

## Swedish savings banks prepared for uncertain future

### ANALYSTS

Sean Cotten  
+46735600337  
sean.cotten@nordiccreditrating.com

Geir Kristiansen  
+4790784593  
geir.kristiansen@nordiccreditrating.com

For many Swedish savings banks, 2019 resulted in peak operating profits driven by low funding costs, strong financial gains after a dip in late-2018, growing balance sheets, and strong dividend payments in respect of their holdings in Swedbank AB (Swedbank). The strong results outweighed the negative impact of changes in commission fees for insurance and reduced margins for commercial real estate loans transferred to Swedbank. In addition, there was a material decline in the market value of banks' holdings in Swedbank, although this had only a marginal effect on savings banks' capital and earnings.

Looking ahead to the remainder of 2020, savings banks face challenges with falling asset quality as a result of the ongoing response to the COVID-19 pandemic. As evidence, we note that of the six savings banks which have publicly reported according to IFRS9 for the first quarter of 2020, two reported material increases in their non-performing loans (NPLs) levels and we expect higher losses and earnings pressure for all Swedish savings banks.

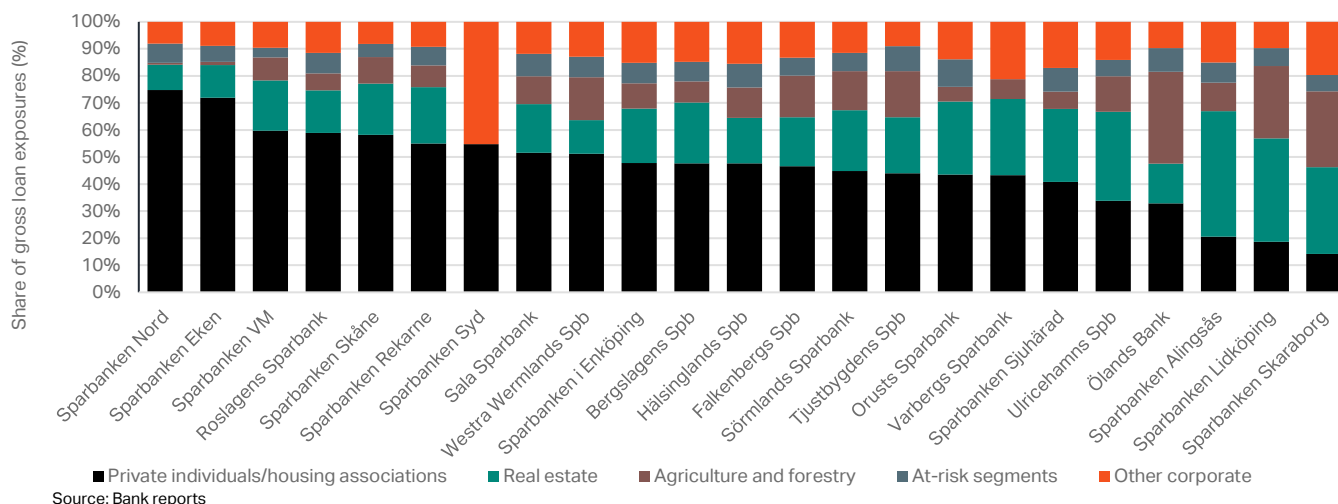
In April, Nordic Credit Rating (NCR) adjusted downwards its view on the Swedish banking sector to reflect expectations of slower growth and higher unemployment. In addition, NCR revised the outlooks on its public ratings on two Swedish savings banks – Sparbanken Rekarne and Sparbanken Västra Mälardalen (Sparbanken VM) – to negative. This reflects the uncertain future facing both banks and their savings bank peers on many fronts, which could further affect our view of the operating environment for banks in Sweden, and negatively impact their earnings and longer-term loss performance. In a severe economic downturn, loss reserves could even put pressure on banks' capital positions, collateral coverage, and other aspects of their operations.

In this analysis, NCR compares 24 Swedish savings banks and considers the banks' earnings, capital, asset quality and exposures as well as their interlinkages with Swedbank. All but one, Sparbanken Syd, have strong cooperation with Swedbank which permeates nearly all facets of their business.

