Key Financial Ratios (end-2016)



Source: Moody's Banking Financial Metrics

## Credit Strengths

- » Refocused growth strategy to further improve core earnings
- » Sound capitalization
- » Solid funding structure and liquidity profile
- » Large volume of deposits resulting in deposit ratings benefiting from a very low loss-given-failure rate and two-notch uplift from the BCA. For senior unsecured debt, our LGF analysis indicates a one-notch uplift from the BCA.

## Credit Challenges

- » Still elevated problem loans, but positive trend in asset quality on the back of a positive macro trend
- » Improving profitability driven by low credit provisions

## Rating Outlook

- » Sydbank's ratings carry a stable outlook reflecting the bank's satisfactory capital buffers and our expectation that still elevated problem loans will benefit from the positive macro trend.

## Factors that Could Lead to an Upgrade

- » 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.

## Factors that Could Lead to a Downgrade

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

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## Key Indicators

Exhibit 2

### Sydbank A/S (Consolidated Financials) [1]

	3-17 <sup>2</sup>	12-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>3</sup>	CAGR/Avg. <sup>4</sup>
Total Assets (DKK million)	137,552	146,686	142,742	152,316	147,892	-2.2 <sup>5</sup>
Total Assets (EUR million)	18,497	19,728	19,128	20,455	19,824	-2.1 <sup>5</sup>
Total Assets (USD million)	19,784	20,808	20,778	24,752	27,316	-9.4 <sup>5</sup>
Tangible Common Equity (DKK million)	11,027	11,372	11,024	10,887	9,805	3.7 <sup>5</sup>
Tangible Common Equity (EUR million)	1,483	1,529	1,477	1,462	1,314	3.8 <sup>5</sup>
Tangible Common Equity (USD million)	1,586	1,613	1,605	1,769	1,811	-4.0 <sup>5</sup>
Problem Loans / Gross Loans (%)	5.6	5.6	7.1	8.6	9.1	7.2 <sup>6</sup>
Tangible Common Equity / Risk Weighted Assets (%)	18.1	17.9	16.2	15.0	13.5	16.8 <sup>7</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	32.4	33.2	41.3	44.9	48.7	40.1 <sup>6</sup>
Net Interest Margin (%)	1.5	1.7	1.7	1.9	1.9	1.7 <sup>6</sup>
PPI / Average RWA (%)	3.8	3.0	2.5	2.8	2.8	3.0 <sup>7</sup>
Net Income / Tangible Assets (%)	1.3	1.0	0.8	0.7	0.1	0.8 <sup>6</sup>
Cost / Income Ratio (%)	54.0	57.2	60.1	57.4	56.5	57.0 <sup>6</sup>
Market Funds / Tangible Banking Assets (%)	15.4	21.8	22.9	34.3	34.1	25.7 <sup>6</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	26.8	28.1	25.6	34.0	38.0	30.5 <sup>6</sup>
Gross Loans / Due to Customers (%)	101.5	106.7	110.9	107.9	108.2	107.1 <sup>6</sup>

[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] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented

Source: Moody's Financial Metrics

## Detailed Rating Considerations

### Blue growth strategy will improve core earnings

We believe Sydbank's strategic plan, announced in October 2015 and called Blue Growth, intends to maintain the positive trend in core earnings which we observe since the beginning of 2014. However, we consider the bank's objectives ambitious as the plan anticipates to increase its net operating income by around DKK240 million until 2018. In addition to Sydbank's targeted ratio of a 12% return on equity (2016: 13.1%, 2015: 10.1%), further elements include (1) an increase core income by a minimum of DKK50 million per annum; (2) reduced costs by DKK50 million per annum - compared with a current cost base of DKK2.6 billion; and (3) reaching an average impairment charges of a maximum of 50 basis points on its loan book during one economic cycle.

Sydbank's ability to deliver on its profitability targets, including tight cost control and fostering new business, will be a key factor to improve our assigned profitability score of ba2, in particular due to pressure on revenues from the low interest rate environment, low credit demand in Denmark, and the general high competition in the Danish banking sector. Net interest income is Sydbank's main source of revenue, accounting for around two thirds of operating income. During the first three months of 2017, Sydbank reported pre-tax profits of DKK574 million (58% increase year-on-year), driven by a decline in impairment charges down to 1 bp from 4 bps (71% decline compared to the same quarter last year) and an increase in investment portfolio earnings to DKK136 million (versus a DKK22million loss in the same period last year). However, core income remained flat in the quarter at DKK1,053 million (compared to the same period last year). Moreover, in the first quarter of 2017, expenses remained stable at DKK691 million (DKK681 million in Q1 2016).

