PROPOSED CHANGES IN NORWAY'S CAPITAL REGULATIONS INCREASE BURDEN FOR SMALL BANKS

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The Norwegian Ministry of Finance is proposing to increase capital buffers to compensate for lower risk exposure amounts (REAs) for the country's banks, most of which are likely to see a net increase in capital requirements as a result. In this article, Nordic Credit Rating (NCR) examines the likely impact on a selection of the country's banks (see Appendix 1). Although the proposed increase in capital buffers appears to be equal for all Norwegian banks, the reduction of REAs following the implementation of the capital requirements regulation (CRR) and the capital requirements directive (CRD IV), is likely to be more beneficial to larger banks – which tend to use internal ratings-based (IRB) capital models – due to the removal of the Basel I floor.

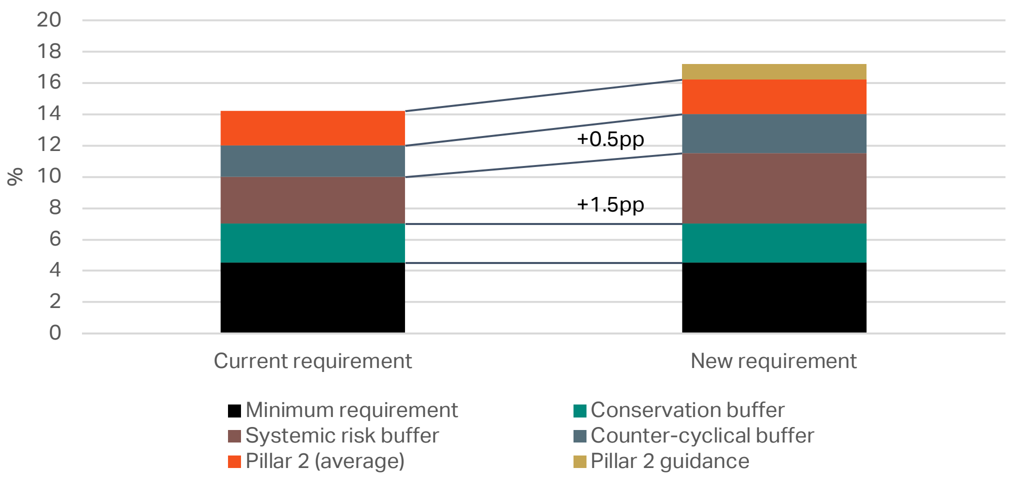
Among our selection of banks, only BN Bank (BN), predominantly a residential mortgage lender, would be better off in terms of lower capital requirements given lower risk weights for residential mortgages after the removal of the floor. In addition, the owners of Samspar, i.e. the smaller banks in the SpareBank 1 Alliance, would benefit through proportional consolidation of Samspar's holding in BN. Other banks using the Standard approach would, however, face significantly higher capital requirements if the proposals are put into effect.

Bank alliances and the resultant cost sharing have enabled the Norwegian savings bank sector to thrive, but increased capital requirements would have to be met by individual banks. The heavier burden on banks using the standard approach would be a competitive disadvantage relative to the larger banks and could trigger increased consolidation within the sector.

NEW CAPITAL REQUIREMENTS IN TRAIN

Norway is implementing EU capital requirement regulations not already incorporated into domestic legislation. These regulations – the CRR and CRD IV – allow a 23.8% capital discount for banks' SME customers and stipulate removal of the transitional Basel I floor for Norwegian banks using the IRB approach. Standard banks are only affected by the inclusion of the SME rebate.

