Nordic Credit Rating

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Tailwind expected for Norwegian banks in the fourth quarter of 2019

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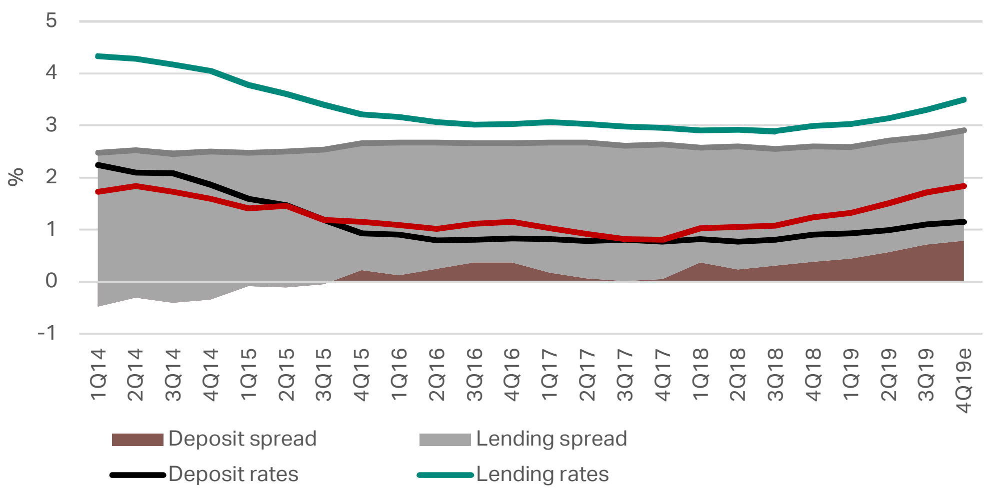
Nordic Credit Rating (NCR) expects that Norwegian banks will on average report a strong fourth quarter in 2019, driven by higher lending and deposit margins and strong performance in the financial markets. *Solid foundations for Norwegian banks* also lead us to believe that loan losses will remain moderate in the short term.

STRONG IMPROVEMENT IN INTEREST MARGINS

We expect that the total interest spread will have increased by 7 bps from the previous quarter and by 31 bps from the fourth quarter of 2018, to 2.91%. The expected quarter-on-quarter increase will likely have been driven equally by higher lending and deposit spreads. More than half of the effect of an increase in lending rates, announced in September 2019, will likely come in the fourth quarter. However, the banks have not announced a general increase in deposit rates and the spread increase from the previous year is likely to be entirely driven by a 36 bps increase in deposit spreads. Note that the Norwegian Interbank Offered Rate (NIBOR) is up by 60 bps year-on-year, which is not (yet) matched by an increase of about 50 bps in lending rates.

Given the assumption that short-term interest rates will level out, which currently seems to be the case, we expect that the lending spread will continue to increase in the first quarter of 2020, driving both total spread and net interest margin further upwards. Changes in 2020 will obviously depend on competition for loan and deposit customers. We believe that competition is likely to ease due to reduced competitive advantages for Nordic banks and continuing uncertainty about capital requirements for standard banks; increased non-systemic buffers might or might not lead to lower Pillar 2 requirements (see *Proposed changes in Norway's capital regulations likely to punish small banks*, 1 Oct. 2019). Uncertainty about the effect of new minimum requirements for own funds and eligible liabilities on funding costs could also make banks less aggressive in terms of pricing.

Figure1. Lending and deposit rates and spreads (relative to 3-month NIBOR)

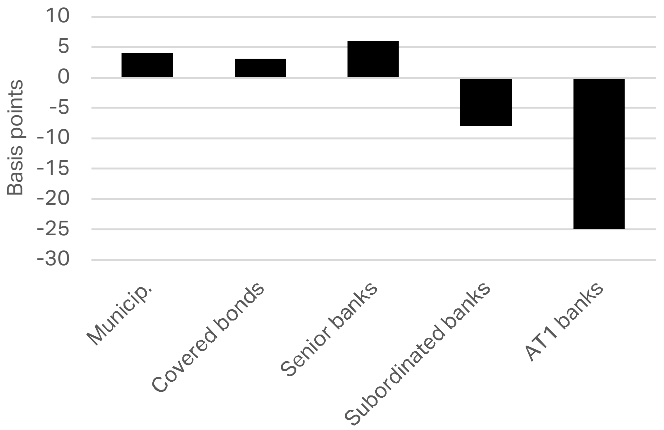


Based on data from Statistics Norway and NCR.

FINANCIAL MARKETS LIKELY TO REWARD HIGH RISK APPETITE

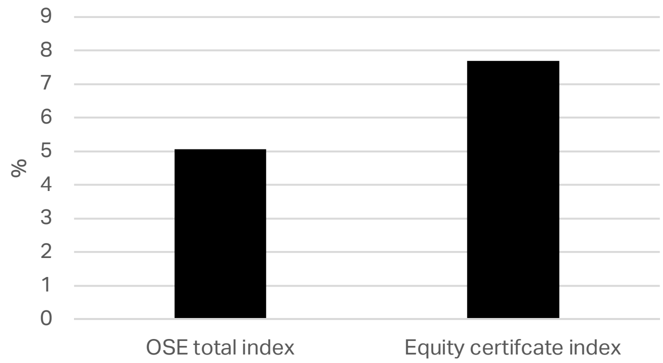
We expect that banks with particularly high risk appetite in terms of their financial portfolios will report strong net financials in the fourth quarter of 2019 due to strong stock market returns and lower spreads in the high yield bond market. Bank-owned insurance companies are also likely to benefit from strong financial returns and relatively low property and casualty claims due to mild winter conditions (so far) in Norway.

