Norwegian savings banks – A bank crisis scenario

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While most Norwegian banks appear well prepared to survive the impact of the Coronavirus crisis due to their strong profitability and capitalisation, some could be at risk of breaching their pillar 2 buffer requirements if loan losses reach the levels of 1991, the peak-year of the country's last major banking crisis. We set out to determine the likely exposure of Norway's savings banks if the current crisis compares with that of the early 1990s and found that among the more exposed banks are Sparebanken Sør, SR-Bank, Sparebanken Møre, SpareBank 1 SMN, Totens Sparebanken and SpareBank 1 Nordvest.

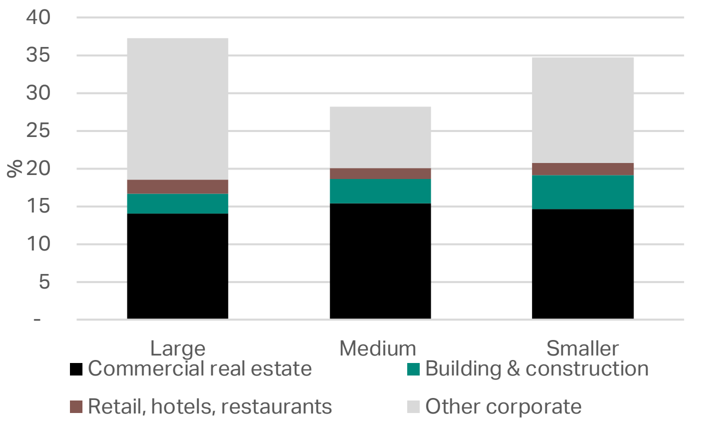
MORE THAN HALF OF SAVINGS BANKS' CORPORATE LOANS ARE TO HIGH-RISK SECTORS

We believe that the banking crisis of the early 1990s can give us some indication of which sectors are more at risk, even though we believe that the likelihood of a full-scale banking crisis now is reasonably low. The main reasons for this are the significantly lower interest rate levels of today compared with the double-digit interest rates of 30 years ago, a pro-active government supporting companies with significant reductions in revenues, higher levels of benefits for the unemployed, liquidity support programmes for banks and corporates, and significantly higher equity and liquidity requirements for banks. Nevertheless, Nordic Credit Rating (NCR) recently lowered its assessment of the Norwegian banking sector to 'a-' from 'a' due to the economic effects of the COVID-19 pandemic (see NCR sees increased risk for Norwegian banks, 3 Apr. 2020).

In this report we focus on the exposure of 24 savings banks - eight large, eight medium-sized and eight small - to high-risk sectors, their possible loan losses, and the likely effect on their capitalisation (figures 4-6).

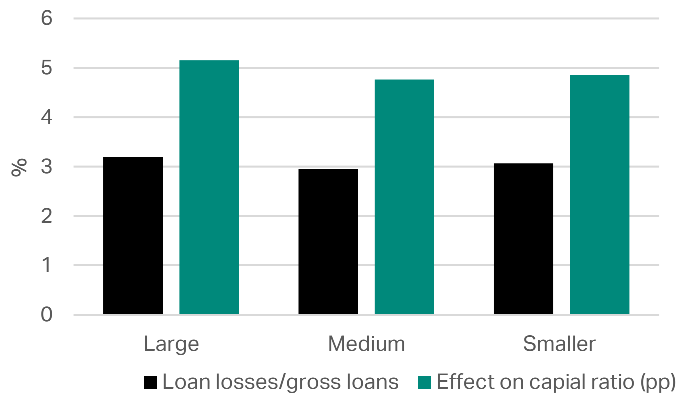
While savings banks are predominantly mortgage banks, the share of corporate loans within their lending is on average 33%. Of this, an average 44% consists of loans to commercial real estate, a sector we believe would pose a major risk in a protracted crisis. In the short-term, retail, hotel and restaurants have the highest risk, but lending to these sectors is relatively small at an average 5% of corporate loans. We have also included oil-related borrowers and building and construction among the high-risk sectors.

