

## NORWEGIAN BANKS' SME DISCOUNT LIKELY TO BE FINANCED BY MORTGAGE CUSTOMERS

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In 2019, Norway is set to implement EU capital requirement regulations not already incorporated in domestic legislation. These regulations, the capital requirements regulation (CRR) and the capital requirements directive (CRD IV), include capital discounts for banks' SME customers. In our view, given the Norwegian financial supervisory authority's (FSA's) ambition to uphold banks' total core equity requirements through higher Pillar 2 requirements, reduced capital charges for SME customers are likely to be financed by higher capital charges for other customers. In the case of Norwegian savings banks, the burden is most likely to shift to mortgage loan customers.

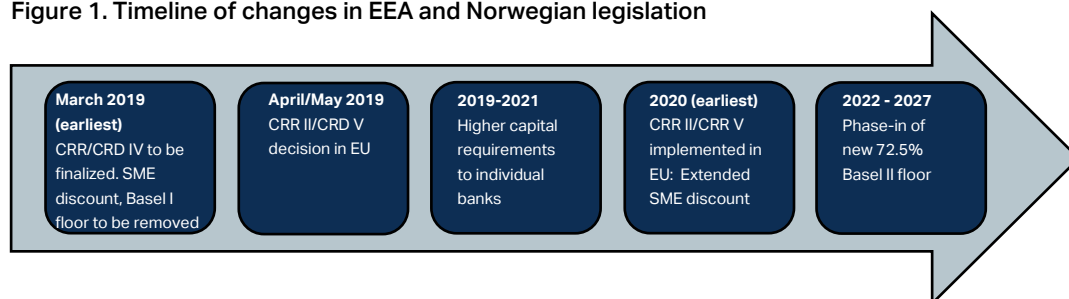
We believe that this will lead to higher margins, or in effect lending rates, on mortgage loans to offset lower margin requirements for SME customers. We expect that banks with low levels of SME loans, typically large internal ratings-based (IRB) banks, will be able to cut lending rates more for SME loans and increase lending rates less for other loans. Accordingly, given constant total equity, larger banks stand to gain market share.

Norway will also be forced to remove the transitional Basel I floor for IRB banks. This is a prerequisite if IRB banks are to benefit from the SME discount. The FSA has signalled that higher common equity Tier 1 (CET1) ratios due to the removal of the Basel I floor will be offset by higher capital requirements. Nevertheless, the change should allow IRB banks to benefit from the SME discount and to report CET1 ratios that are more comparable with those of Swedish and other European banks.

### IMPLEMENTATION OF CRR/CRD IV – BACKGROUND

Norwegian rules already largely mirror CRR/CRD IV, the EU's prudential framework for credit institutions and investment companies. The two main exceptions are that Norway has yet to implement the SME discount<sup>1</sup> and remove the 80% Basel I floor for IRB banks. Norwegian authorities have argued that the country's SMEs have no need for support though lower capital weights and that the discount does not reflect lower risk. However, the SME discount and the Basel I floor are not part of national discretion permitted under CRD IV and will have to be implemented in 2019.

Figure 1. Timeline of changes in EEA and Norwegian legislation

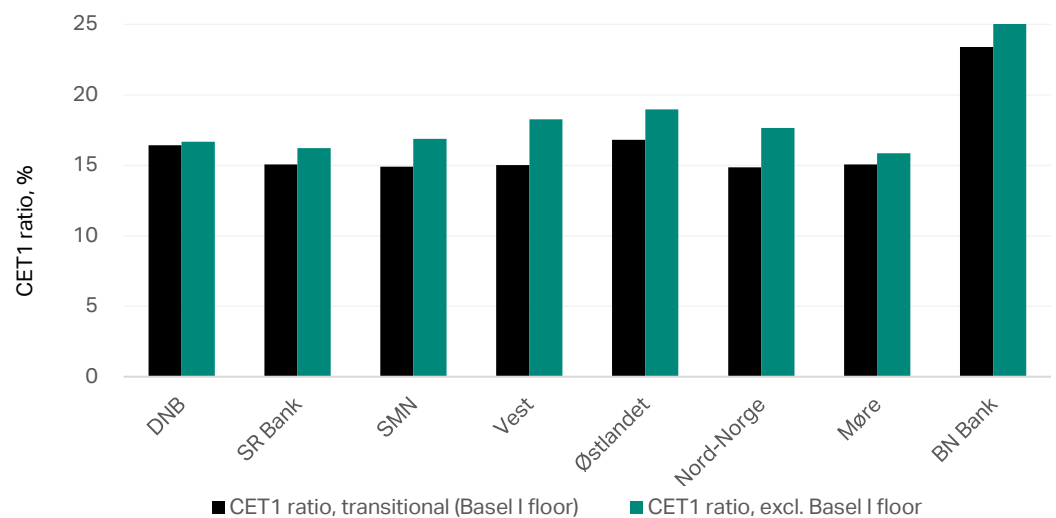


<sup>1</sup>The SME discount reduces the capital requirement for SME loans by 23.8% for financial institutions with less than EUR 50m in revenues and fewer than 250 employees, providing their exposure is less than EUR 1.5m.

