

BIGGER IS BETTER AMONG NORWEGIAN SAVINGS BANKS

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In preparing this report we looked at shifts in the different elements of the sector's profit and loss accounts in recent years and found consistent differences of performance related to size. Specifically, larger banks outperformed smaller banks due to higher non-interest income and better cost efficiency. We also noticed differences between bank alliances and independent banks, with alliance banks benefiting from extensive cooperation on infrastructure and better economies of scale.

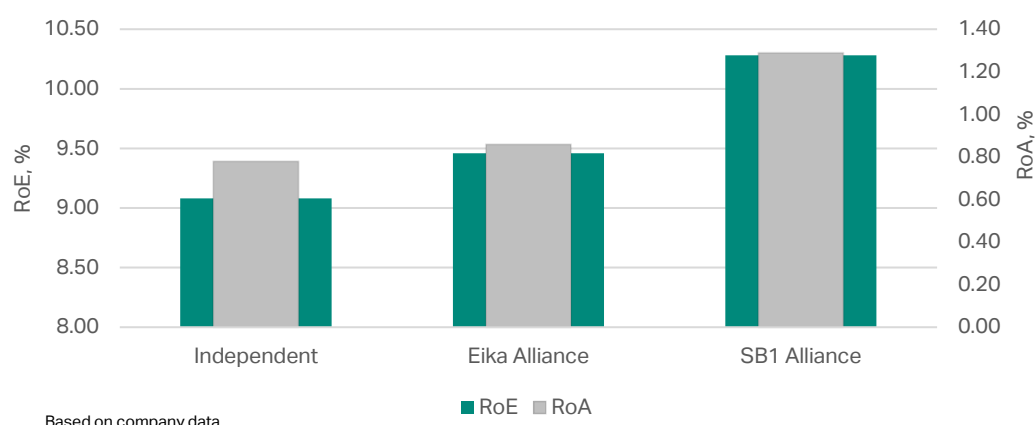
SPAREBANK 1 ALLIANCE LEADS THE PACK

Norwegian savings banks¹ reported an average return on equity (RoE) of 9.9% for 2018, marginally down from 10% in the previous year, while return on assets (RoA) increased to 1.08% from 1.07%. A strong build-up of equity in the sector seems to have run out of steam, however, as the average equity ratio was up by a mere 8bps to 10.6% in 2018.

Norway has two major savings bank alliances; the SpareBank 1 (SB1) Alliance, with mostly large local and regional savings banks, and the Eika Alliance, which consists of smaller, local savings banks. There is also a group of independent banks, which in some cases have jointly owned product companies and co-operate on a project basis.

While we found that, on average, the banks in the Eika Alliance performed better in 2018 than independent savings banks, both groups significantly lagged the banks in the SB1 Alliance. This seems mainly to be driven by higher core non-interest income. We bypassed the problem of banks unloading loans to associated covered bond companies by focusing on total core income and found that the SB1 Alliance was still in the lead. A lower level on non-interest income is probably the main explanation for seemingly higher cost efficiency among independent banks.

Figure1. RoE and RoA of savings bank alliances, 2018



¹Based on data from 81 banks representing 97.4% of the sector's assets.

A SHORT NOTE ON METHODOLOGY

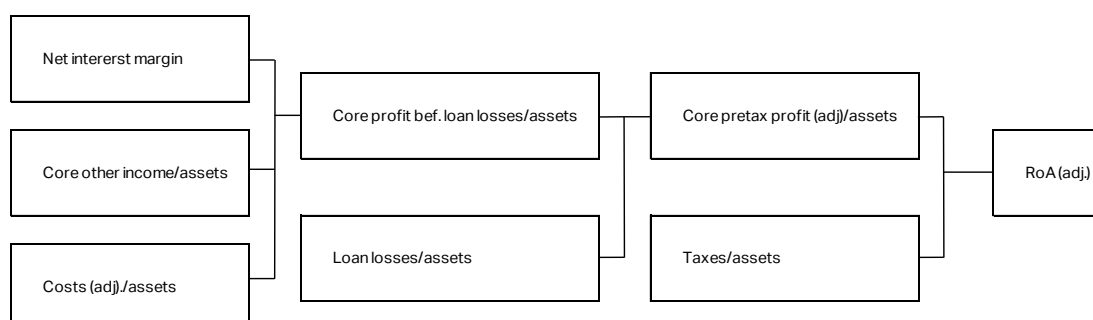
In compiling this report, we used a data set of 81 of a total of 96 savings banks, representing 97.4% of domestic savings banks' assets. The missing banks belong to what we classify as Group 1 banks; ie banks with less than NOK 5bn in assets. There are still 40 Group 1 banks represented in our data set. See figure 2.