Figure 1. Corporate loan books of large, medium-sized and small savings banks, 2019



Based on company data

Figure 2. Loan loss scenario and effect on the capital ratios of large, medium-sized and smaller savings banks



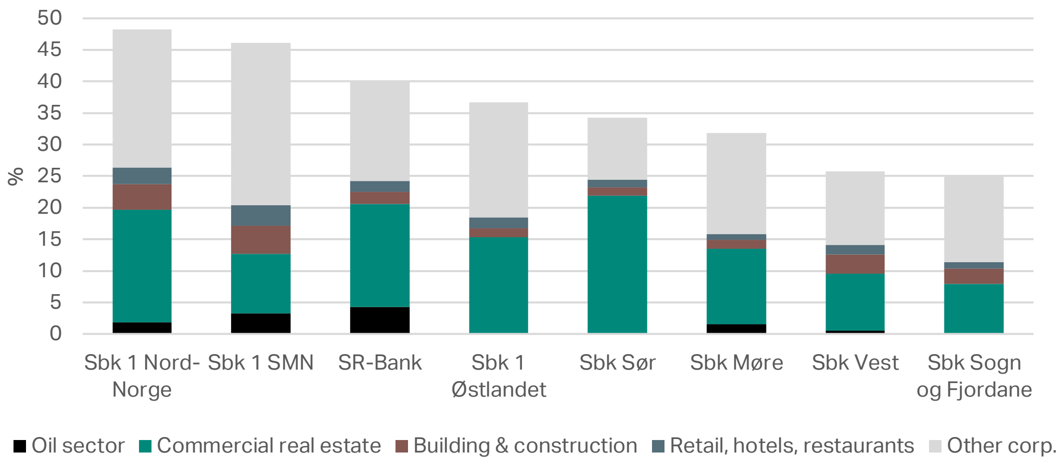
Based on company data

INDIVIDUAL BANKS' EXPOSURE TO CORPORATE LOANS AND HIGH-RISK SECTORS

While large savings banks have higher exposure to corporates (Figure 1), the exposure to high-risk sectors seems to be broadly similar among the diffferent size brackets. Note also that small banks, especially, tend to include loans to power utilities, which are low risk, together with building and construction lending. Another complicating factor in comparing indiviual banks is that banks in the SpareBank 1 alliance transfer significant parts of their mortgage loans to a jointly owned covered bond company. For the purpose of this report, we have included only loans on the balance sheet and have thus exluded transferred loans where the individual banks do not carry the credit risk.

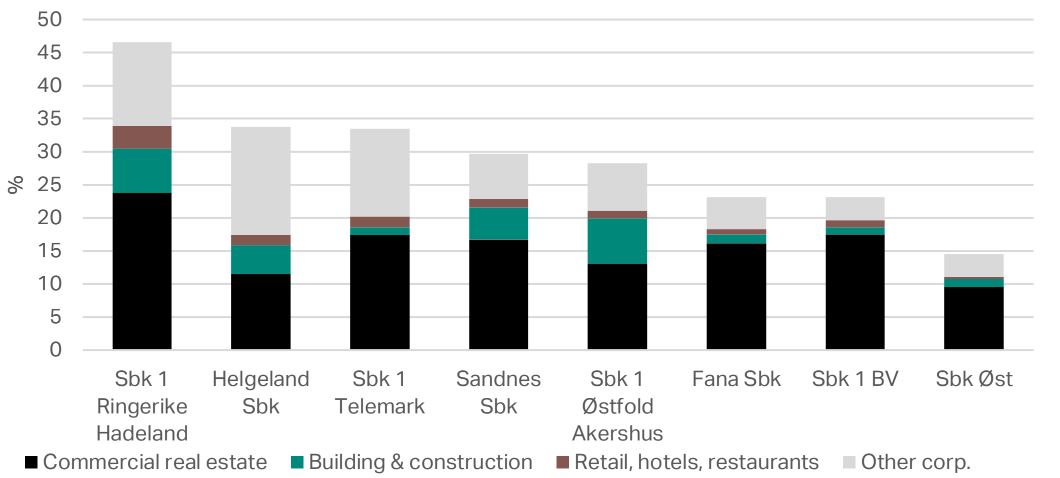
In figures 3-5, the banks are ranked by total corporate exposure. Among the large banks, where we also have included direct exposure to the oil sector, SpareBank 1 Nord-Norge has the highest share of corporate exposures. However, Sparebanken Sør has higher exposure to high-risk sectors, followed closesly by SR-Bank. Among medium-sized banks, SpareBank 1 Ringerike Hadeland stands out, partly due to the fact that 40% of its loans to private customers are transferred to the jointly owned covered bond company, while Sandnes Sparebank has the second highest share of exposures to high-risk sectors. Among the small banks, Totens Sparbank has the highest share of coprorate loans, but to a large extent these are agriculture loans with retail characteristics. We thus regard Haugesund Sparebank as having the highest risk in the corporate loan book among the small banks. Figure 6 illustrates that the picture would not change much if off balance sheet items (guarantees and undrawn credits) had been included.

