Nordic Credit Rating

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Nordic niche banks face uncertain future for nonperforming loans

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UPDATE 2 Apr. 2020: For comparability, adjusted figures for Marginalen Bank have been added to the figures to reflect SEK 3.5bn in purchased non-performing debt portfolios reported as stage 3 loans.

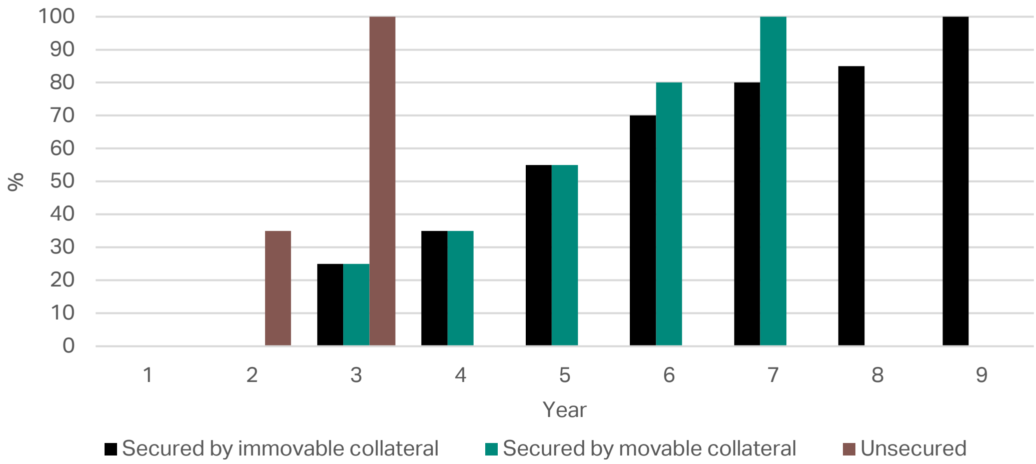
Given coordinated efforts by Nordic central banks and regulators, NCR believes that the COVID-19 crisis will be more about credit risk than a lack of liquidity, as was the case during the 2008-2009 financial crisis. See *Coordinated relief package supports bank creditworthiness*, 16 Mar. 2020. The significant increase in unemployment due to COVID-19 will most certainly lead to higher levels of non-performing loans (NPLs), despite available benefits for the unemployed. This will probably lead to capital constraints for banks, despite reduced counter-cyclical buffers, and lower lending capacity.

IFRS 9 HAS A PRO-CYCLICAL EFFECT ON LOAN LOSSES

IFRS 9 accounting regulations, implemented in 2018, require banks to make earlier recognition of loan losses on impaired loans. Under IFRS 9, loan loss provisioning has to be increased if there are material changes in circumstances (loans moved from Stage 1 to Stage 2) for individuals or groups of borrowers and, depending on collateral, when loans have been non-performing for more than 90 days (classified as Stage 3). The change in principles was a response to underreported loan loss provisions during the financial crisis. It is clear, though, that a significant increase in loan losses will have a pro-cyclical effect on credit as reserves are increased while banks are unable to provide new loans. However, consumer loans could act as a bridge during this period and support retail demand.

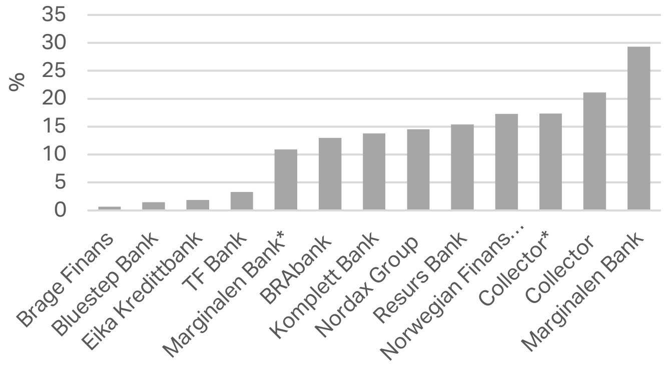
If the COVID-19 crisis is protracted and NPLs increase, we believe that regulators might have to postpone or reconsider the prudential backstop regulation in the EU's reform of capital requirements for banks' NPLs, which is set to take effect from 1 Jan. 2022. The backstop mandates that unsecuritised loans extended after April 2019 that have been non-performing for three years or more have to be written down in full (see Figure 1). We believe that banks' efforts to get ahead of this regulation by reducing NPL stocks have contributed to a sharp fall in NPL prices in the secondary market in recent months.

Figure1. Prudential NPL backstop - CET1 deductions as % of non-performing exposure



