Norwegian savings banks in a zero interest rate environment

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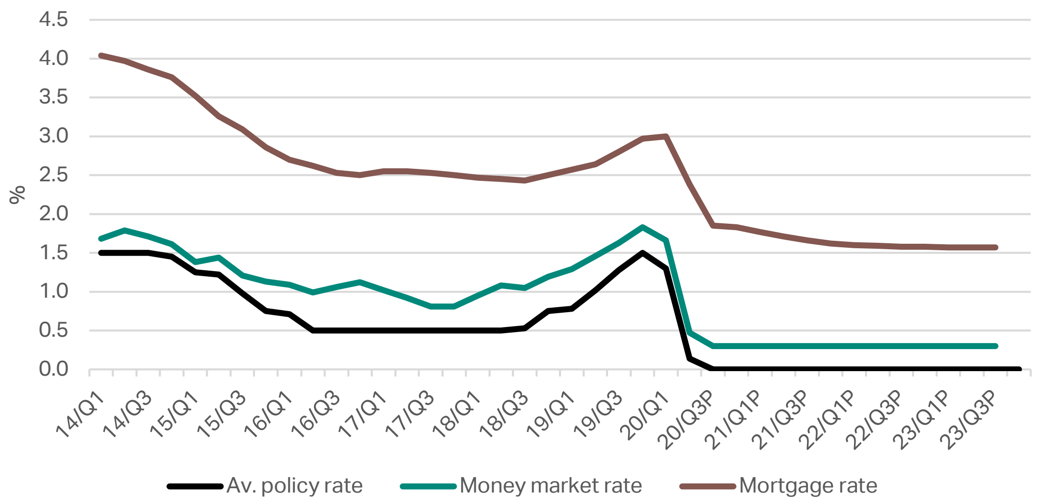
On 7 May 2020, the Norwegian central bank, Norges Bank, decided for the first time in its history to reduce its key policy rate to zero percent. Nordic Credit Rating (NCR) believes that this will have a negative impact on Norwegian banks' net interest margins due to lower deposit spreads and lower returns on liquidity and on interest-free funding; the latter is weighing particularly heavily on the country's highly capitalised banks. In our view, a representative Norwegian savings bank could take a hit of about 24% to net interest income (NII), due to the effect of lower short-term rates alone, with a similar impact on return on equity. However, we do not expect to see the full effect until 2021.

COVID-19 PANDEMIC TRIGGERS UNPRECENDENTED INTEREST RATE ACTION

Norges Bank expects the policy rate to stay at zero percent for the next three years. Economic activity is expected to pick up as measures to contain COVID-19 are eased, but it will likely take time for output and employment to return to the levels prevailing before the pandemic. Moreover, current levels of uncertainty are unusually high, and the central bank declined to provide its customary fan chart detailing its future thinking in its most recent Monetary policy update.