Figure1. Proposed capital requirements including Pillar 2 guidance



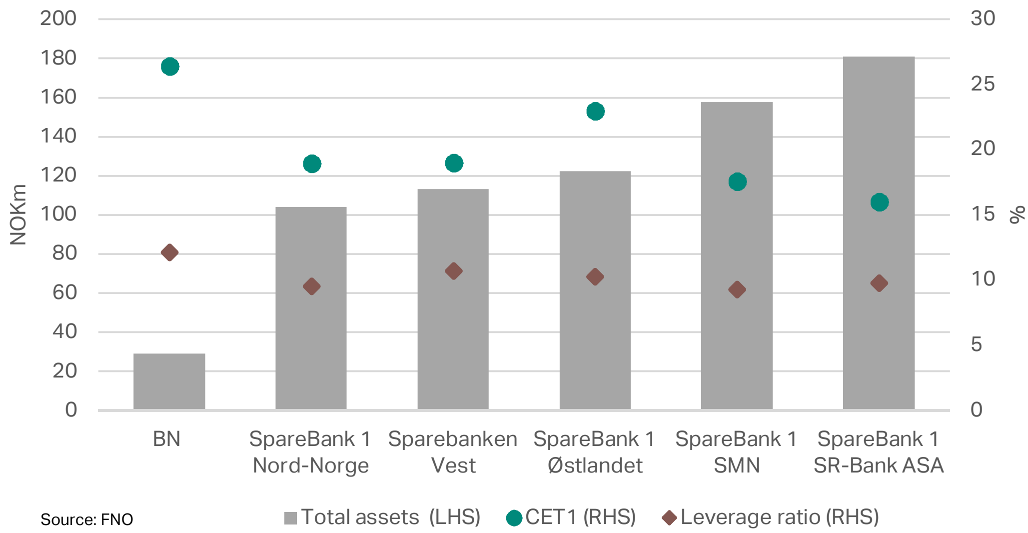
Source: NCR, FSA

The removal of the Basel I floor and implementation of the SME discount would, according to the Ministry of Finance, increase banks' average common equity Tier 1 (CET1) ratio by 1.3pp. While the FSA has proposed compensating for this by increasing the number of systemically important financial institutions, individual increases in Pillar 2 requirements and tightening of internal risk models, the Ministry of Finance has made an alternative proposal to increase the systemic risk buffer for all banks by 1.5pp. In Figure 1, we have also included 1% Pillar 2 Guidance (P2G), which we believe will replace the management buffer and form a soft requirement from 2020. The 1%-level is a minimum and individual banks could be advised to hold a higher level of P2G. The FSA could increase a bank's Pillar 2 requirement if the bank is not in compliance with the advised P2G level. In the chart we have also included a 0.5pp increase in the countercyclical buffer which comes into effect from 1 Jan. 2020.

CAPITALISATION OF NORWEGIAN SAVINGS BANKS

The Norwegian authorities have sought to secure the stability of the financial sector by implementing strict capital requirements and limiting the use and flexibility of IRB models. Figure 2 shows that Norwegian savings banks (and BN) which use the Advanced IRB (A-IRB) approach had leverage ratios of about 10% at the end of 2018. CET1 ratios ranged from 16% to 26%, with a median of 19%.

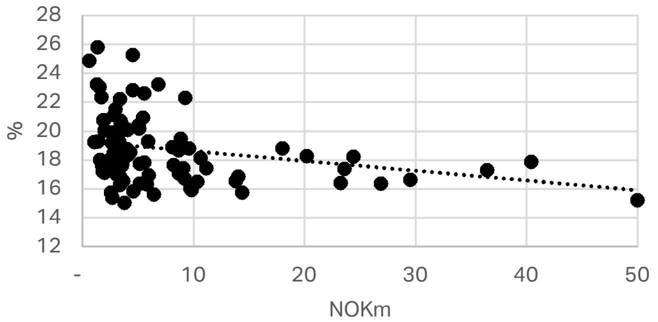
Figure 2. CET1 ratios and assets of A-IRB banks, end-2018



Source: FNO

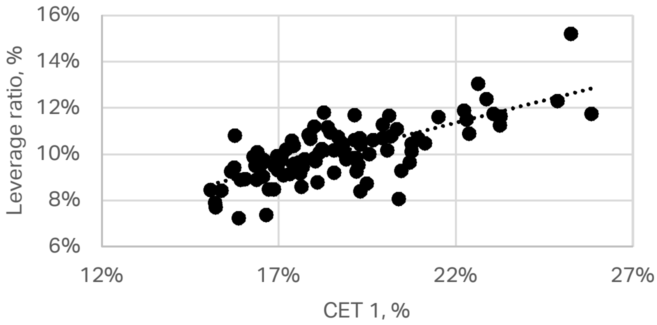
Figure 3 shows the CET1 ratios for savings banks using the Standard approach and the Foundation IRB (F-IRB) approach, which have zero Basel I floor effect. These banks had CET1 ratios ranging from 15.1% to 25.8%, with a median of 18.4%. There is a moderate (-35%) negative correlation between size and capitalisation. The median leverage ratio for these banks was 10.1% (see Figure 4).