Figure 3. Gross lending to selected sectors - large savings banks, 2019



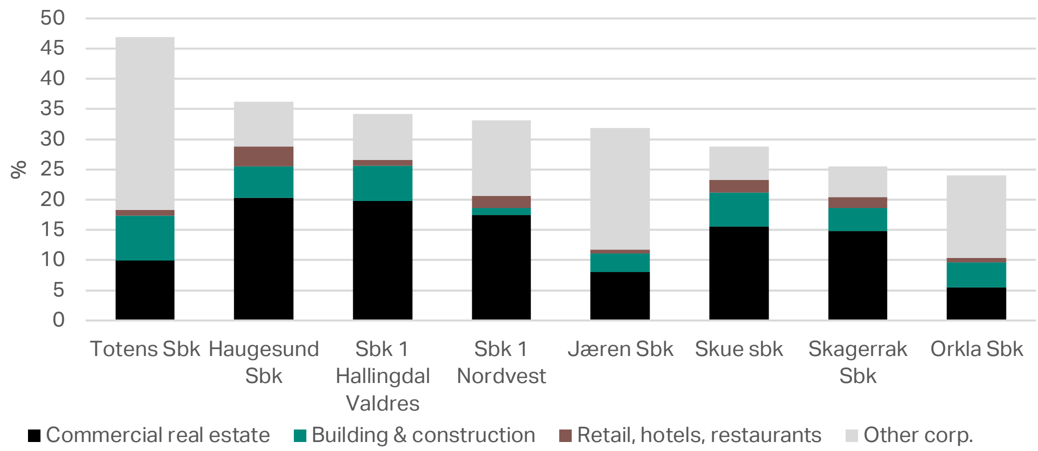
Based on company data

Figure 4. Gross lending to selected sectors – medium-sized savings banks, 2019



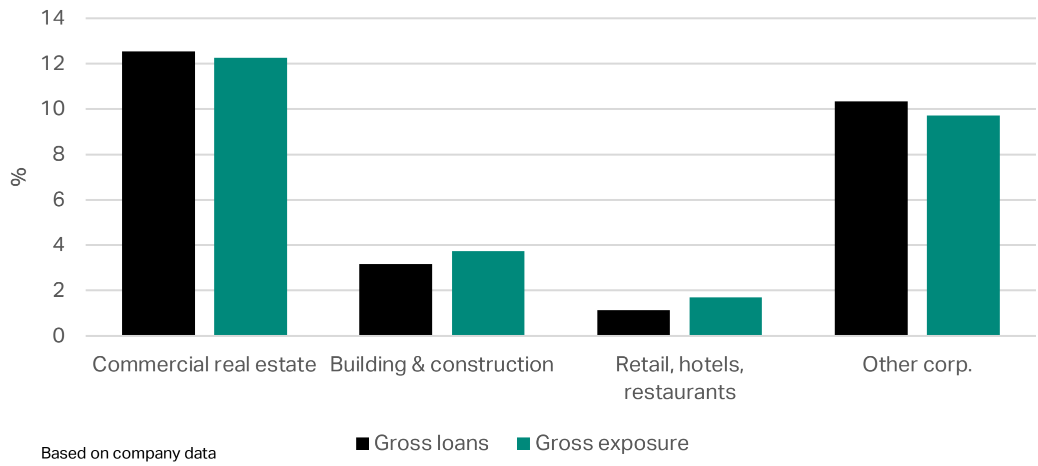
Based on company data

Figure 5. Gross lending to selected sectors - small savings banks, 2019



Based on company data

Figure 6. Gross lending and total exposure to selected sectors – all 24 savings banks, 2019