Figure 1. Norway short-term interest rates, projections for 2020-23

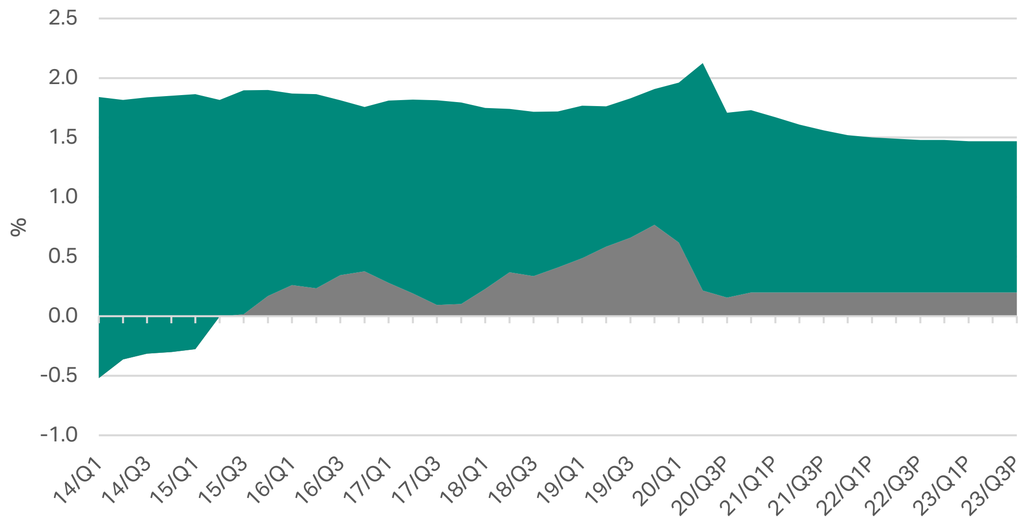


Source: Norges Bank

The future interest rate expectations cited in this note, including mortgage rates, are based on Norges Bank's projections, resulting in the spreads illustrated in Figure 2. Norwegian banks reacted quickly and cut their mortgage rates by 40 bps after the most recent 25-bp cut in the policy rate, and we believe that their customers have received about 80% of the wider 1.5-pp cut in the policy rate since the beginning of the year. Norges Bank appears to expect that competition will gradually squeeze out most of the remainder over the next couple of years.

We assume that deposit rates will not fall below 10bps on average. This is based on the experience of Sweden, where banks avoided cutting deposit rates below zero even in a sub-zero interest rate environment. Based on Norges Bank's projection, the three-month market rate will stabilise at 30bps, resulting in a deposit margin at 20bps (there is a downside risk, though, deposit margins were negative as late as 2015). This means the average deposit spread will fall by 152bps from a peak in the fourth quarter of 2019, which is not mitigated by a 13bps increase in lending spreads. Accordingly, Figure 2 illustrates a likely significant fall in combined spreads, particularly in the second and third quarters of 2020.

Figure 2. Norway mortgage and deposit spreads – turning downward again

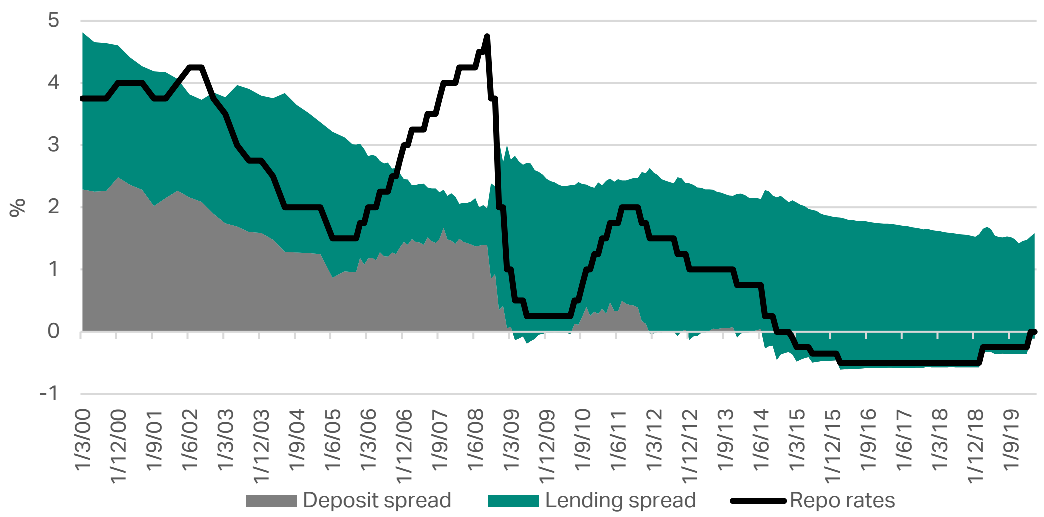


Based on Norges Bank and NCR data.

THE SWEDISH EXPERIENCE WITH SUB-ZERO POLICY RATES

The Swedish policy rate (the repo rate) was cut to zero in October 2014 and reduced further to minus 0.5% in February 2016. This initially led to an increase in total spreads since mortgage rates were kept relatively stable. However, when the Swedish central bank reduced the repo rate further, the country's banks were unable to counteract weaker deposit spreads, even though lending spreads had been remarkably stable through the sub-zero interest rate period. Please note that the spread in Figure 3 refers to the repo rate and not the market rate as in Figure 2.