Figure 2. Our banking categories

	GROUP 1	GROUP 2	GROUP 3	GROUP 4	TOTAL
Total assets (NOKbn)	<5	5-10	10-50	>50	
Number of banks:					
SB1 Alliance	0	3	6	4	13
Eika Alliance	36	12	4	0	52
Independent	4	4	4	4	16
Total	40	19	14	8	81

We have looked at shifts in key numbers in 2018 and differences between the size groups and alliance affiliations. For the most part we looked at key figures based on value-weighted averages within the Du Pont model framework, adjusted for net trading income, gains/losses on fixed assets and other extraordinary items.

Figure 3: Du Pont model banks



LARGER BANKS HAVE RELATIVELY STABLE NET INTEREST MARGINS

Norwegian savings banks' average net interest margin (NIM) fell by 5bps in 2018, to 1.67%, which can be explained by higher funding costs (i.e. a rising Norwegian Interbank Offered Rate). According to the Norwegian financial supervisory authority, the NIM for all banks increased by 11bps to 1.79%. We believe that the increase for the entire market can be explained by growth in high-margin consumer lending, particularly in 2017, in which the savings banks did not take part. NIMs have been relatively stable for the larger savings banks (groups 2 and 3) since 2011, while NIMs for smaller banks have been sliding from higher levels.

Transfers of low-margin mortgage loans to partly-owned covered bond companies, which is common in both banking alliances, will contribute to higher average NIMs as low-margin loans are effectively removed from the balance sheet. This may explain the higher margins for banks belonging to alliances compared with those of independent banks in figure 5.

Figure 4. NIM by size group, 2011-18

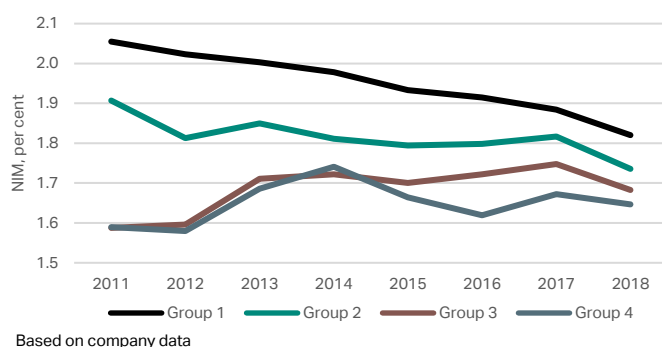
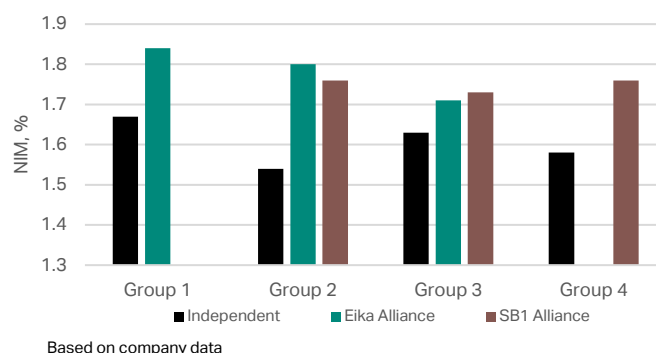


Figure 5. NIM by size group and banking alliance, 2018



OTHER CORE INCOME BOOSTS ALLIANCE MEMBERS' PERFORMANCES

Other core income as a percentage of total core income has varied between 34-40% since 2011, with no clear trend. Other core income/assets fell by 8bps in 2018 to 0.92% of assets.