Figure 3. CET1 ratios against assets of Norwegian savings banks using the Standard method, end-2018*



Source: FNO

Figure 4. Leverage ratios against CET1 ratios of Norwegian savings banks using the Standard method, end-2018

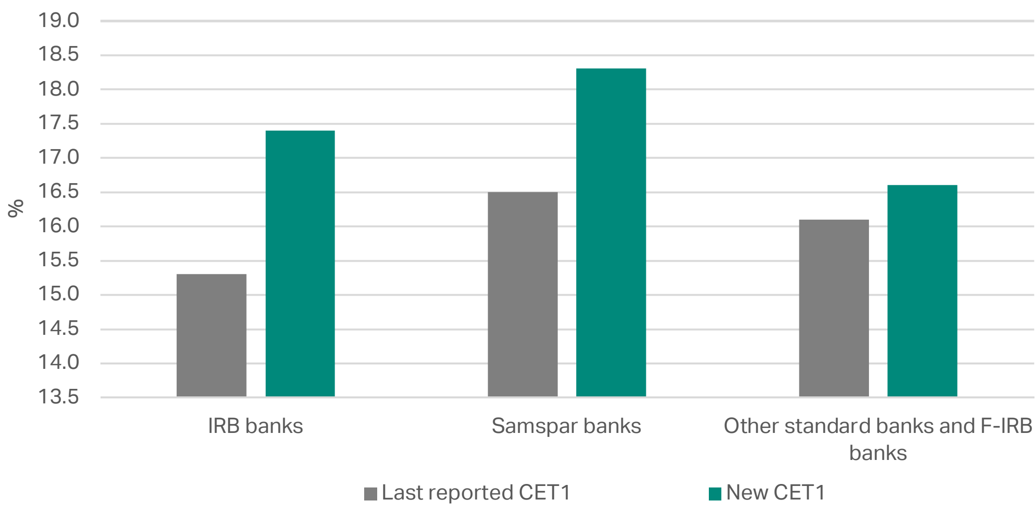


Source: [FNO

EFFECT OF PROPOSED REGULATIONS ON CAPITALISATION

Figure 5 shows that our selection of A-IRB banks (which includes DNB) will increase their average CET1 ratio by 2.1pp as a result of the proposed regulations. The Samspar banks, which constitute the smaller banks in the SpareBank 1 Alliance, will increase their average CET1 ratio by 1.8pp, while other banks, mostly savings banks, will see an average increase of only about 0.5pp. The reason for the likely difference is that the Samspar banks are consolidating their ownership in jointly-owned A-IRB institutions BN and SpareBank 1 Boligkreditt. BN, in particular, stands to be significantly affected by the removal of the Basel I floor, and we assume that the regulations governing proportional consolidation will remain unchanged. The other savings banks, however, stand to benefit only modestly from the SME-discount (see Appendix 1 for the effects on individual banks).

Figure 5. Last reported CET1 ratios (Q2 2019) and CET1 ratios on removal of Basel 1 floor and implementation of SME discount



Source: NCR, company data

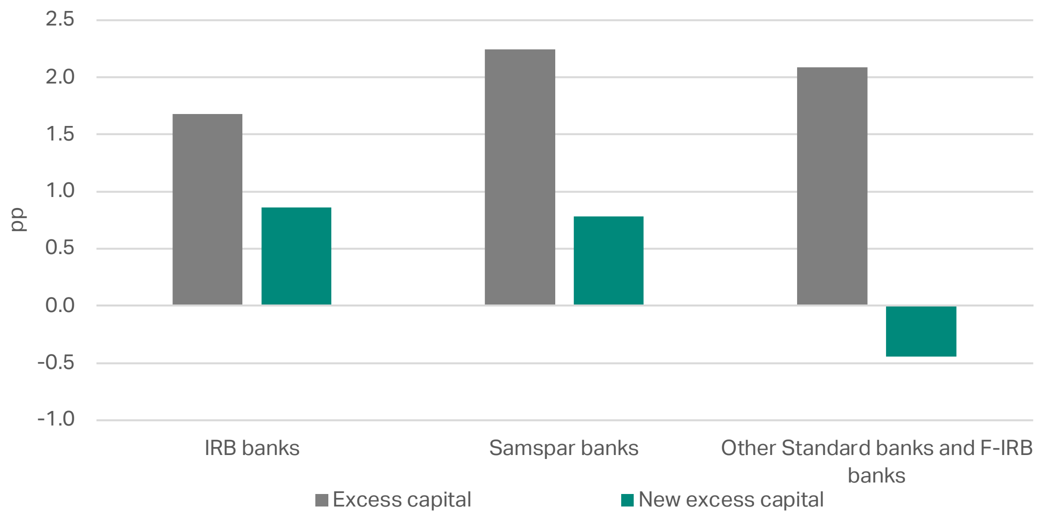
In Figure 6 we show the projected changes in excess capital upon removal of the Basel I floor and implementation of the SME discount as well as the new capital requirements and an assumed P2G of 1%, as illustrated in Figure 1. All three groups of banks will see a negative net effect. However, other Standard banks and Sparebanken Møre, the country's only F-IRB bank, will see a greater negative effect and will in fact have a median capital level 0.9pp lower than required. We note, however, that

Standard banks will have three years to build their capital, since the systemic risk buffer will be increased by 0.5pp annually.