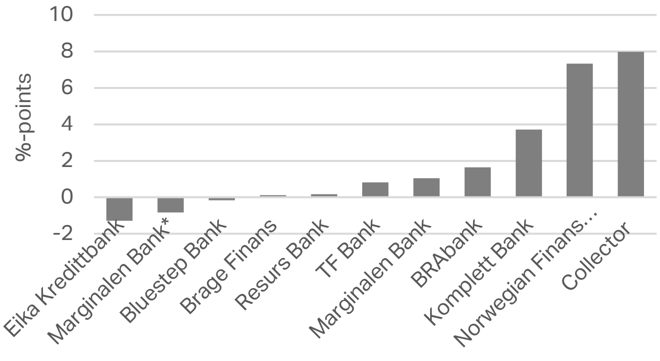
Source: European Council

Figure 2. Problem loans to gross loans, 2019



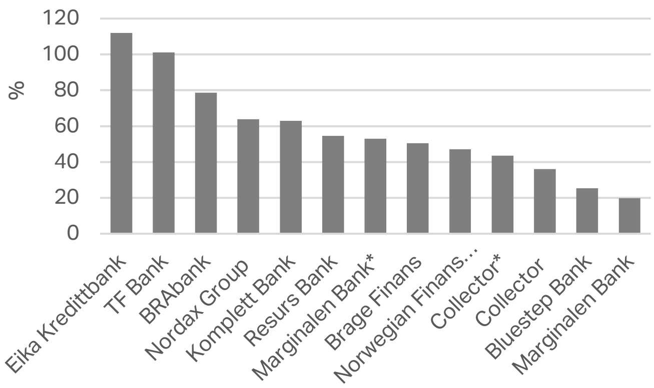
*Adjusted for acquired NPLs Based on company data

Figure 3. Change in problem loans to gross loans, 2019



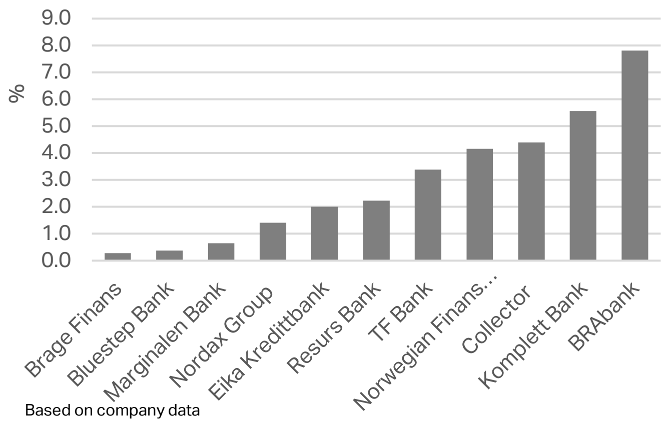
*Adjusted for acquired NPLs Based on company data

Figure 4. Loan loss reserves to problem loans, 2019



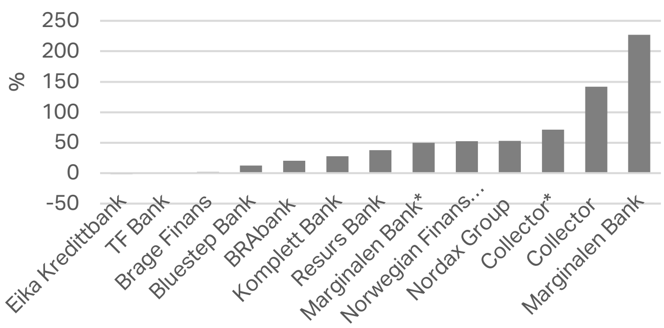
*Adjusted for acquired NPLs Based on company data

Figure 5. Loan losses to avg. net loans, 2019



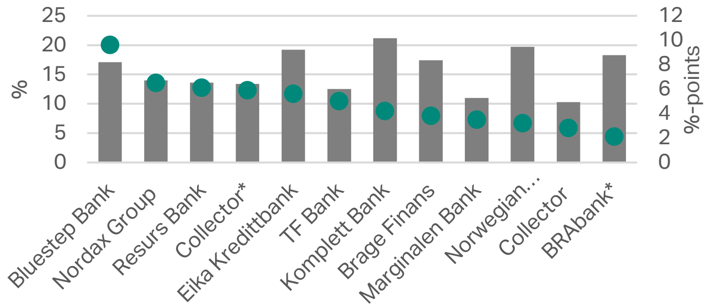
Based on company data

Figure 6. Problem loans, net of reserves, to equity, 2019



*Adjusted for acquired NPLs Based on company data

Figure 7. CET1 ratio and capital surplus, 2019**



*Adusted for acquired NPLs and equty issue March 2020. **Given 1% cc-buffer requirement in Norway, zero in Sweden and Finland. Based on company data

Regulators are using additional tools to cushion the impact of the current crisis on banks and individuals. For example, the Swedish FSA allowed borrowers to postpone mortgage repayments due to a fall in income associated with COVID-19, without banks having to classify the respective loans as non-performing. In fact, to incentivize banks to carry on lending it might be necessary for regulators to allow higher levels of NPLs or allow banks not to book COVID-19 related NPLS, at least for capital requirement purposes. The Norwegian Ministry of Finance could consider postponing an impending increase in the systemic buffer to 4.5% from 3% which is scheduled to take effect from end-2020 for banks using internal ratings based models.

SIGNIFICANT DIFFERENCES IN LOAN LOSS PROVISIONS BETWEEN NICHE BANKS

The reduced counter-cyclical buffers, to zero from 2.5% in Sweden and to 1% from 2.5% in Norway, might not be sufficient to avoid a fall in capital ratios below required levels for some banks. In addition, we note that the transition rules for the effect of IFRS 9 on CET1 capital do not apply to new NPLs.

Figures 2-4 illustrate that there are significant differences in loan loss provisioning between niche banks. Some of the difference can be explained by differences in business mix, e.g. lending for vehicles and equipment compared with unsecured consumer loans and credit cards. However, NCR believes that banks with high risk appetites are at risk of falling below capital thresholds as NPLs increase. This applies in particular to banks with high levels of net problem loans to equity and low capital surplus (see figures 6 and 7.)

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