Figure 6. Other core income to assets by size group, 2011-18

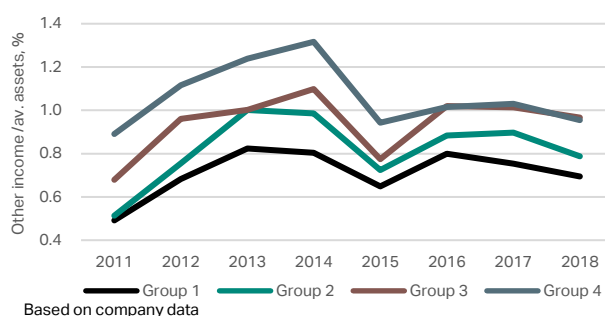


Figure 7. Other core income to assets by size group and banking alliance, 2018

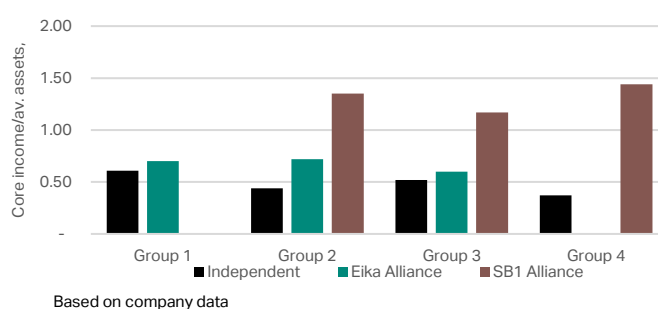


Figure 8. Total core income to assets by size group, 2011-18

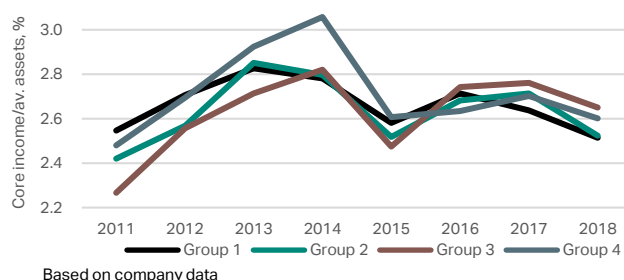
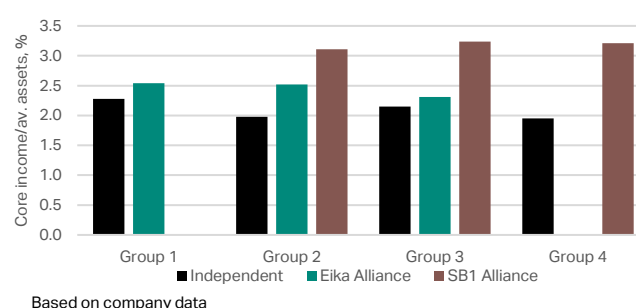


Figure 9. Total core income to assets by size group and banking alliance, 2018



Notably, there is a 26bps difference between Group 1 and Group 4 in terms of other core income/assets. However, this falls to only 9bps when we include NIM and look at total core income. This is largely an effect of net interest income on transferred loans being booked as fee income but is also because smaller banks in rural areas often operate with higher margins. Still, the conclusion is that larger banks have marginally higher core income than smaller banks and alliance members outperform independent banks.

OPERATING EXPENSES TRENDING DOWN

Operating expenses to assets have fallen in recent years and declined by 3bps in 2018. We would expect that larger banks would be more cost effective than smaller banks and that banks belonging to alliances would be more efficient than independent banks. However, even if figure 10 shows that the first assumption holds true, the independent banks in figure 11 appear to be more cost efficient. Moreover, the cost/income ratio shows the same picture. Accordingly, we conclude that lower assets in alliance-affiliated banks due to loan transfers are not a valid explanation.