### SAVINGS BANKS' ASSET QUALITY IS SUPPORTED BY COLLATERALISED LENDING

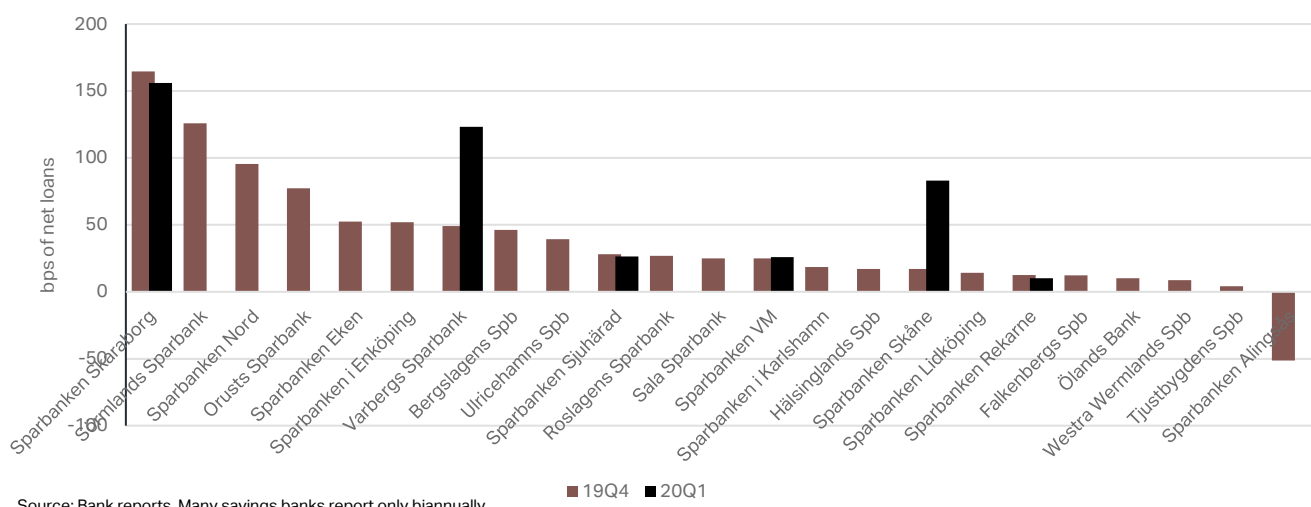
Swedish savings banks' exposures are heavily associated with property lending to individuals, corporations, and the farming and forestry sectors. On average, 50% of loans are to private individuals or housing associations, 22% to commercial real estate, and 10% to forestry and agricultural lending. The banks have relatively modest exposures to at-risk segments, with about 6% of exposures to construction, retail, hotels and restaurants, though not all banks report complete segment details.

Figure 1. Savings banks' lending exposures by sector, 2019



The strong and growing economy and low interest rates have supported strong asset quality for most Swedish banks in recent years, however, the response to COVID-19 is having material consequences on specific regions and sectors which can have a heavy impact on individual banks. On average, savings banks reported only 2bps in loan loss provisions in 2019 and 5bps in 2018. As of end-2019, net NPLs (reflecting IFRS9 stage 3 loans net of reserves) across the sample stood at 37bps, down from 43bps a year earlier. These levels are in line with an 'aa' or 'a' level loss performance under our criteria. However, of the six banks which have publicly reported according to IFRS9 for the first quarter of 2020, two have had material increases in their levels of NPLs. Varbergs Sparbank's net NPLs increased to 123bps from 49bps three months earlier and Sparbanken Skåne's reported net NPLs increased to 83bps from 17bps. We acknowledge that these NPLs could be associated with just a few customers, but we expect that loss levels for the entire year are likely to be higher across the board if the economy is unable to rebound in the third quarter.