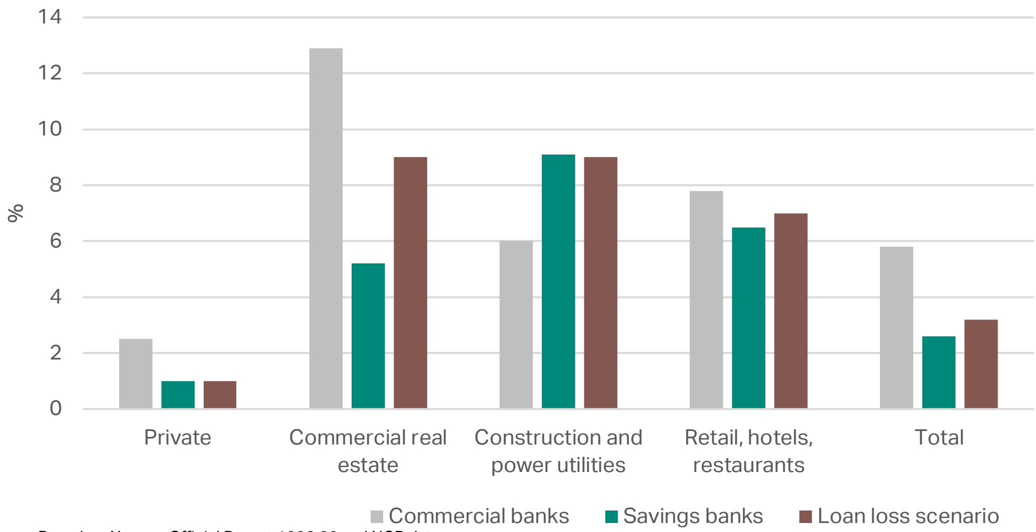
Based on company data

A BANK CRISIS SCENARIO AND THE LIKELY EFFECT ON CAPITALISATION

In the last major banking crisis in Norway, which peaked in 1991, savings banks incurred their heaviest losses on building and construction, which currently accounts for 11% of corporate loans. As illustrated in figure 7, in 1991, commercial banks had their heaviest loan losses on commercial real estate. Loan losses to private customers were, however, small, particularly for savings banks, at 1.0% of lending. We believe that higher losses on private customers for commercial banks at the time can be explained by a relatively high share of consumer lending.

We have drawn up a scenario for one-year loan loss risk based on the experience from 1991. Note, however, that a crisis of that magnitude would most likely last for several years; average annual loan losses for savings bank amounted to 2.35% of lending in the 1988-1991 period. Our crisis scenario assumptions are also illustrated in figure 7. The reasons why total losses are higher than average for savings banks in 1991 (3.2% vs 2.6%) are that we include 10% loan losses on exposure to the oil sector and assume higher loan losses on commercial real estate (we use the median of savings banks' and commercial banks' loan loss levels). We assume that loan losses for other corporate sectors are 5%.