Figure 10. Operating costs to assets by size group, 2011-18

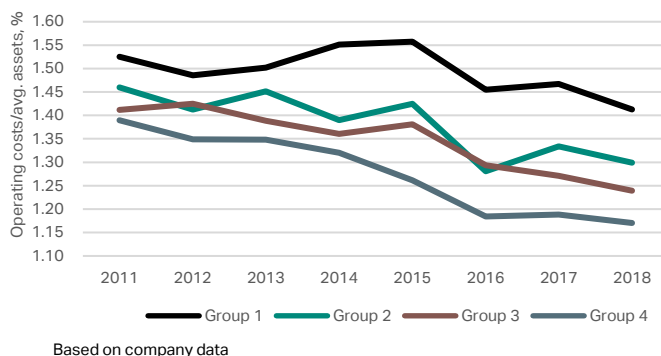


Figure 11. Operating costs to assets by size group and alliance, 2018

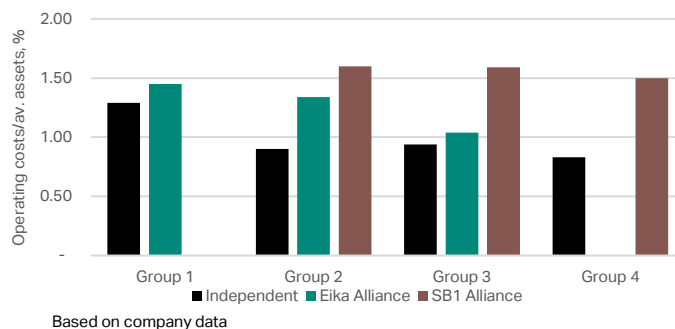


Figure 12. Cost to income by size group, 2011-18

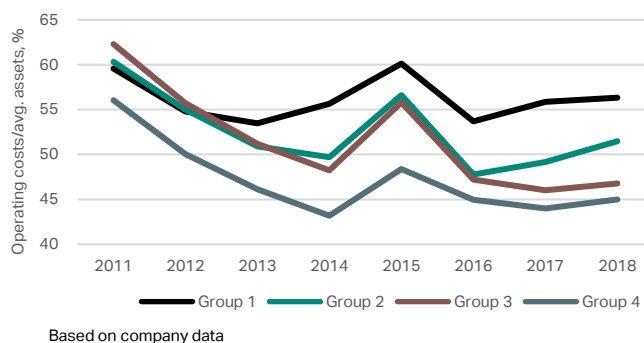
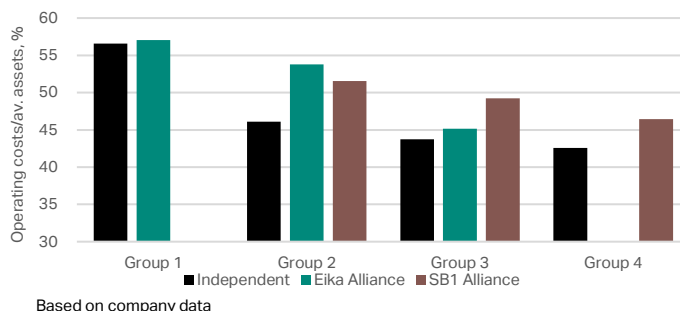


Figure 13. Cost to income by size group and alliance, 2018



This is not a mystery, however, since the other operating income generated in the banking alliances, notably the SB1 Alliance, increases cost levels. These revenue streams are still highly profitable, though, and in figures 14 and 15 we resolve the picture by combining both income and operating costs in the core profit before losses to assets metric. Again, we see no clear trend recent years, but note that core profit before losses to assets fell by 8bps from 2017 to 2018 to 1.38% on average for all savings banks due to lower core income.

Figure 14. Core profit before losses to assets by size group, 2011-18

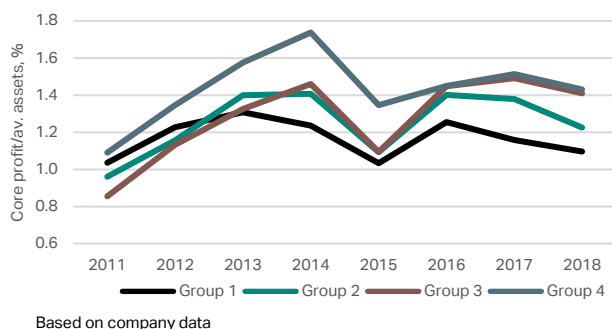
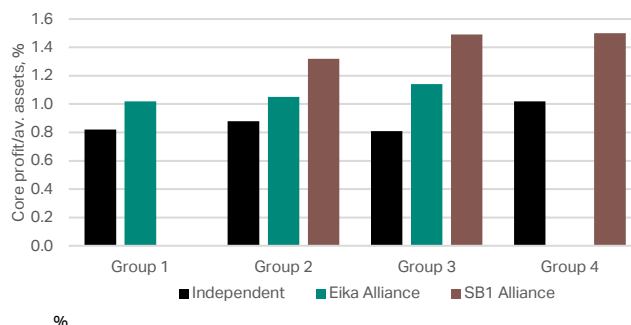