Figure 2. Spread changes in 3Y bonds (financials) in Q4/19



Source: DNB Credit Weekly

Figure 3. The Norwegian stock market in Q4/19

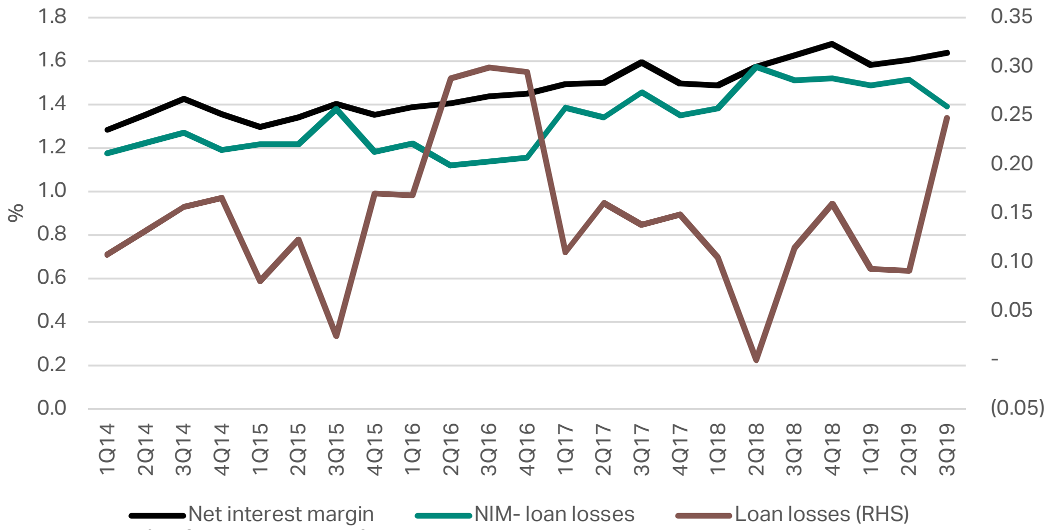


Source: Oslo Børs

LOAN LOSSES EXPECTED TO BE MODERATE

Loan losses tend on average to be higher in the fourth quarter than any other. However, the third quarter of 2019 was impacted by NOK 1bn in loan losses related to DNB's exposure to Thomas Cook, which accounted for 30% of Norwegian banks' loan losses in the quarter. Accordingly, we expect loan losses to fall in the fourth quarter. DnB reported large reversals within the oil, gas and offshore sector in the third quarter but continuing weakness in this sector could lead to more loan losses in 2020/21.

Figure 4. Net interest margin and loan losses (annualised, as a % of avg. total assets)

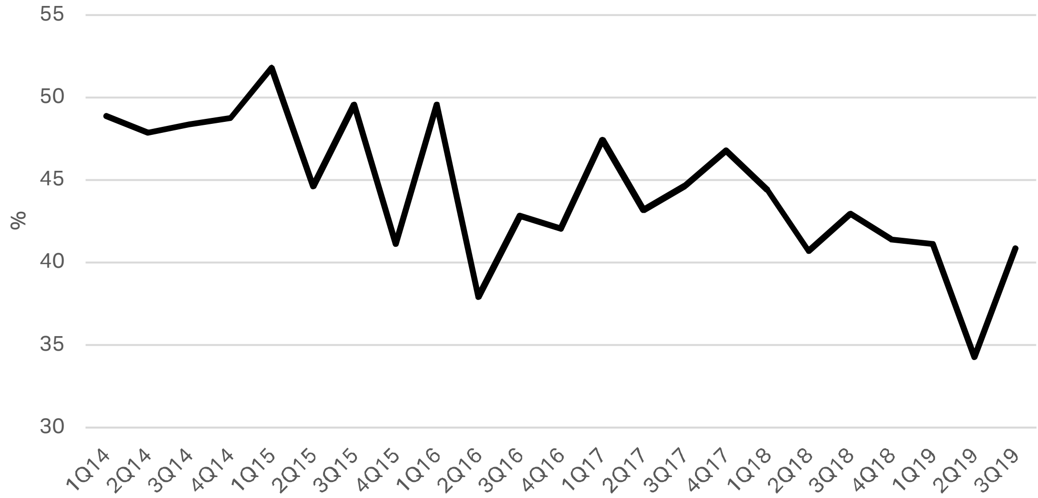


Based on data from Statistics Norway and NCR

STONG COST EFFICIENCY

The cost/income ratio for Norwegian banks has been trending downwards for several years and is approaching 40%. Historically, cost levels in the fourth quarter have been close to the average for the year.

Figure 5. Cost/income (excluding gains/losses on financial instruments)



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