The Basel I floor (which requires capital levels to be at least 80% of Basel I requirements) was meant to be transitional through 2009, but the global financial crisis that broke out late in 2008 effectively extended that deadline across Europe. Norway is the only country in the European Economic Area (EEA) yet to remove the floor and will have to do so when the remaining CRR/CRD IV regulations are implemented. This will have a major impact on IRB banks' risk exposure amounts (REAs) and capital ratios.

The FSA's aim is to keep the leverage ratio for Norwegian banks at the same level as before full implementation of CRD IV. To this end, the FSA has proposed that the country's regional savings banks should be defined as systemically important financial institutions, offsetting the impact of removal of the Basel I floor on most IRB banks. Higher Pillar 2 requirements will also be used to maintain overall capital levels.

**Figure 2: Change in CET1 ratios for selected IRB banks with and without the Basel I floor**



Based on NCR estimates using company data. From left: DNB ASA, SpareBank 1 SR-Bank, SpareBank 1 SMN, Sparebanken Vest, SpareBank 1 Østlandet, SpareBank 1 Nord-Norge, Sparebanken Møre, BN Bank

## THE EFFECT OF THE SME DISCOUNT ON STANDARDISED BANKS

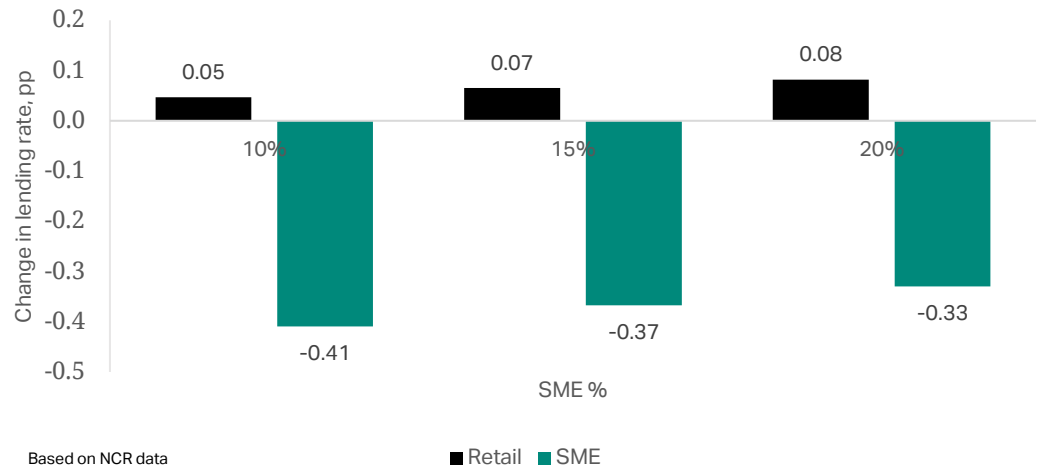
We do not have sufficient information to calculate the effect of the SME discount on individual banks and have therefore made rather broad assumptions to simulate the impact on banks with different levels of SME loans and initial 16% CET1 target levels (before the increased Pillar 2 requirement). These "model" banks do not let other customers subsidise the SME discount; i.e. all products need to meet the required return on equity (RoE) of 10%. Figure 3 shows the effect of the SME discount under current EU legislation<sup>2</sup>.

The effect of the SME discount is less positive for SMEs and more negative for retail customers for banks with a high level of SME loans on their balance sheets (see Figure 3). We believe that, using the

<sup>2</sup>When CRR II is implemented, first in the EU and then in the rest of the EEA, the exposure is proposed to be increased to EUR 2.5m, while larger SME loans will also benefit from a proposed discount of 15%. We are not certain if the Norwegian FSA will be able to fully offset the effect on REAs through higher capital requirements.

standardised method, a typical Norwegian savings bank has 10-20% SME loans < EUR 1.5m, which is about 30% of total REAs. Other variables, such as cost-to-income ratio and loan loss ratio, have a small impact on required net interest margin (NIM) given a target RoE of 10% and are held constant. Figure 3 illustrates that the effect on NIM, or required lending rate, is limited for retail customers but more significant for SME customers.