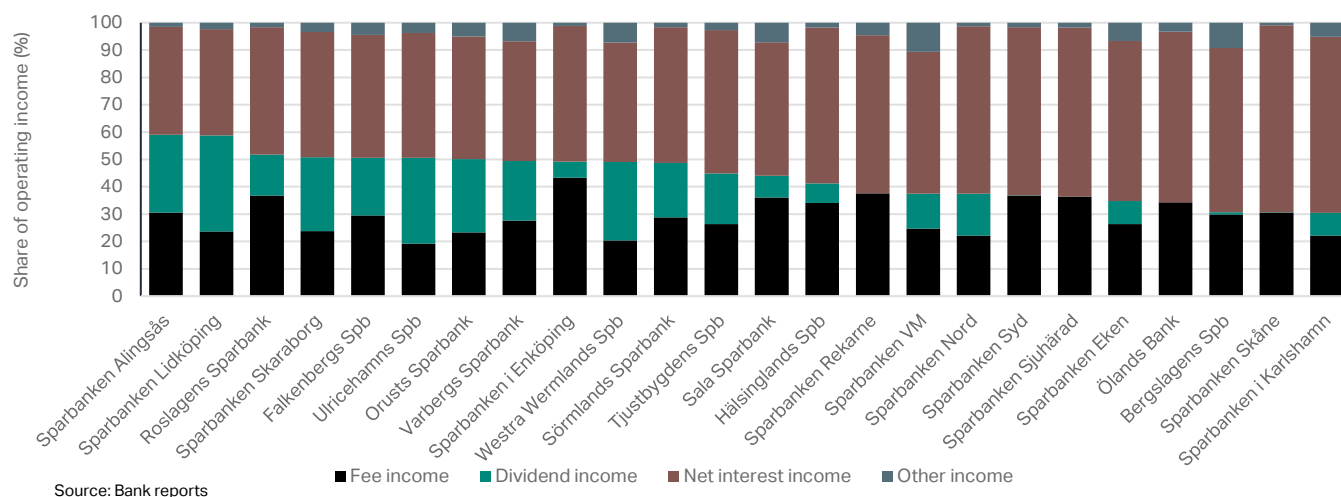
Figure 2. Savings banks' net stage 3 loans as a share of total lending, 2019Q4 and 2020Q1(where reported)



### SAVINGS BANKS EARNINGS REFLECT INTERLINKAGES WITH SWEDBANK

Savings banks' earnings are in large part affected by the share of business volumes transferred to Swedbank as well as the size of each bank's investments in Swedbank shares. Sparbanken Syd is the only bank in the sample without commission or dividend income associated with Swedbank. It has transferred over SEK 10bn in mortgage loans to SBAB and over SEK 10bn in customer savings to external providers.

Figure 3. Savings banks' operating income by source, 2019



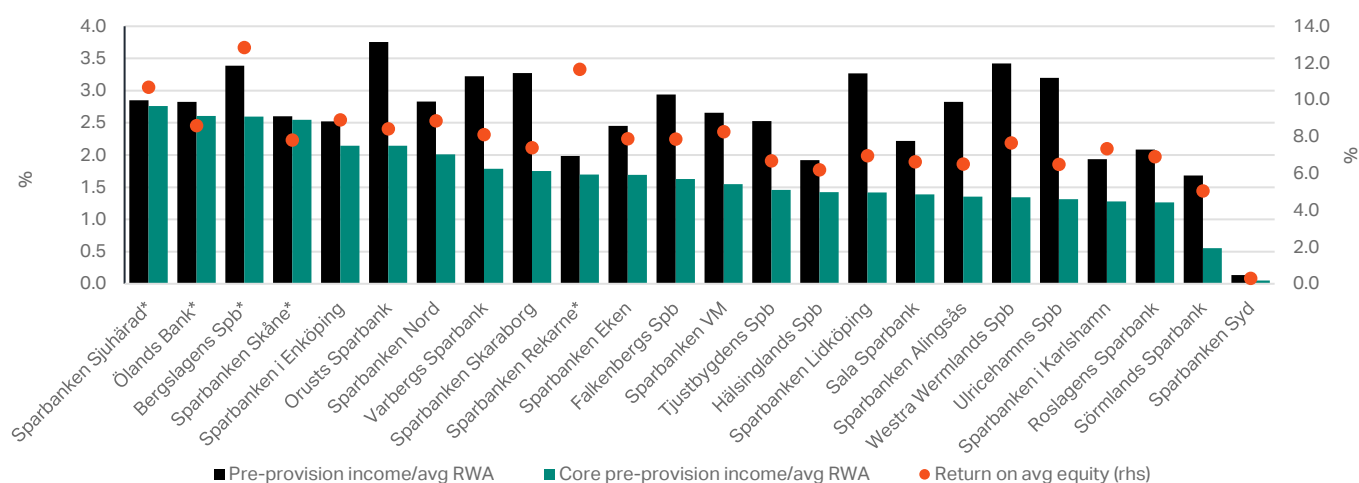
Most Swedish savings bank revenues are earned from traditional banking products, associated fees and loans, and savings transferred to Swedbank. In 2019, their weighted average net interest margin was 1.92%, which is well below historic averages given currently low interest rates and pressure on deposit margins. In addition, the banks have been negatively affected by changes in Swedbank's insurance commission structure and reduced margins on commercial real estate loans transferred to Swedbank. However, many have improved their bottom lines by increasing the share of loans on their own balance sheets and as a result of increased ownership and a 9% increase in Swedbank's dividend in 2019.