Figure 7. Loan losses by sector 1991 and assumptions for a crisis scenario



Based on Norway Official Report 1992:30 and NCR data

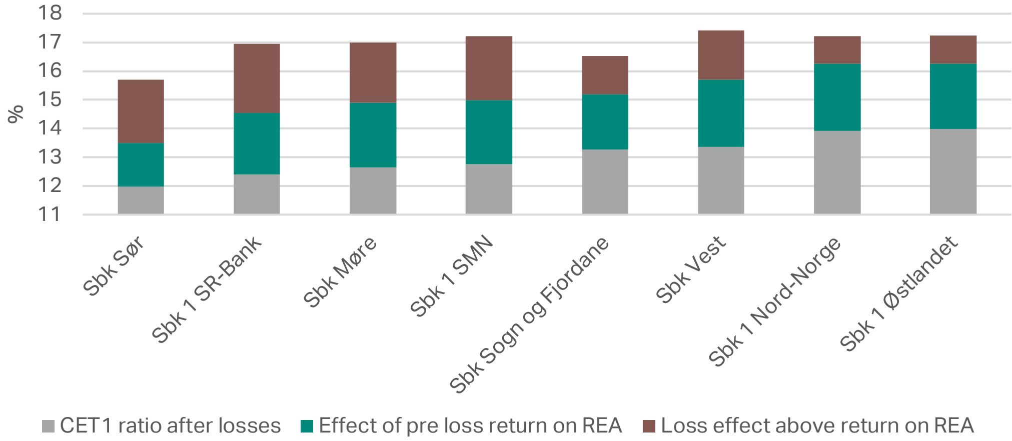
In figures 8-10 we illustrate the effect on common equity Tier 1(CET1) as at year-end 2019 on individual banks given the loan loss scenario discussed above and assuming that the effect of pre-loss results on risk exposure amounts (REA) is the same as in 2019, i.e. we do not adjust for extraordinary items and do not factor in an increase in REA. It is likely that pre-loss profit will be lower in 2020 due to lower extraordinary income and weaker net financial income. The current minimum requirement for these banks, excluding pillar 2 requirements but including the current countercyclical buffer of 1%, is 11%. CET1 levels above that would cover the pillar 2 requirement, management buffer, growth and dividends.

For example, Sparebanken Sør had a CET1 ratio of 15.7% at end-2019. Given a loan loss scenario of 3.3% of lending, the CET1 ratio would fall to 12%, which would mean that the bank would be unlikely to comply with its 2% pillar 2 requirement (see figures 11-13). However, including a pre-provision profit in REA of 2%, its CET1 ratio would be 13.5% and above the pillar 2 requirement. Among the large banks, SR-Bank, Sparebanken Møre and SpareBank 1 SMN would also have CET1 ratios below the combined pillar 1 and 2 requirement. These banks have pillar 2 requirements of respectively 1.7%, 1.7% and 1.9%.

None of the medium-sized savings banks appear to be at risk of breaching their pillar 2 requirements, given our bank crisis loan loss scenario, even before accounting for pre-provision profit. Among the small savings banks, however, Totens Sparebank and SpareBank 1 Nordvest would be unable to comply with their pillar 2 requirements of 1.6% and 2.4%, respectively, before accounting for pre-provision profit.

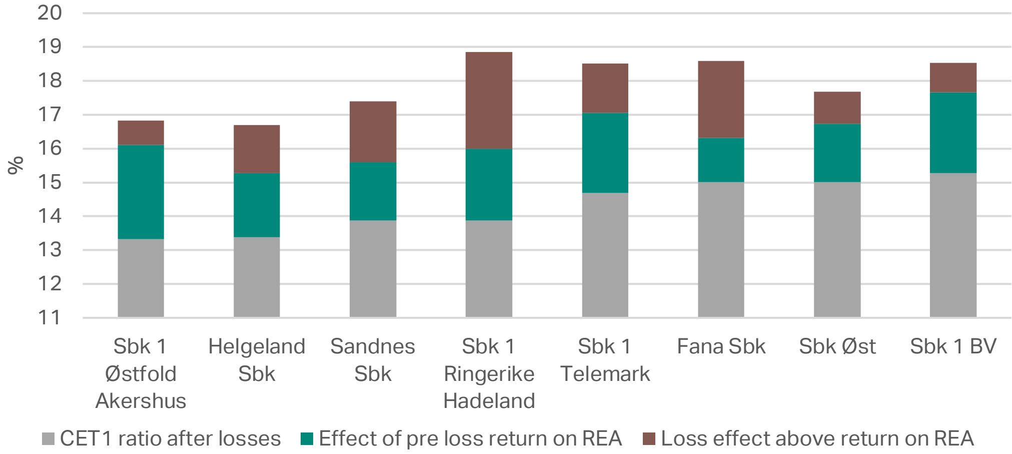
It is noteworthy, however, that if the countercyclical buffer is removed, which is likely in such a negative scenario, the banks would not be in breach of their pillar 2 requirements. The banks in our sample are generally well capitalized and at least two years with loan losses at these levels would be needed to create a full-blown bank crisis.