However, Sparebanken Møre might have to add capital and/or cancel dividends to fulfil all buffer requirements from 2020 as the bank, in line with the A-IRB banks, will have to meet the entire 1.5pp increase by the end of 2019. The bank might not have sufficient capital to cover the P2G requirement from 2020, but we expect it to have time to build the capital necessary to meet this softer requirement. See Appendix 1 for our calculations of the net capital effect for individual banks.

The FSA could reduce the Pillar 2 capital requirement for individual banks if the proposed regulations make it prudent to do so. On average, the Standard banks (excluding the Samspar banks) will face a 2.5pp higher requirement (all buffer increases minus the effect of the SME discount) while the average Pillar 2 requirement in our selection of banks is 2.3%. This would satisfy the FSA's objective of maintaining banks' capital levels after implementation of CRR/CRD IV. The FSA is, however, somewhat hawkish on capital requirements, and if it wants to level the playing field, it could instead choose to increase capital levels at A-IRB banks by imposing risk-weight floors for exposures secured by mortgages on commercial properties, in anticipation of higher requirements following implementation of Basel IV.

Figure 6. Excess capital as of Q2 2019 given new capital requirements, removal of the Basel I floor and implementation of the SME discount



Source: NCR, company data

From 2021 or 2022, it is likely that Norway will implement an extended SME discount (SME II), which means that the discount will include loans up to EUR2.5m against EUR1.5m under the current proposal. This will, broadly speaking, double the effect of the SME discount (from an average 0.5pp for Standard banks and 0.2pp for A-IRB banks) and mitigate some of the effect of the higher systemic risk buffer.

LIKELY EFFECT OF NEW REGULATIONS ON COMPETITIVE POSITION AND LENDING MARGINS

We predict several effects of the proposed regulations, of which number 1 and 2 below assume that the FSA will not reduce Pillar 2 requirements or in other ways level the playing field for the different groups of banks.

1) A competitive disadvantage for smaller banks using the Standard method due to higher capital requirements.
2) A better capitalised banking sector, particularly for smaller banks which arguably have higher default risk.
3) More comparable capital ratios between Norwegian and other Nordic/mainland European banks. See our report *Nordic banks' capital measures lack comparability*, 20 Sep. 2018.

   https://nordiccreditrating.com/article/nordic-banks-capital-measures-lack-comparability
4) Banks will switch focus from retail mortgage customers to SME customers. See our report *Norwegian banks' SME discount likely to be financed by mortgage customers*, 28 Jan. 2019.

   https://nordiccreditrating.com/article/norwegian-banks-sme-discount-likely-be-financed-mortgage-customers

The combination of higher buffer requirements, the removal of the Basel I floor and the implementation of the SME discount will on average lead to higher capital requirements for all categories of bank. If we assume that the banks will operate with zero excess capital above the P2G requirement, median A-IRB banks could reduce their capital by 0.5pp, the Samspar banks by 1.2pp and other Standard banks will have an unmet capital requirement of 0.9% (including P2G). Due to differences in risk weights and capital requirements, a Standard bank will under the current regime have to take about 20bps higher margin than an A-IRB bank on a mortgage loan. Under the new regime, the difference will increase to over 30bps. Note that the SME discount is not helping the mortgage customers. This implies a weaker competitive position for these, mostly smaller, banks. Note, however, that this group also contains some relatively large banks such as Sbanken, Sparebanken Møre and Sparebanken Sør.

We expect that foreign banks operating in Norway will have to meet the increased systemic risk buffer requirement for their Norwegian operations and thus the new proposal will not lead to an increased disadvantage for Norwegian banks.

New legislation on governance and capital requirements and increased costs related to IT and product development create an increasing burden, which is particularly heavy for the smaller banks. So far, alliances have enabled the savings bank sector to survive through cost sharing, but increased capital requirements must be met by individual banks. This could increase the pace of currently slow restructuring in the sector. This is not a stated objective for the financial authorities, but we believe they would be unlikely to take steps to prevent it.