The possibility that Swedbank might cancel or lower its dividend for 2019 could have a material impact on some savings banks' earnings. Swedbank has paid out 75% of its net profit over the past seven years, including SEK 14.2 per share in the first quarter of 2019 after revelations about money laundering became public. One of Swedbank's peers, SEB, has cancelled its dividend for 2019 and there is continued pressure from the Swedish regulator for banks to be prudent when considering dividend payments in the current economic climate. While Swedbank has not decided, we believe it likely that Swedbank will cancel or reduce its dividend further than the previously announced reduction to 50% of net profit. Of the 24 savings banks covered in this survey, five are directly owned by Swedbank (Figure 10) and do not directly own Swedbank shares. Sparbanken Syd has no holdings in Swedbank and Bergslagens Sparbank has only a very small holding.

Sweden's savings banks' have good earnings metrics but have not historically been among the elite earners in the Nordic region given relatively low leverage and less efficient operations and economies of scale than the country's larger banks. NCR's analysis of savings banks' earnings considers core lending and fee revenues, given the volatility of trading revenues and, as is the case in 2020, the lack of control over Swedbank's dividend decisions, despite the high aggregate ownership by the savings banks and related foundations. In addition, we consider comparability of risk weighted assets given the use of internal ratings-based (IRB) models by some savings banks, though we have not made adjustments for this in this commentary. According to our key risk-adjusted earnings metric, pre-provision income to risk weighted assets, the 24 savings banks generated 1.8% of core pre-provision capital during 2019 and 2.6% when trading, dividend and other income were considered. The banks' return on average equity for 2019 was 7.6%, with all five banks using IRB models reporting over 10% and having a lower share of equity to assets than the overall peer group.

By our criteria, these levels are in line with a 'a' to 'bbb' earnings assessment, which also considers a bank's cost efficiency and revenue stability. However, we expect earnings prospects to fall somewhat during 2020, in part due to higher funding costs, higher NPLs, and lower transaction volumes.

Figure 4. Savings banks' risk-adjusted earnings and return on equity, 2019



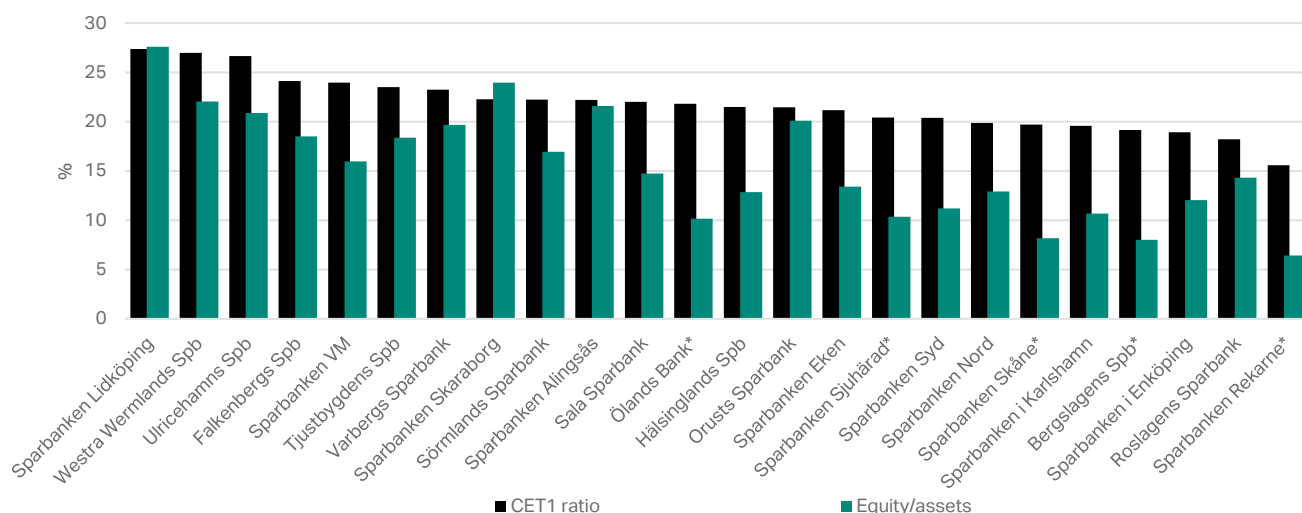
Source: Bank reports. RWA-risk-weighted assets. \*Uses IRB models in capital calculations. Core pre-provision income considers only net interest income and fee & commission income.