Figure 8. CET1 2019 and the effect of loan loss scenario and pre-provision profit equal to 2019 – large savings banks



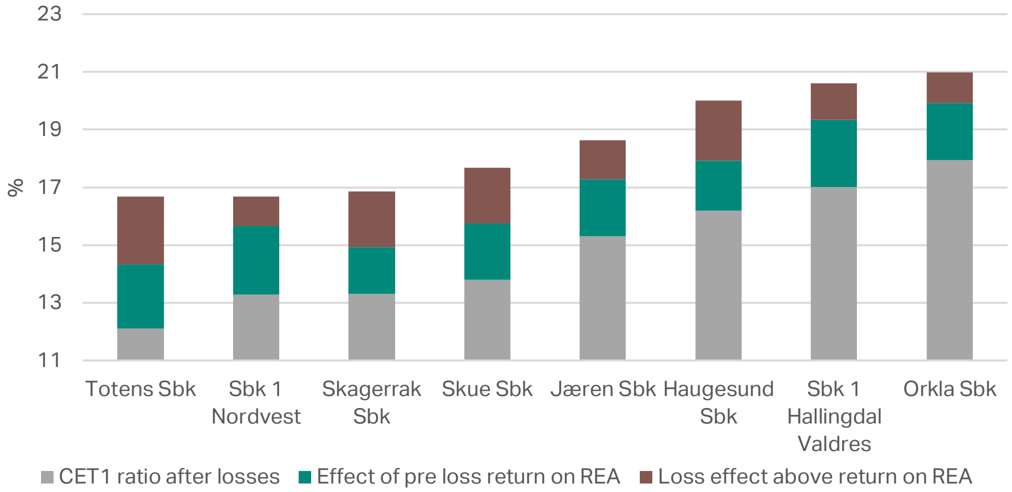
Based on NCR data

Figure 9. CET1 2019 and the effect of loan loss scenario and pre-provision profit equal to 2019 – medium-sized savings banks



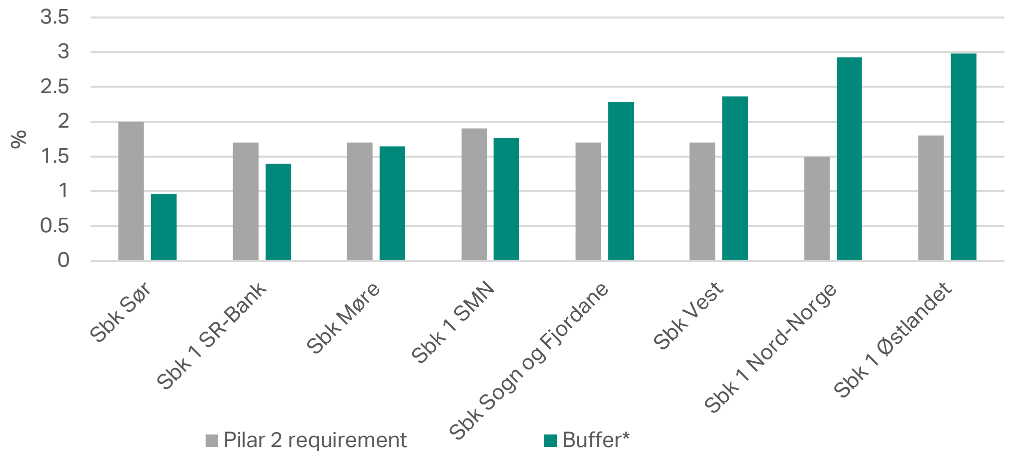
Based on NCR data

Figure 10. CET1 2019 and the effect of loan loss scenario and pre-provision profit equal to 2019 – small savings banks