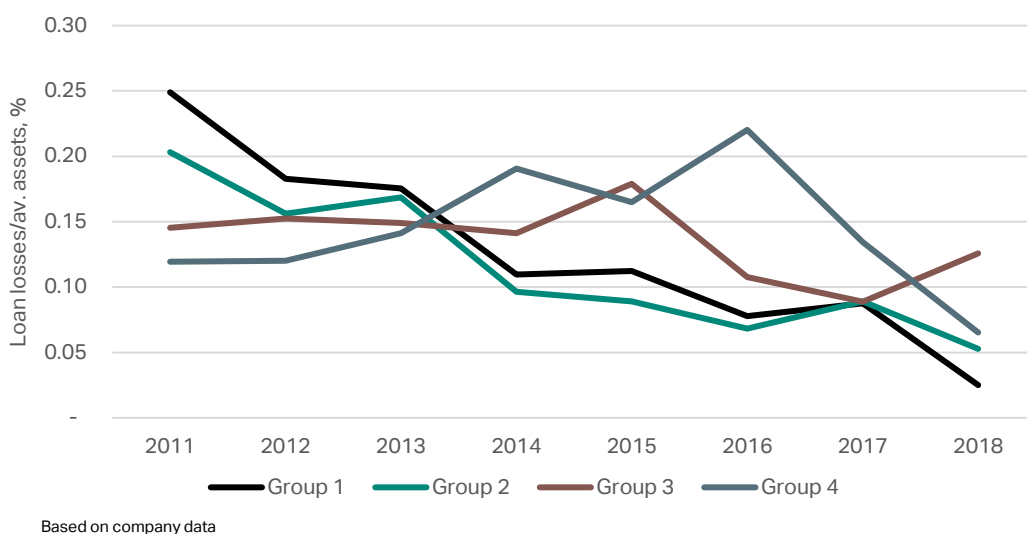
Figure 15. Core profit before losses to assets by size group and alliance, 2018



LOAN LOSSES FALLING

Loan losses remained at moderate levels through the oil price crisis, and have trended down after 2016 also for the larger bank. Loan losses to avg. assets were down by 5bps from 2017 to 7bps in 2018. There is no clear difference between the size groups or alliance affiliations (not shown in figure 16), although the smaller banks have been less affected by the decline in oil prices due to lower oil exposure.

Figure 16. Loan losses to average net loans, 2015-18



PROFITABILITY STABLE IN RECENT YEARS

When we sum everything up in the core pretax profit to assets and RoA metrics (figures 17 and 19), we see that after a period of volatility due to loan losses, the larger banks have been more profitable than the smaller banks, except in 2016 due to loan losses related to the oil service industry. Group 3 banks have slightly outperformed Group 4 banks as measured by RoA, though this was due to weaker trading income for the largest banks which particularly affected the fourth quarter of 2018. Moreover, we see in figures 18 and 20 that banks in the SB1 alliance are on average more profitable than members of the Eika Alliance while independent banks are the least profitable among their Norwegian savings bank peers. In total, RoA was up by 1bp in 2018 to 1.08%, driven by lower loan losses.

We have included the RoE metric in figures 21 and 22 and see that only Group 4 banks, together with the SB1 Alliance banks in Group 3 (not shown), were able on average to generate RoE consistently above 10% in the 2011-18 period. Better capital efficiency among Group 4 banks gave them a clear lead in this respect than did the RoA metric. Figure 23 illustrates that the sector has built capital since 2011, but less so in 2018 than the earlier years.