Figure 3. Sweden - Repo rate and spreads



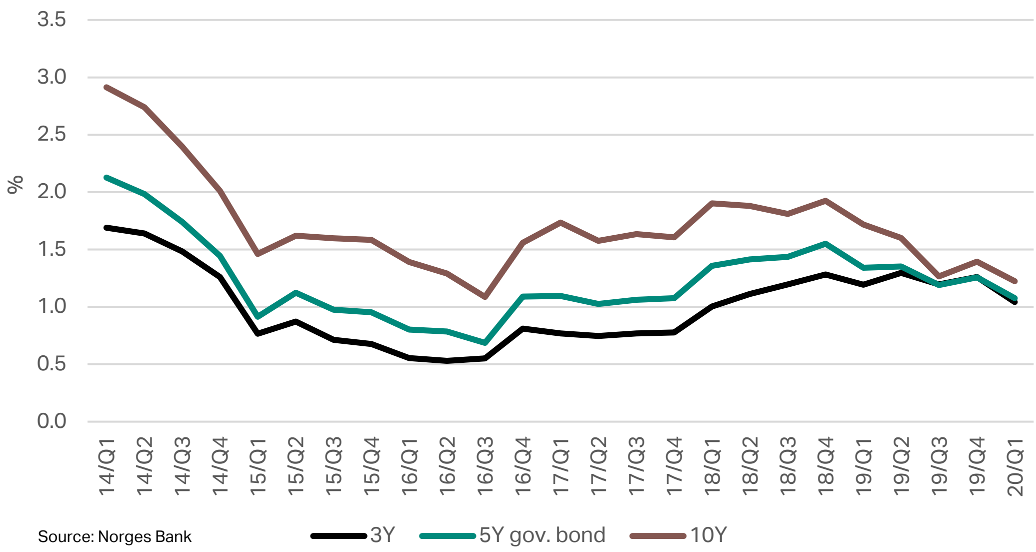
Source: Statistics Sweden, Riksbanken

We think it unlikely that Norges Bank will cut its policy rate below zero. In Working Paper 4/2019,) the central bank presented an empirical study of the Swedish experience and concluded that once policy rates turn negative, the usual transmission mechanism of implementing monetary policy through the bank sector breaks down. Moreover, because a negative policy rate reduces bank profits, the total effect on aggregate output can be contractionary. Norges Bank's data suggest that a policy rate of minus 0.50% increases borrowing rates by 15 bps, as a consequence of banks' efforts to protect profitability, and reduces output by 7 bps.

IN THE LONG RUN...

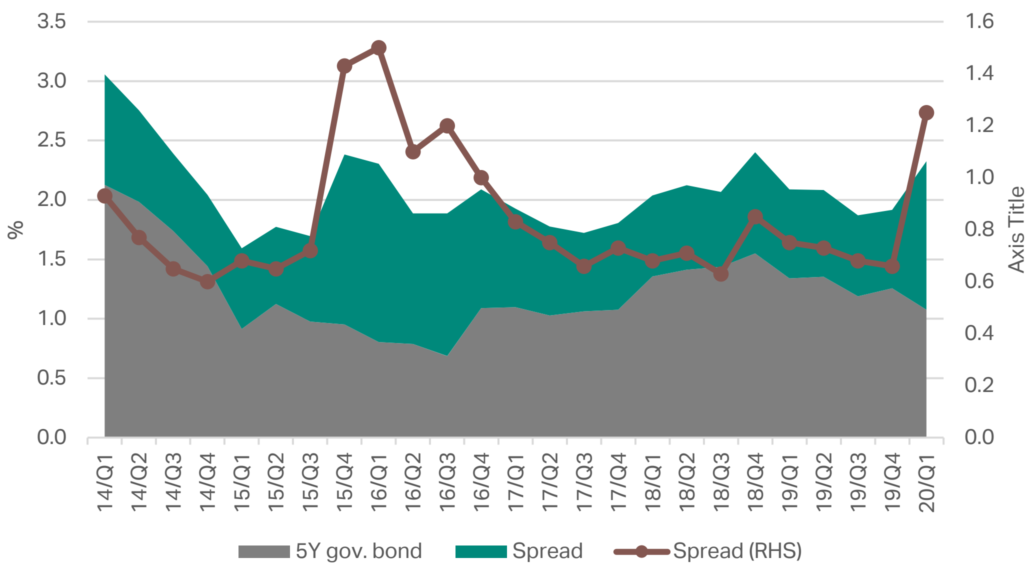
Long-term interest rates in Norway started to slide earlier than money market rates, and the 5-year government bond is down by about 30 bps from the second quarter of 2019. On the other hand, the average spread for a 5-year senior bank bond is up by 52 bps. Even though the spread is likely to come down, it will take time to reprice the banks' long-term funding costs and the effect is uncertain. Accordingly, we do not take changes in long-term funding costs into account in the following scenario.