## SAVINGS BANKS' CAPITAL RATIOS REMAIN STRONG DESPITE STRONG LENDING GROWTH

Generally, Swedish savings banks maintain very high capital levels and low leverage. While the 30% fall in Swedbank's share price since the end of 2018 has directly affected equity levels and basic leverage ratios, it has had only a modest impact on savings banks' capital levels and regulatory leverage ratios because the banks deduct their respective Swedbank shareholdings exceeding 10% of their common equity Tier 1 (CET1) capital. Most savings banks report regulatory CET1 ratios in excess of 20%, even considering the deduction for Swedbank holdings. (For more information on the impact of Swedbank's share price on savings banks' capital ratios see [Q&A: Swedbank judgement and share price impacts on Swedish savings banks](#), 23 Mar. 2020).

As is typically the case, banks using IRB models in their capital calculations (see Figure 5) have lower leverage ratios than banks using standardised calculations. Notably banks directly owned by Swedbank and consolidated into Swedbank's own capital requirements use IRB models, as does Bergslagens Sparbank. The weighted average CET1 ratio for all 24 banks was 21.4% at end-2019, up from 21.0% at end-2018. By our criteria, these levels are just below the 22% we expect for a 'aa' capital assessment, which also considers hybrid capital instruments (rare among Swedish savings banks) and other forms of capital flexibility to avoid minimum regulatory requirements.

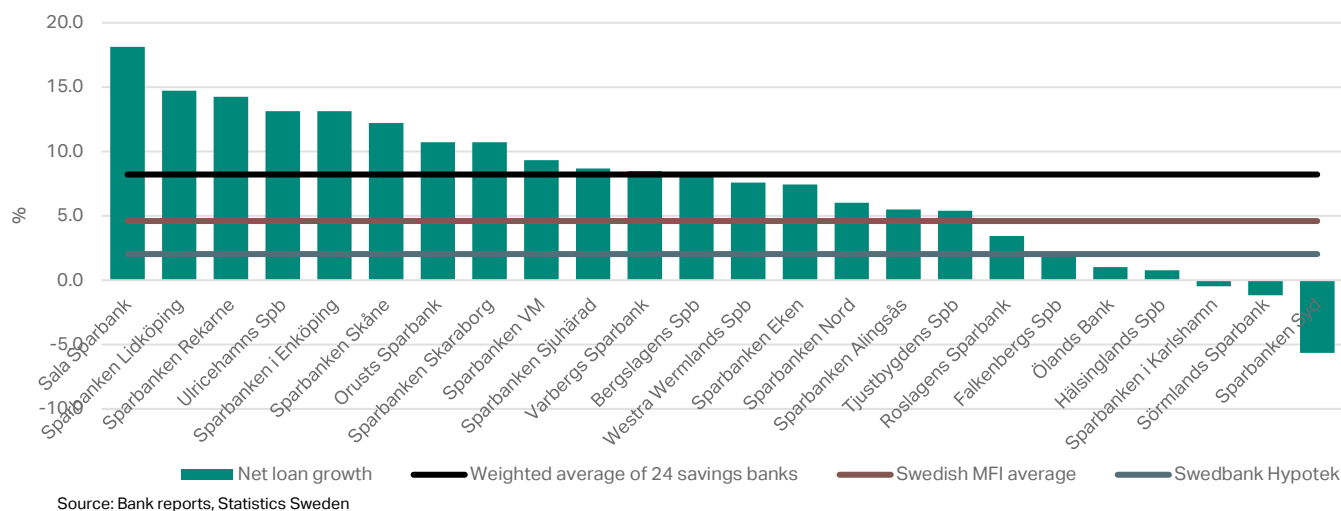
Figure 5. Savings banks' CET1 ratios and leverage ratios, end-2019



