Nordic Credit Rating

SECTOR COMMENT
FINANCIAL INSTITUTIONS
26 March 2019

RAPIDLY GROWING AND PROFITABLE NICHE BANKS FACE CHALLENGES

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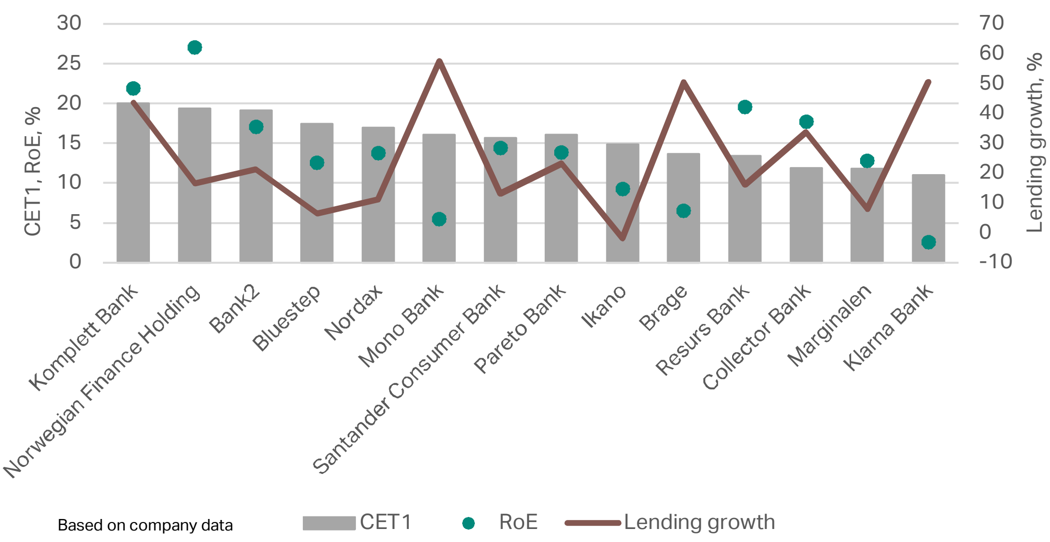
Niche banks are taking increasing market shares in the Norwegian and Swedish credit markets and generally showing strong profitability. Nordic Credit Rating (NCR) sees challenges ahead, however, due to slower growth prospects, higher funding costs and, most likely, higher credit losses. In this note we compare a selection of seven Norwegian and seven Swedish niche banks. We found that banks focused on consumer lending were more impacted by higher loan losses in 2018 but remain more profitable than other niche banks. We also found that Norway's higher capital requirements seem strongly linked to higher risk profiles and therefore return on equity (RoE). From a rating perspective, strong capitalisation more or less counterbalances a higher credit risk profile.

PROFITABLE AND GROWING NICHE BANKS

The Norwegian banks include three focused mainly on unsecured consumer lending (Komplett Bank, Norwegian Finance Holding/Bank Norwegian, and Mono Bank), two with a higher element of secured lending (Santander Consumer Bank and Brage), one focused on refinancing distressed mortgage loans (Bank2) and one focused on financing commercial projects (Pareto Bank). The Swedish banks include two focused mainly on unsecured consumer lending (Nordax Bank and Resurs Bank), one focused on refinancing distressed mortgage loans (Bluestep Bank), three diversified consumer banks (Ikano, Marginalen and Collector Bank) and one which we classify as a provider of payment solutions to retailers (Klarna Bank).

Figures 1 illustrates that the Norwegian banks are generally better capitalized and are also on average reporting higher RoE than the Swedish banks. This can be explained by different business models, risk profile and cost efficiency. However, the Swedish Banks are largely reporting comparable lending growth with the Norwegian banks.