EFFECT OF NEW CAPITAL REGULATIONS ON RATINGS

Reported CET1 ratios are likely to increase by 2.1pp for IRB banks, 1.8pp for Samspar banks and 0.5pp for other Standard banks. Capital requirements will increase as well, but we believe that only banks with negative excess capital in Appendix 1 are likely to increase their underlying capitalisation. In terms of our credit ratings, a 1pp increase in capitalisation would generate about one notch of uplift in the capital subfactor, which accounts for 17.5% of our total indicative credit assessment, see Figure 11. However, increased capitalisation due to changes in risk weights which are not reflecting lower actual risk will not qualify for rating uplift. See our financial institutions rating methodology (https://nordiccreditrating.com/governance/methodologies) for more details.

Figure 1. Capital scoring initial scoring guidelines*

SUBFACTORS	aa	a	bbb	bb	b
Capital ratios	Capitalisation and flexibility are exceptional in comparison with 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 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 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 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 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 REA calculations.

Appendix 1

%	CURRENT CET1 REQ.	NEW CET1 REQ.	CURRENT CET 1	NEW CET 1	CURRENT EXCESS CAPITAL	NEW EXCESS CAPITAL
A-IRB Banks						
DNB	15.5	17.8	16.5	17.5	1.0	-0.3
BN Bank	14.5	17.5	17.7	21.7	3.2	4.2
SR-Bank	13.7	16.7	14.4	16.4	0.7	-0.3
SpareBank 1 SMN	13.9	16.9	15.0	17.4	1.1	0.5
SpareBank 1 SNN	13.5	16.5	15.3	17.2	1.8	0.7
SpareBank 1 Østlandet	13.8	16.8	16.7	17.7	2.9	0.9
Sparebanken Vest	13.7	16.7	14.7	17.0	1.0	0.3
Median IRB banks	**13.8**	**16.8**	**15.3**	**17.4**	**1.1**	**0.5**
Samspar banks						
SpareBank 1 BV	13.9	16.9	16.6	18.3	2.7	1.4
SpareBank 1 Østfold Akershus	13.7	16.7	16.2	18.0	2.5	1.3
SpareBank 1 NordVest	14.4	17.4	15.1	16.3	0.7	-1.1
Sparebanken Telemark	14.2	17.2	16.5	18.4	2.3	1.2
SpareBank 1 Ringerike Hadeland	13.7	16.7	17.4	19.2	3.7	2.5
SpareBank 1 Søre Sunnmøre	15.1	18.1	16.1	17.3	1.0	-0.8
Sparebank 1 Modum	14.5	17.5	17.3	18.5	2.8	1.0
Median Samspar banks	**14.2**	**17.2**	**16.5**	**18.3**	**2.5**	**1.2**
Standard/F-IRB banks						
Sparebanken Møre	13.7	16.7	15.1	15.7	1.4	-1.0
Sparebanken Sør	14.0	17.0	15.0	15.4	1.0	-1.6
Sparebanken Sogn og Fjordane	13.9	16.9	15.3	15.6	1.4	-1.3
Sparebanken Øst	14.3	17.3	16.7	17.1	2.4	-0.2
Helgeland Sparebank	14.2	17.2	15.2	15.8	1.0	-1.4
Sandnes Sparebank	14.5	17.5	16.6	16.9	2.1	-0.6
Fana Sparebank	14.5	17.5	17.3	17.9	2.8	0.4
Jæren Sparebank	14.2	17.2	16.7	17.2	2.5	0.0
Totens Sparebank	13.6	16.6	15.2	15.7	1.6	-0.9
Haugesund Sparebank	13.6	16.6	15.9	16.4	2.3	-0.2
Aurskog Sparebank	13.6	16.6	15.2	15.7	1.6	-0.9
Skue Sparebank	14.7	17.7	15.5	16.0	0.8	-1.7
Skagerrak Sparebank	15.5	18.5	16.2	16.7	0.7	-1.8
Orkla Sparebank	14.3	17.3	16.4	16.9	2.1	-0.4
Spareskillingsbanken	14.3	17.3	20.6	21.1	6.3	3.8
Skudenes & Aakra Sparebank	14.4	17.4	16.8	17.5	2.4	0.1
Høland og Setskog Sparebank	15.4	18.4	16.0	16.5	0.6	-1.9
Sogn Sparebank	15.0	18.0	21.4	21.9	6.4	3.9
Melhus Sparebank	15.3	18.3	16.2	16.7	0.9	-1.6
Sbanken	13.5	16.5	14.9	14.9	1.4	-1.6
Median standard/F-IRB banks	**14.3**	**17.3**	**16.1**	**16.6**	**1.6**	**-0.9**

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