Figure 4. Norway long-term interest rates



Source: Norges Bank

Figure 5. Average long-term funding costs for Norwegian banks

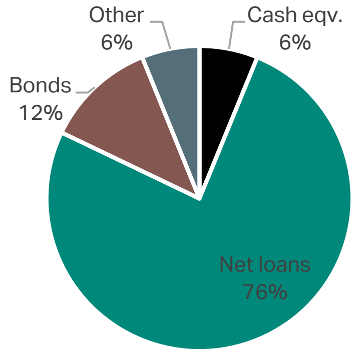


Source: Norges Bank, NCR

EFFECT OF LOW SHORT-TERM INTEREST RATES ON NET INTEREST MARGIN

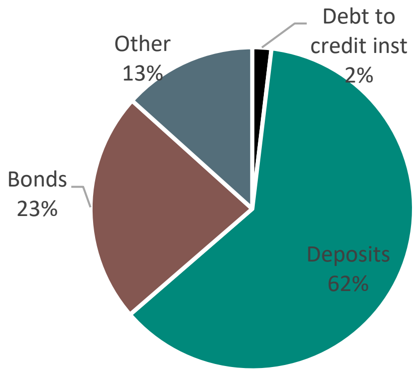
Due to the high proportion of private savings entrusted to institutional investors via mutual funds and pension assets, Norwegian banks rely on the bond market as well as deposits to fund their operations. The average loan-to-deposit ratio for savings banks was 123% in 2018. Bond funding is mostly long-term while deposits are mostly short-term. In this note, we are focusing on the effect of lower short-term rates, and we assume for simplicity's sake that all deposits and loans are short term.