Figure1. CET1 ratios and RoE, 2018

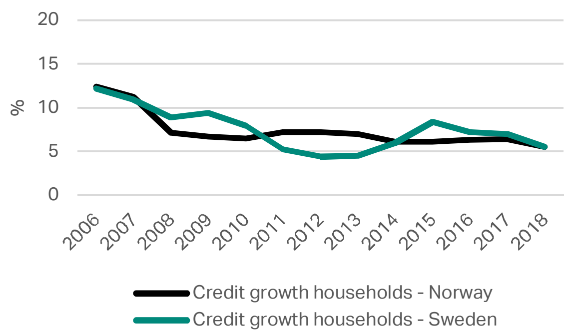


Based on company data

CONSUMER LENDING GROWING FASTER THAN CREDIT GROWTH

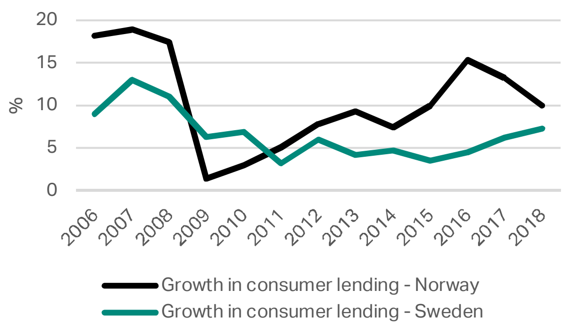
In Norway, consumer lending has grown by over 10% annually since 2015 and in this period has been twice as high as total credit growth. In the past five years, we have also seen an influx of startup consumer lenders in Norway, among them Komplett Bank, Monobank, Instabank, BB Bank and MyBank, In the more mature Swedish market, consumer lending has been growing only marginally faster than credit growth. In 2018, tighter regulations in Norway reduced growth in consumer lending, but it still came in at a healthy 10%. In Sweden, consumer lending increased from 5.5% in 2017 to 7%, some of which can be attributed to aggressive Norwegian banks focusing on cross-border growth opportunities. NCR plans to assess the impact of stricter lending regulations introduced in Norway in February 2019 and Norway's new debt registry to come into force in April this year. We believe that both factors will have a dampening effect on the growth of unsecured lending to households.

Figure 2. Growth in household lending, 2006-18



Based on data from Statistics Norway, Statistics Sweden, NCR

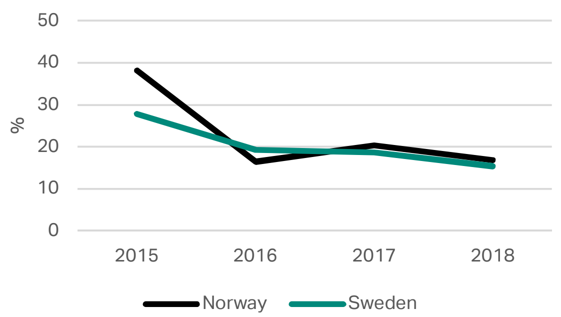
Figure 3. Growth in consumer lending, 2006-18



Based on data from Statistics Norway, Statistics Sweden, NCR

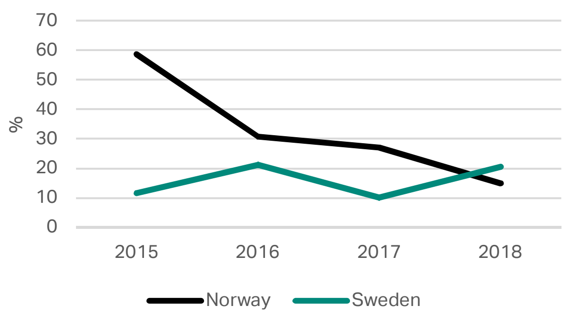
Lending growth among the Norwegian banks in our study was as high as 16.8% in 2018 and that of the Swedish banks almost equally strong at 15.4%. We believe that these banks are both increasing the size of the market, due to a wider availability of lending products and marketing, as well as taking market shares from incumbent banks. Moreover, several of these banks offer cross-border lending or have operations abroad which are growing rapidly. Loan growth was closely matched by deposit growth at 15.0% and 20.6% respectively. Essentially, these high-margin banks have been able to attract deposits by offering guaranteed deposits at rates above those offered by universal banks and savings banks, and by tapping into new Nordic markets and Germany.