Sydbank's profitability is in line with the average for rated Danish peers. For the first three months of 2017, the bank's net income to tangible banking asset ratio was 1.3% (1.0% in 2016). We note the positive movement in the bank's impairment charges, accounting for around 2% of pre-provision income (PPI) in the first three months of 2017 compared with around 9% in the same period last year. At end-March 2017, the bank's loan book decreased by 7% compared with the same period last year, due to the bank's change of joint funding agreement with Totalcredit (which was effective as of January 2017). The agreement was changed from an offsetting model according to which the Bank covers losses as regards the entire loan to a guarantee model according to which Sydbank provides a guarantee for the part of the loans in the LTV range of 60-80% (the bank has no longer a credit risk related to the part of the loan in this LTV interval). As a consequence of the amendment of the agreement, funded bank loans are no longer recognised in the Bank's

balance sheet. At end-March 2017, funded mortgage loans were DKK5.7 billion. Sydbank has provided guarantees for DKK 1.2 billion as regards the part of the loans in the LTV range of 60%-80%.

### Still elevated but improving asset quality driven by benign domestic environment

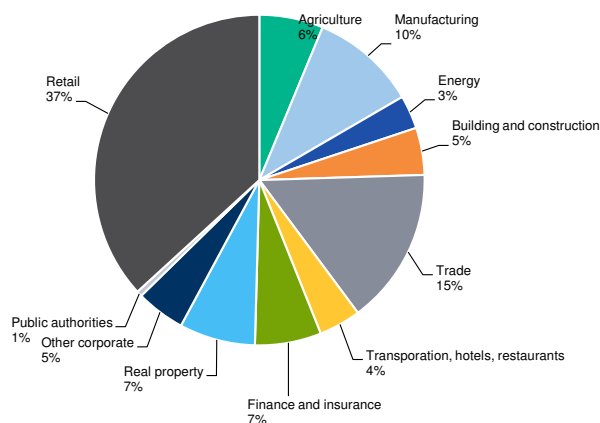
Our assigned Asset Risk score of ba1 indicates that asset risk remains a relative weakness for Sydbank. However, following a weakening in asset quality during the financial crisis and the low-growth period that followed, Sydbank's asset-quality challenges have started to ease. At end-March 2017, Sydbank's problem loans (measured as gross loans subject to individual impairments) amounted to 5.6% of gross loans, unchanged compared to year-end 2016 (7.1% at year-end 2015). 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 (provision coverage of 69% at end-March 2017), 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 Danish financial crisis on the economy and prolonged weak economic growth thereafter. In addition, in recent years the Danish FSA tightened impairment rules with respect to the treatment and valuation of collateral. At the end of March 2017, around 24% of problems loans were related to agriculture, hunting, forestry and fisheries, in line with year-end 2016. The continued elevated level of problem loans illustrates the difficulties faced, especially by the Danish agricultural industry, which we expect to persist in the coming years. In August 2016, Sydbank announced it will offer selected agricultural clients the option to convert part of their debt into subordinated loan capital in a bid to create better prospects and encourage farmers to continue to work towards increasing earnings. As a result, in the first quarter of 2017 debt concerning an additional seven agricultural exposures was converted to subordinated loan capital and DKK67 million was converted, bringing the total amount converted to DKK565m at end-March 2017.

Exhibit 3

#### Sydbank's loan portfolio breakdown by sector at end-March 2017



Source: Company reports

Around 37% 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.

### Sound capitalization

Our assigned aa3 Capital score reflects Sydbank's solid capital position, a relative strength in the assessment of the bank's standalone profile. As of March 2017, Sydbank's Tier 1 and total capital ratios were 16.0% and 18.1%, respectively (2016: 17.4% and 19.2%), compared with an individual solvency requirement according to the Danish FSA calculation of 10.2%, i.e. unchanged compared with

end-2016. In March 2017, Sydbank initiated a share buyback programme of DKK664 million and will be completed by 31 December 2017, reducing its capital ratios by 1.0 percentage point in the first quarter. Moreover, the announced repayment of DKK828 million Additional Tier 1 has reduced the capital ratio by 8bps. At end- March 2017, CET1 ratio was 15.6% (2016: 16.1%). Also, following the trend in recent quarters, risk weighted assets declined by 4% to DKK60.9 billion, driven by a reduction in market and credit risk.

### Solid funding structure and liquidity profile

Our baa1 Combined Liquidity Score reflects Sydbank's solid funding and liquidity profile. Sydbank's customer deposits (excluding deposits from pool plans) accounted for around 65% of total liabilities at end-March 2017 (2016: 61%), with improving trend in recent years, while its reliance on short-term interbank liabilities has decreased significantly. Excluding repo transactions which accounted for 6% of its total funding, unsecured bank lending represented around 3% of the total funding, down from more than 20% in 2007.