Figure 6. Norwegian savings banks' assets, 2018



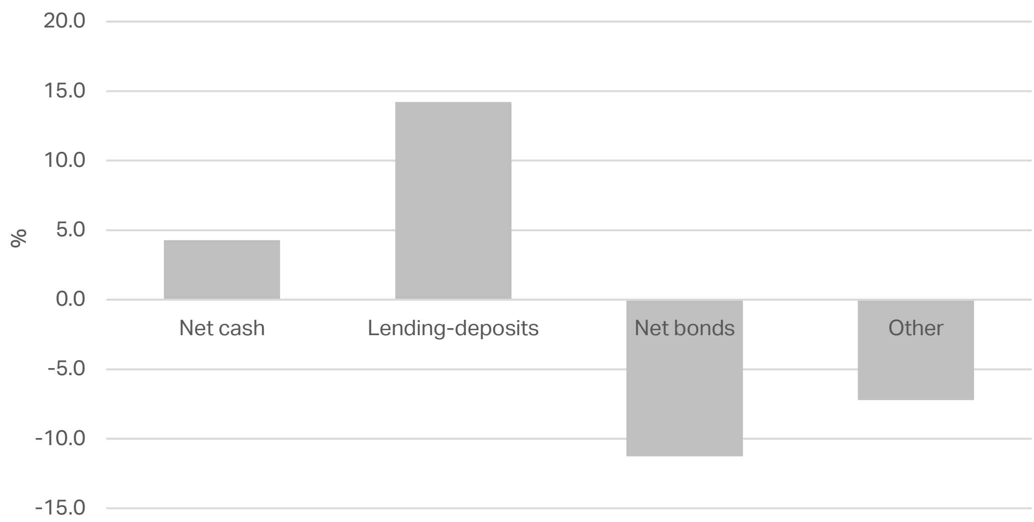
Source: Finance Norway

Figure 7. Norwegian savings banks' funding, 2018



Source: Finance Norway

Figure 8. Norwegian savings banks' net assets and funding, 2018



Source: Finance Norway, NCR

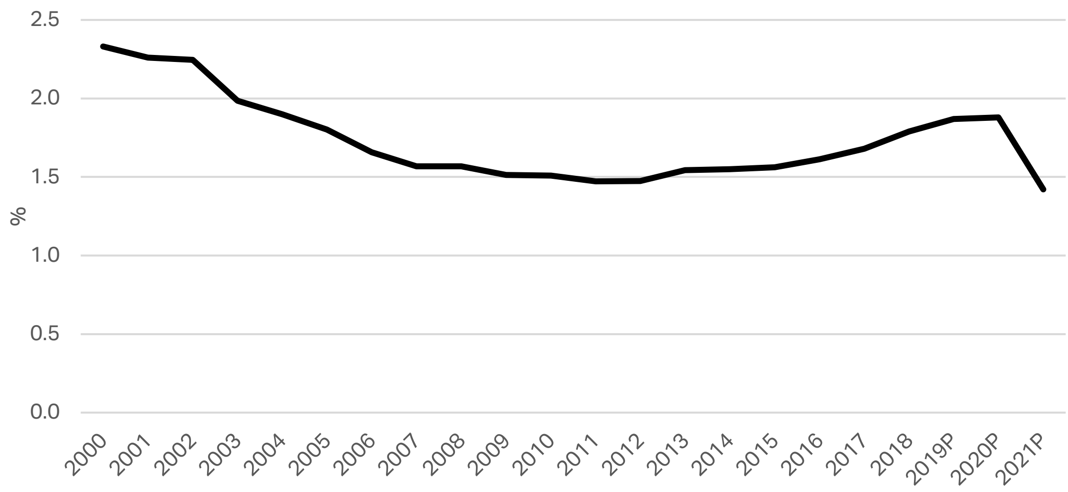
In Figure 9, we consider a savings bank with a fairly representative balance sheet to illustrate the effect of the interest rate scenario presented in Figures 1 and 2. We use a projection of interest rates and margins for 2021 and assume all else being equal, including lending volumes. We see that even if interest expenses were to fall by 60% from 2019 to 2021, mainly due to lower interest on deposits, interest income would fall by 36%, mainly due to lower interest on lending. Total NII in this scenario would fall by 24%. Moreover, had we assumed long-term interest rates 1pp lower, affecting income on commercial paper and bonds and interest on debt securities issued, the effect on NII would still be minus 24%.

This would also bring the net interest margin down by 45bps to 1.42% (see Figure 10), and lower return on equity by 20-30% at the highly capitalised Norwegian savings banks. If this effect were to come on top of increased loan losses it could have a dramatic impact on the country's banking sector, see Norwegian savings banks – A bank crisis scenario, 28 April, 2020. The European Central Bank has argued that the impact of negative interest rates on profitability is broadly neutral when credit losses in particular are considered, see Negative rates and the transmission of monetary policy, 13 May 2020. However, we do not necessarily agree that this holds true in a lock-down situation in economies with low loan losses to start with. Moreover, Norges Bank came to a different conclusion based on Nordic data in the study cited above.

Figure 9. Estimated effect on net interest income in a representative savings bank

	Avg. Interest Rate (%)		Income		
NOKm	2019	2021	2019	2021	Change (%)
Interest on amounts due from credit institutions	1.55	0.30	84	16	-81
Interest on loans to customers	2.75	1.69	2,346	1,444	-38
Interest on commercial paper and bonds			265	265	0
Total interest income			2,695	1,726	-36
Interest on amounts due to credit institutions	1.55	0.30	35	7	-81
Interest on deposits from customers	0.93	0.10	584	63	-89
Interest on debt securities issued			236	236	0
Other interest expenses			63	63	0
Total interest expenses			918	368	-60
Net interest income			1,777	1,357	-24

Figure 10. Norwegian Banks' net interest margin and projections for 2020-2021



Based on Norges Bank and NCR data.

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