Figure 4. Loan growth selected niche banks, 2015-18



Based on company data

Figure 5. Deposit growth selected niche banks, 2015-18



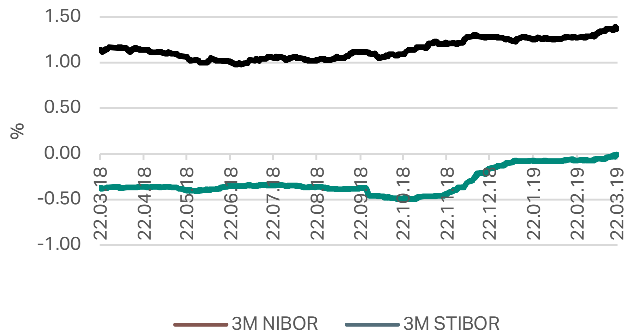
Based on company data

HIGHER FUNDING COSTS LIKELY

Despite their high deposit rates, the niche banks in our study are generally dependent on at least some market funding. In 2018, increased money market rates had in sum a small negative impact on their net interest margins (NIMs). The impact was, however, more pronounced for the smaller banks. Thus, unweighted average NIM in both countries saw a 20-bps reduction in NIM in 2018.

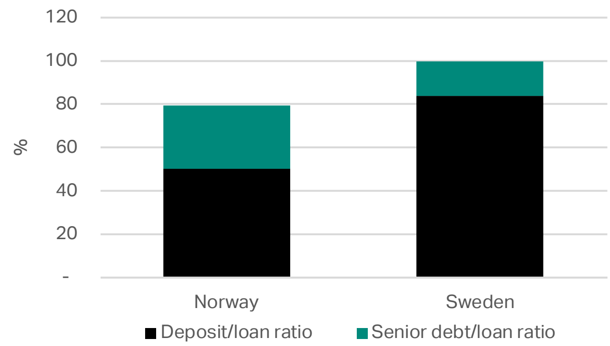
We believe that market funding rates will continue to increase in 2019 and lead to continued margin pressure, particularly if competition for deposits intensifies. In Norway, annual contributions to the Banks' Guarantee Fund will from 2019 depend to a greater degree on the individual bank's business model and risk profile. Banks with riskier business models will have to pay relatively more than banks with lower risk, and this will likely have some negative effect on margins. In figure 8 and 9, we see that the banks we have defined as focused on consumer lending (see page 1) have significantly higher NIMs. The higher cost of funding is for Norwegian banks somewhat mitigated by more reliance on equity as a funding source, ref. figure 7.