In common with other regional and local banks, Sydbank funds its retail and commercial mortgage loans off balance sheet through mainly Totalkredit (unrated) 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.

At the end of March 2017, liquid banking assets accounted for around 27% of tangible banking assets (similar level compared to 2015 compared to 34% in 2014) part of which are used for repo transactions. We consider the bank's liquidity to be relatively high compared with the Danish peers. Our Liquid Resources score reflects our view that liquidity is a relative strength for Sydbank's standalone credit assessment.

## Notching Considerations

### Loss Given Failure

Sydbank is subject to the EU Bank Recovery and Resolution Directive (BRRD), which we consider to be an Operational Resolution Regime. We apply our advanced Loss Given Failure (LGF) analysis to Sydbank's liabilities, considering the risks faced by the different debt and deposit classes across its liability structure at failure. 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 and a 5% run-off in preferred deposits. These are in line with our standard assumptions.

For Sydbank's A3 deposits, our LGF analysis indicates a very low loss-given-failure, leading to a two-notch uplift from the bank's baa2 Adjusted BCA from which these ratings are notched.

For Sydbank's Baa1 senior unsecured debt, our LGF analysis indicates a low loss-given-failure, leading to a one-notch uplift from its baa2 Adjusted BCA from which these ratings are notched.

### Government Support

The implementation of the EU BRRD has caused us to reconsider the potential for government support to benefit certain creditors. We continue to consider the probability of government support to Sydbank to be low and hence do not assign any systemic support to the bank's ratings.

### 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.

## Rating Methodology and Scorecard Factors

Exhibit 4

### Sydbank A/S

#### Macro Factors

**Weighted Macro Profile**                      **Strong +**    **100%**

Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	6.7%	ba1	← →	ba1	Expected trend	
Capital						
TCE / RWA	18.1%	aa2	← →	aa3	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	1.0%	baa1	↑	ba2	Earnings quality	
Combined Solvency Score		a3		baa2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	21.8%	baa1	← →	baa1	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	28.1%	a3	← →	a3	Stock of liquid assets	
Combined Liquidity Score		baa1		baa1		
Financial Profile						
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		

Balance Sheet	in-scope (DKK million)	% in-scope	at-failure (DKK million)	% at-failure
Other liabilities	32,388	26.4%	40,644	33.1%
Deposits	80,946	65.9%	72,690	59.2%
Preferred deposits	59,900	48.8%	56,905	46.3%
Junior Deposits	21,046	17.1%	15,785	12.8%
Senior unsecured bank debt	3,700	3.0%	3,700	3.0%
Dated subordinated bank debt	824	0.7%	824	0.7%
Preference shares (bank)	1,300	1.1%	1,300	1.1%
Equity	3,685	3.0%	3,685	3.0%
Total Tangible Banking Assets	122,843	100%	122,843	100%

Debt class	De jure waterfall		De facto waterfall		Notching		LGF notching guidance versus BCA	Assigned LGF notching	Additional notching	Preliminary Rating Assessment
	Instrument volume + Subordination	Sub-ordination	Instrument volume + Subordination	Sub-ordination	De jure	De facto				
Counterparty Risk Assessment	20.6%	20.6%	20.6%	20.6%	3	3	3	3	0	a2 (cr)
Deposits	20.6%	4.7%	20.6%	7.7%	2	2	2	2	0	a3
Senior unsecured bank debt	20.6%	4.7%	7.7%	4.7%	2	-1	1	1	0	baa1
Dated subordinated bank debt	4.7%	4.1%	4.7%	4.1%	-1	-1	-1	-1	0	baa3
Junior subordinated bank debt	4.1%	4.1%	4.1%	4.1%	-1	-1	-1	-1	-1	ba1
Non-cumulative bank preference shares	4.1%	3.0%	4.1%	3.0%	-1	-1	-1	-1	-2	ba2 (hyb)

Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Assessment	3	0	a2 (cr)	0	A2 (cr)	--
Deposits	2	0	a3	0	A3	A3
Senior unsecured bank debt	1	0	baa1	0	--	Baa1
Dated subordinated bank debt	-1	0	baa3	0	--	Baa3
Junior subordinated bank debt	-1	-1	ba1	0	--	Ba1
Non-cumulative bank preference shares	-1	-2	ba2 (hyb)	0	--	Ba2 (hyb)

Source: Moody's Financial Metrics

## Ratings

Exhibit 5

Category	Moody's Rating
<b>SYDBANK A/S</b>	
Outlook	Stable
Bank Deposits	A3/P-2
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A2(cr)/P-1(cr)
Senior Unsecured	Baa1
Subordinate	Baa3
Jr Subordinate MTN	(P)Ba1
Pref. Stock Non-cumulative	Ba2 (hyb)
Other Short Term	(P)P-2

Source: Moody's Investors Service

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