**Figure 3: Change in lending rate given that 10%, 15% and 20% of total loans are eligible for the SME discount and RoE target 10%**



#### Exhibit 1. Extended SME discount

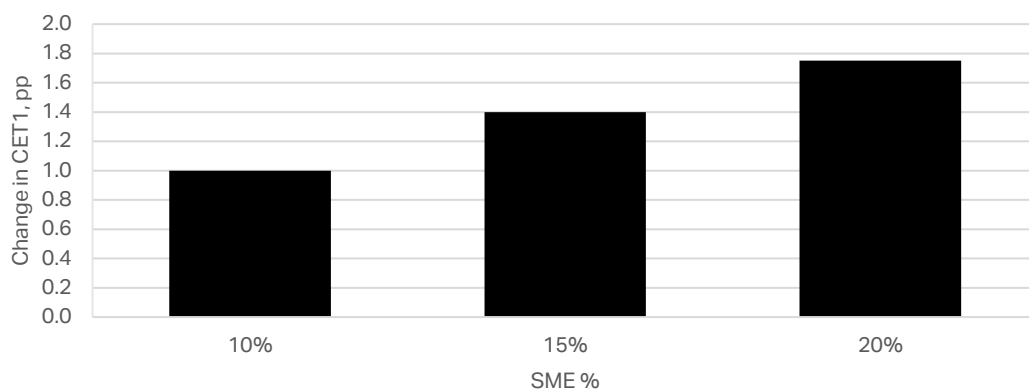
One would expect the proposed extension of the SME discount to include loans up to EUR 2.5m to have a stronger effect on required lending rates. In Figure 4, we assume 30% SME loans, of which half are small loans which qualify for a 23.8% REA discount and the rest are larger loans which get a 15% discount. The lending rate reduction for small SME loans is reduced and lending rates for mortgage loans are increased using constant capital levels.

**Figure 4. Change in lending rates given target RoE of 10% for both retail and SME loans under broader definition of SME loans and a 15% REA discount for SME loans above EUR 2.5m.**



The FSA has calculated that more than half of Norwegian banks will qualify for an increase in their CET1 ratio of 1 pp or more due to the SME discount. Some 15 banks would get an increased CET1 ratio of 1.5% or more<sup>3</sup>.

**Figure 5. Change in CET1 ratio due to SME discount**



Based on NCR data

## THE EFFECT OF THE SME DISCOUNT FOR IRB BANKS

According to the FSA, the SME discount will have an effect of less than 1 pp on the CET1 ratios of IRB banks. This is because IRB banks have a higher share of large corporate loans and a lower share of SME loans within their loan books than standardised banks. We find that given SME loans at 10% of the loan book, CET1 ratios will increase by 0.5 pp, which would be in line with the effect disclosed by Sparebanken Vest in its results for the third quarter of 2018. In Figure 6, we have calculated the effect on the "required" lending rate for a bank with 10% and 15% of loans to SME's (13% and 20% of the respective REAs in our example).

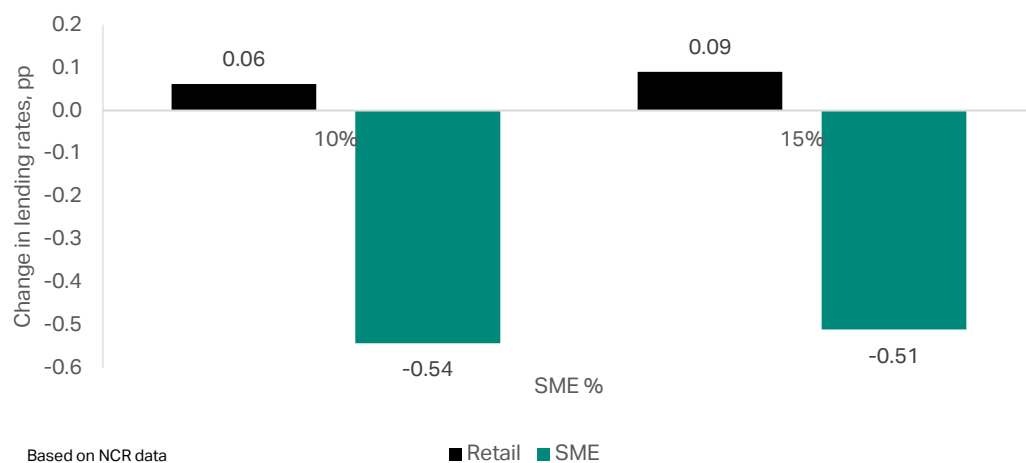
In this example we assume that the target RoE is increased 12% rather than 10% to account for differences in profitability between IRB banks and less capital effective standardised banks. The higher return requirement explains the more pronounced reduction in SME lending rates for IRB banks against standardised banks<sup>4</sup> for a given SME share of lending.

We conclude that large IRB banks are likely to benefit more from the SME discount as they will be able to offer lower lending rates to SMEs while penalizing other customers less to sustain a given RoE. Conversely, smaller savings banks may need to increase retail mortgage rates to compensate for lower SME loan pricing.

<sup>3</sup>The FSA currently assumes that a bank's maximum exposure to an SME is EUR 1.5m. The effect will be stronger if the maximum exposure is increased to EUR 2.5m and more SME loans qualify for a discount of 15%. In the example in Exhibit 1, CET1 ratio would fall by about 1.8 pp.

<sup>4</sup>The FSA will consider IRB applications only from banks with corporate loans (including SME loans) above NOK 30bn.

Figure 6. Change in lending rates given that 10% and 15% of loans are eligible for the SME discount and target RoE of 12% for both retail and SME loans



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