Figure 6. 3-month reference interest rates



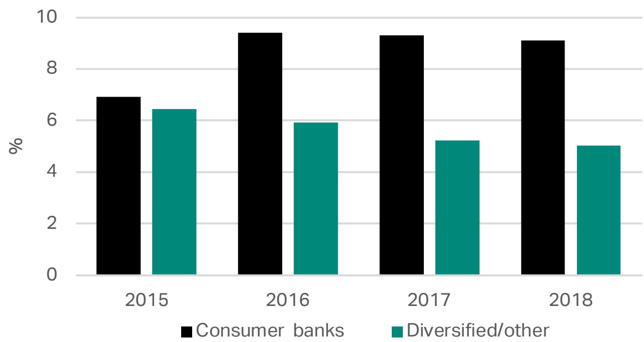
Source: Oslo Stock Exchange, Nasdaq,

Figure 7. Deposit to loan and senior debt to loan ratios, 2018



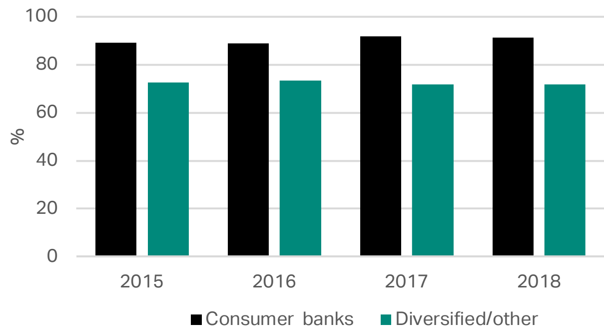
Based on NCR data

Figure 8. Net interest margins, 2015-18



Based on company data

Figure 9. Net interest income as a share of operating revenue, 2015-18



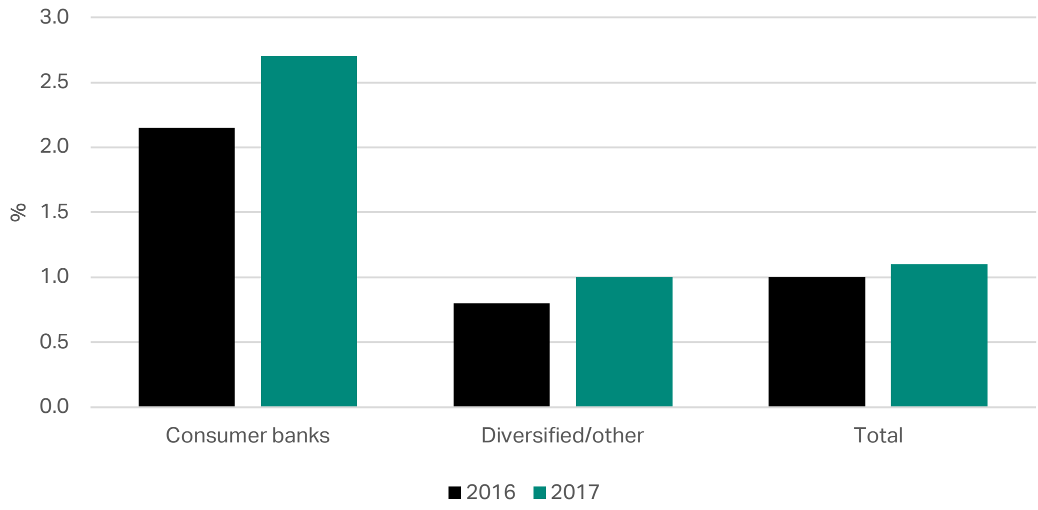
Based on company data

CREDIT LOSSES ON THE RISE

Loan losses as a percentage of net loans in our sample increased from 1.0% in 2017 to 1.1% in 2018. For the five banks focusing on unsecured consumer lending, loan losses increased from 2.1% to 2.7%. According to the Norwegian Financial Supervisory Authority (FSA), total loan losses arising from consumer lending in Norway increased from 1.1% to 1.5% in 2018. From this, we conclude that loan losses on consumer lending are smaller among universal banks and savings banks, possibly due to reversals of loan losses and lower risk profiles.

Some of the increase in loan losses can be attributed to the implementation of IFRS9 (an International Financial Reporting Standard promulgated by the International Accounting Standards Board) even though not all banks in the study follow IFRS standards. Moreover, Norwegian banks have been affected by model changes for Finnish loans requiring higher provisions. Given that consumer loan defaults are less likely for new loans, stalling consumer lending growth in Norway is also likely to contribute to increasing the ratio of loan losses to net lending. Lower lending growth and, in the longer term, a downturn in the economic cycle, could further increase the ratio over the next few years.

Figure 10. Loan losses to average net loans, 2015-18

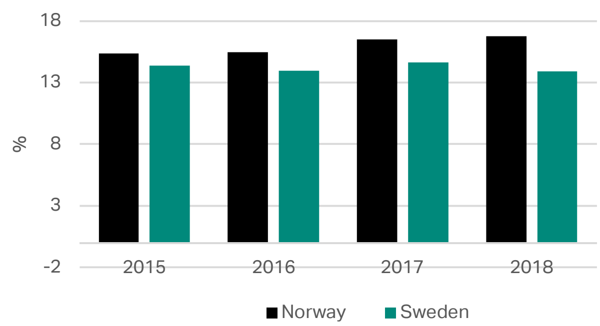


Based on company data

DIFFERENCES IN CAPITALISATION AND PROFITABILITY

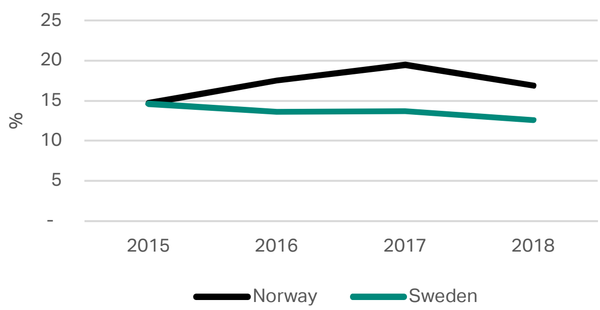
On average, the Norwegian banks in the study have higher CET1 ratios than the Swedish banks, primarily due to higher Pillar 2 requirements for Norwegian niche banks. Normally, we would expect higher capital requirements to have a negative effect on RoE. However, Figure 1 suggests this is not the case.