Source: Bank reports \*Uses IRB models in capital calculations.

Swedish savings banks' capital ratios have remained strong despite strong growth in their loan books. While they have historically financed their loan books with deposits and transferred mortgage loans to Swedbank Hypotek, low interest rates and improving access to the capital markets have led to an increase in lending by most of the banks in our sample. A good portion of the growth in the savings banks' loan books has come from refinancing loans previously transferred to Swedbank Hypotek. During 2019, the savings banks' loans grew by over 8%, which contributed to Swedbank Hypotek's loan book growing by only 2% in the same period, which was well below market-level growth. Sparbanken Skåne, the only Swedish savings bank that issues covered bonds, added nearly SEK 8bn in new lending during 2019. Sparbanken Rekarne increased its lending by SEK 1.5bn, financed in large part by SEK 1bn in new senior debt issuance.

**Figure 6. Savings banks' net lending growth compared with Swedbank Hypotek and all Swedish Monetary Financial Institutions (MFIs), 2019**

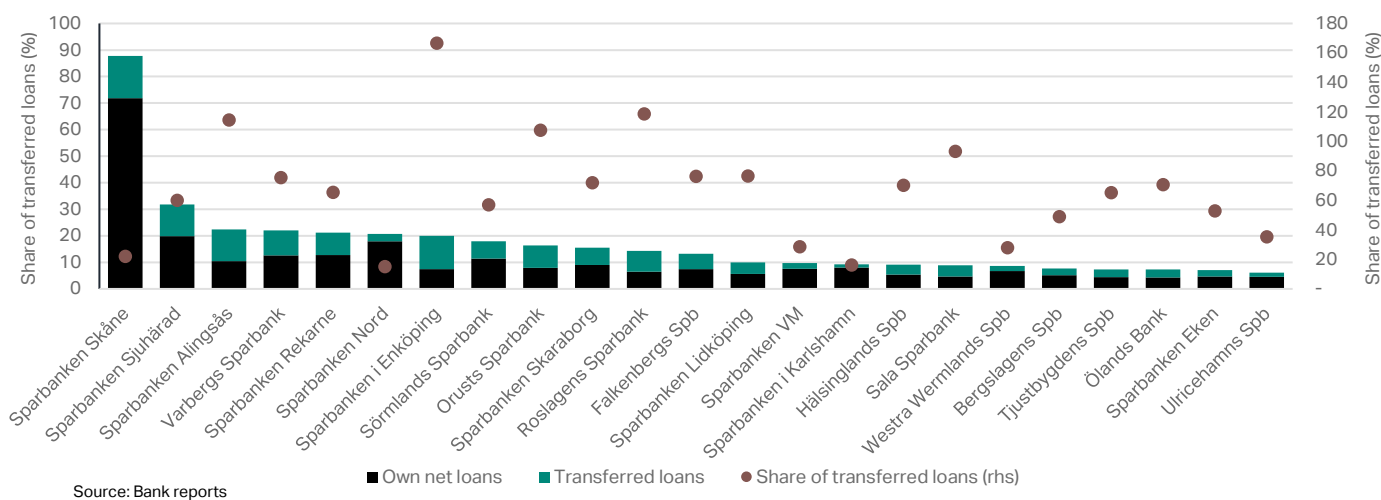


### SAVINGS BANKS' COOPERATION WITH SWEDBANK

Sweden's savings banks and Swedbank have a long history of cooperation dating back to 1942 and, largely in its current form, 1997. The relationship includes cross ownership, with Swedbank owning shares in some savings banks and most savings banks owning shares in Swedbank. Via Swedbank subsidiaries Swedbank Hypotek, Swedbank Finans, Swedbank Försäkring, and Swedbank Robur, Sweden's savings banks can provide a variety of products and services to their own customers. In addition, Swedbank is the clearing bank for the savings banks and there is cooperation on IT infrastructure, risk modelling, and financial reporting, providing economies of scale and cost efficiency benefits.