Figure 17. Core pretax profit to assets by size group, 2011-18

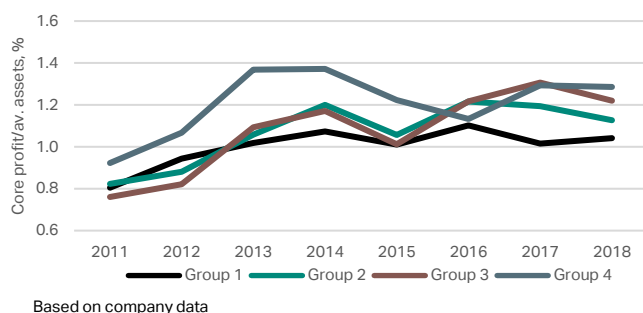


Figure 18. Core pretax profit to assets by size group and alliance, 2018

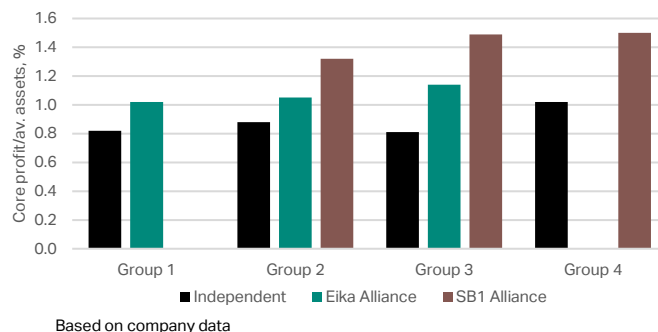


Figure 19. RoA by size group, 2011-18

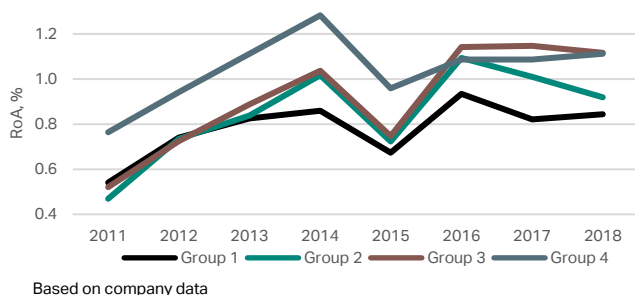


Figure 20. RoA by size group and alliance, 2018

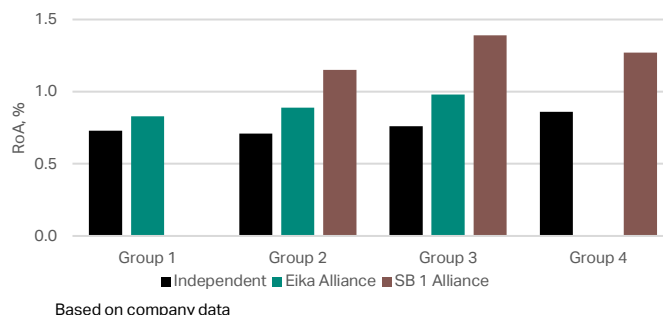


Figure 21. RoE by size group, 2011-18

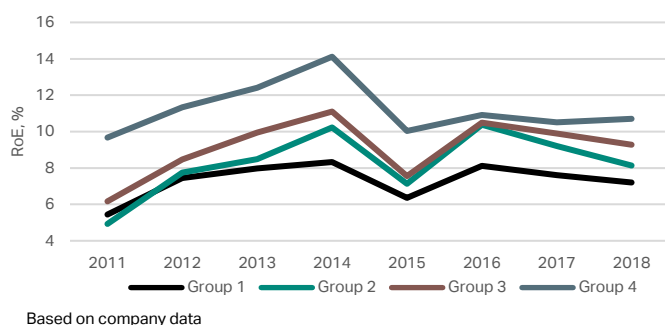


Figure 22. RoE by size group and alliance, 2018

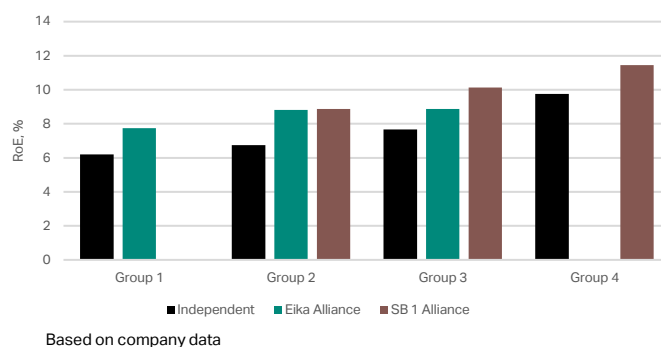


Figure 23. Equity ratio by size group, 2011-18

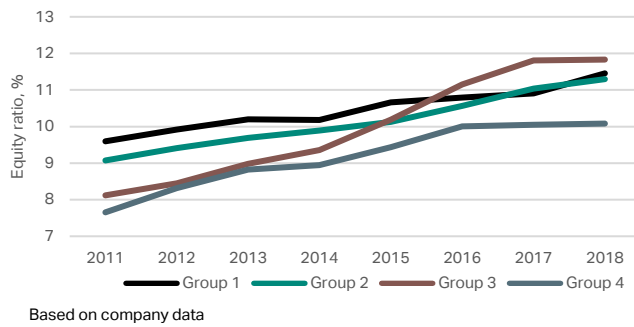
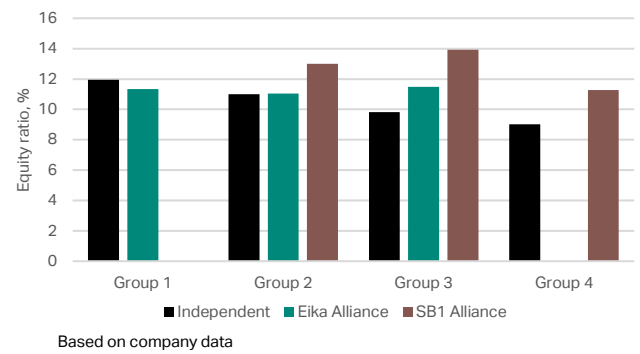


Figure 24. Equity ratio by size group and alliance, 2018



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