Figure 11. CET1 ratios, 2015-18



Based on company data

Figure 12. Return on Equity, 2015-18

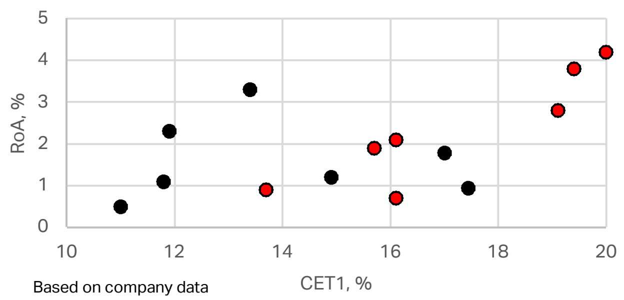


Based on company data

Plotting CET1 ratios against both return on assets (RoA) and RoE shows a highly positive correlation of 80-90% for the Norwegian banks in the study while the Swedish banks have low correlations (see figures 13 and 14). We would expect a negative correlation for CET1 against RoE. However, we believe that the Norwegian FSA has succeeded in imposing higher capital requirements on banks with higher risk profiles (circular 12/2016 from FSA gives some, albeit limited, guidance) leading to higher RoEs. The Swedish FSA does not seem to take a bank's risk profile into account to the same degree in its Pillar 2 capital requirements. Figures 17 and 18 appear to support this idea, showing a 75% positive correlation between CET1 and NIM for the Norwegian banks in the study and -24% for the Swedish banks.

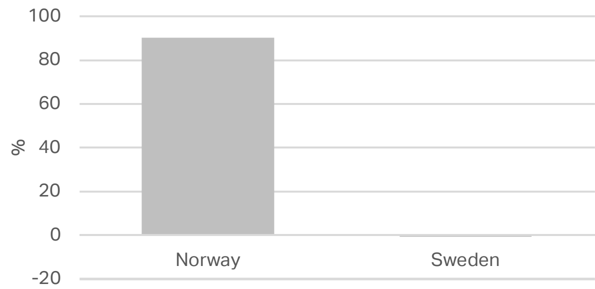
In figures 19 and 20 we illustrate that both NIM and cost efficiency play a role in explaining RoE for both the Norwegian and the Swedish banks. While this is hardly surprising, it supports our view that a bank's risk profile impacts its RoE through higher NIM. Lower correlations for the Norwegian banks than the Swedish banks can be explained by the Norwegian Banks' higher capital ratios.

Figure 13. CET1 against RoA, 2018 (Norwegian banks in red)



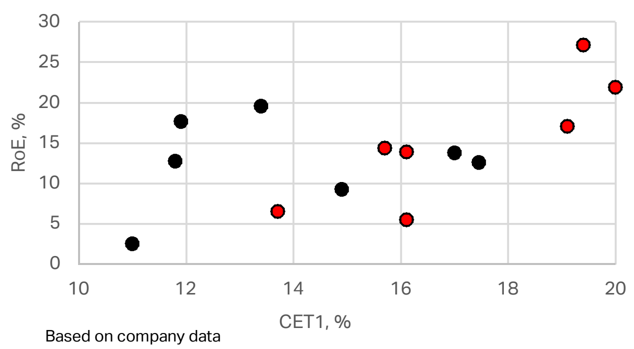
Based on company data

Figure 14. Correlation of CET1 and RoA, 2018



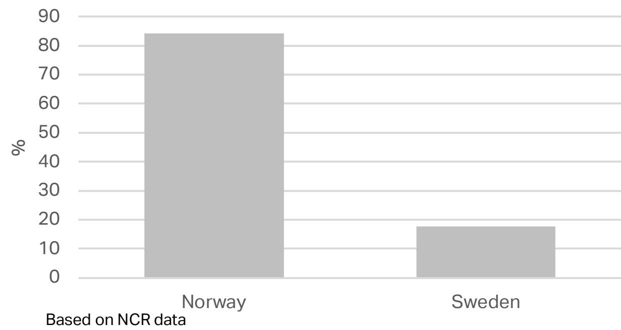
Based on NCR data

Figure 15. CET1 against RoE, 2018 (Norwegian banks in red)