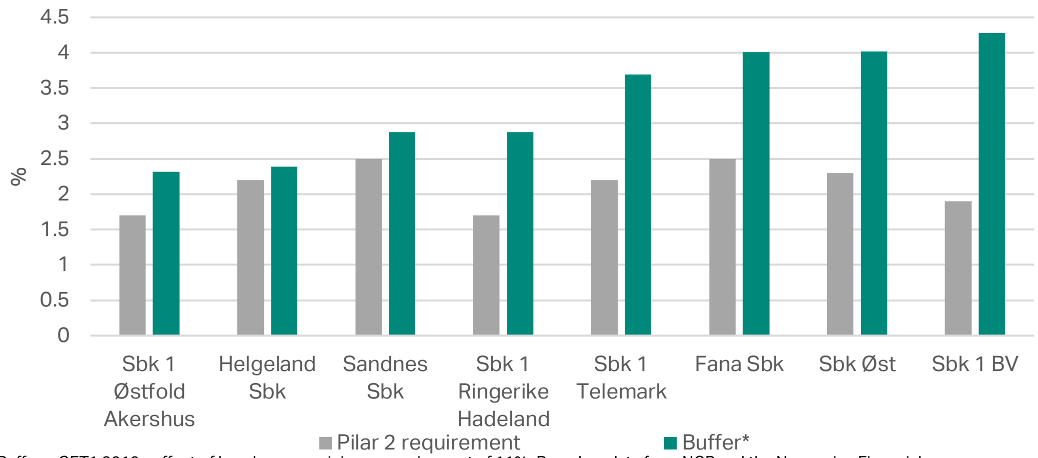
Based on NCR data

Figure 11. Pillar 2 requirement and buffer* - large savings banks



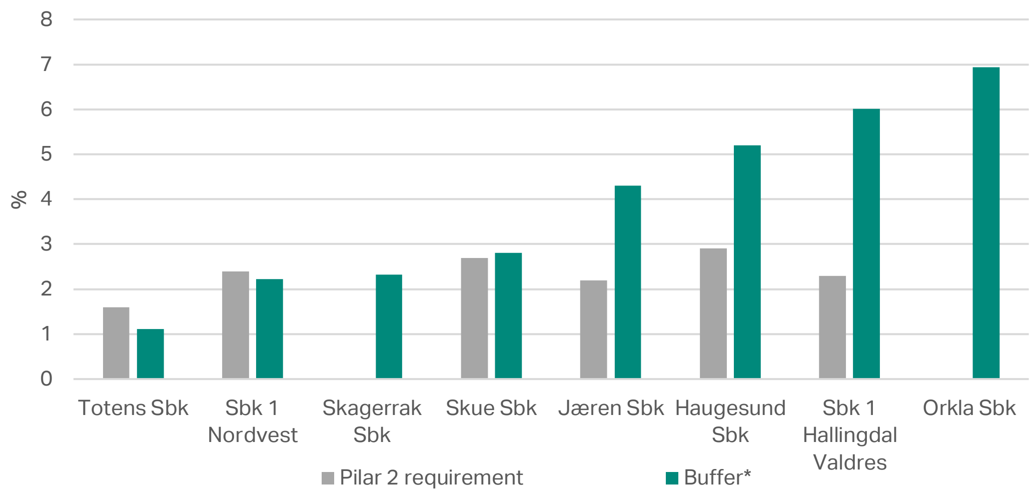
*Buffer = CET1 2019 - effect of loan losses - minimum requirement of 11%. Based on data from NCR and the Norwegian Financial Supervisory Authority

Figure 12. Pillar 2 requirement and buffer* - medium-sized savings banks



*Buffer = CET1 2019 - effect of loan losses - minimum requirement of 11%. Based on data from NCR and the Norwegian Financial Supervisory Authority

Figure 13. Pillar 2 requirement and buffer* - small savings banks



Buffer = CET1 2019 - effect of loan losses - minimum requirement of 11%. Based on data from NCR and the Norwegian Financial Supervisory Authority

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