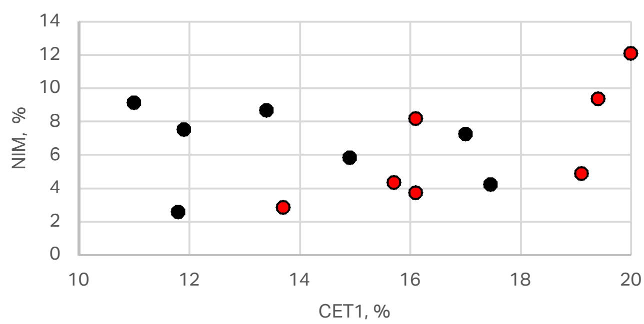
Based on company data

Figure 16. Correlation of CET1 and RoE, 2018



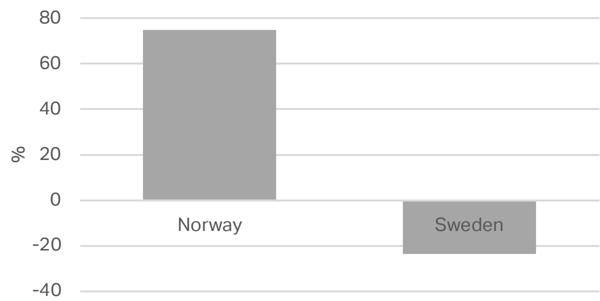
Based on NCR data

Figure 17. CET1 against NIM, 2018 (Norwegian banks in red)



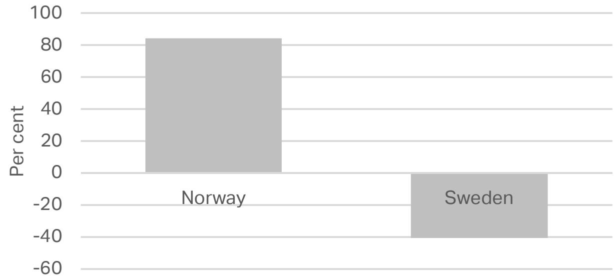
Based on company data

Figure 18. Correlation of RoE and NIM, 2018



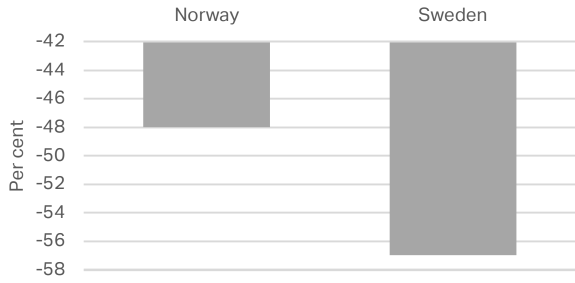
Based on NCR data

Figure 19. Correlation of CET1 and RoE, 2018



Based on NCR data

Figure 20. Correlation of RoE and cost/Income, 2018



Based on NCR data

POTENTIAL EFFECT ON CREDIT RATINGS AS A RESULT OF DIFFERENCES IN CAPITALISATION

In NCR's methodology, 17.5% of a financial institution's rating is based on the credit score for capital, using the framework described below. The Norwegian banks featured in this note have an average capital score of 'a-' while the Swedish banks have an average capital score of 'bbb-'. For most of the Swedish banks in our study, capitalisation at the level of their Norwegian peers would result in a one-notch increase in the bank's overall credit assessment.

Figure 21. Initial capital scoring guidelines*

SUBFACTORS	AA	A	BBB	BB	B
Capital ratios	Capitalisation and flexibility are exceptional in comparison with those of regional peers. The regulatory CET1 ratio is typically 22% or higher. Distance to minimum CET1 requirements is usually higher than 6%.	Capitalisation and flexibility are strong or above average in comparison with those of regional peers. The regulatory CET1 ratio is typically around 18%. Distance to minimum CET1 requirements is usually higher than 5%.	Capitalisation and flexibility are average in comparison with those of regional peers. The regulatory CET1 ratio is typically around 15%. Distance to minimum CET1 requirements is usually higher than 4%.	Capitalisation and flexibility are below average in comparison with those of regional peers. The regulatory CET1 ratio is typically around 12%. Distance to minimum CET1 requirements is usually higher than 3%.	Capitalisation and flexibility are weak in comparison with those of regional peers. The regulatory CET1 ratio is weak, uncertain or deteriorating. Distance to minimum CET1 requirements is usually less than 3%.

* The guideline ratios above may be adjusted to reflect differences in national capital regimes and RWA calculations as described above.

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