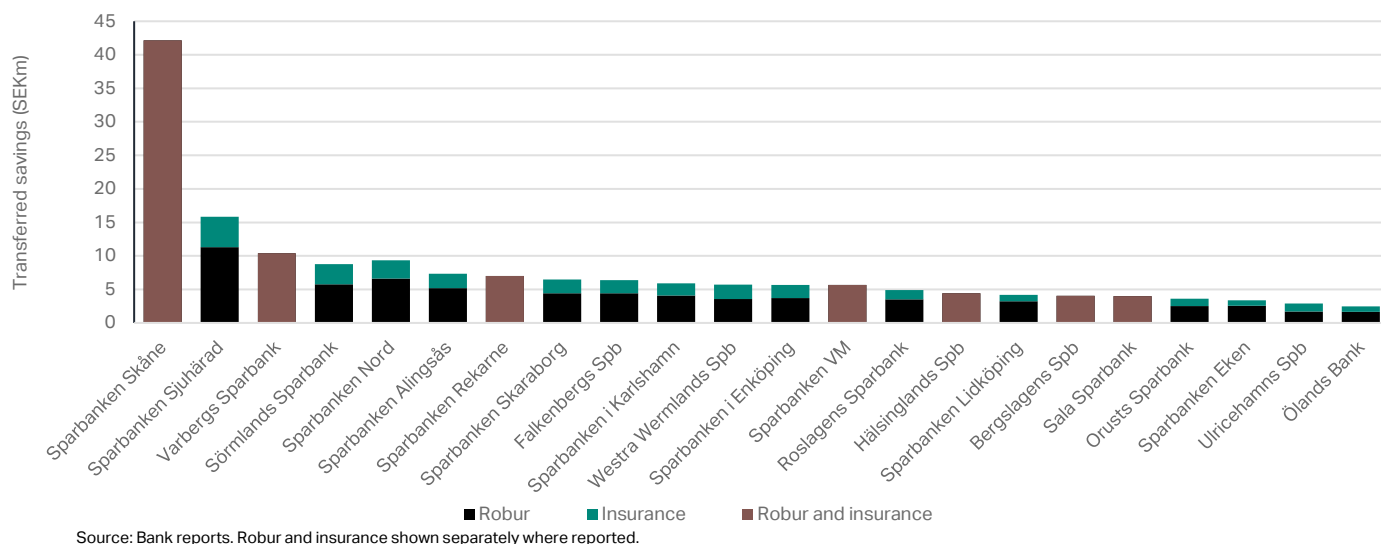
As of end-2019, Swedbank reported that savings banks accounted for 30% of its product sales in the Swedish market. The savings banks generally rely on Swedbank for funding of residential and commercial mortgages, but in recent years have used very liquid markets to increase their own balance sheets. In Figure 7 the savings banks are sorted by the size of their total loan books, including loans transferred to Swedbank. The weighted average of Swedbank financing for the 23 banks cooperating with Swedbank is 54% of total loans. Sparbanken i Enköping stands out with SEK 12.5bn financed with Swedbank compared with only SEK 7.5bn on its own balance sheet, while Sparbanken Nord and Sparbanken i Karlshamn have only 15-16% of their total loans with Swedbank.

**Figure 7. Loans on own balance sheet and transferred to Swedbank Hypotek and Swedbank Finans, end-2019**



In addition to mortgages, the savings banks transfer their customers' assets to Swedbank's asset manager, Robur, as well as its insurance subsidiary, Swedbank Försäkring, in return for which they receive commission income. In addition to assets transferred to Swedbank, several savings banks collectively own their own savings and insurance companies – Indecap Holding, Sparbankernas Försäkrings and Portfolio Försäkra, for example – as alternatives to Swedbank's savings and insurance options.

Figure 8. Insurance and savings assets transferred to Swedbank and Robur, end-2019

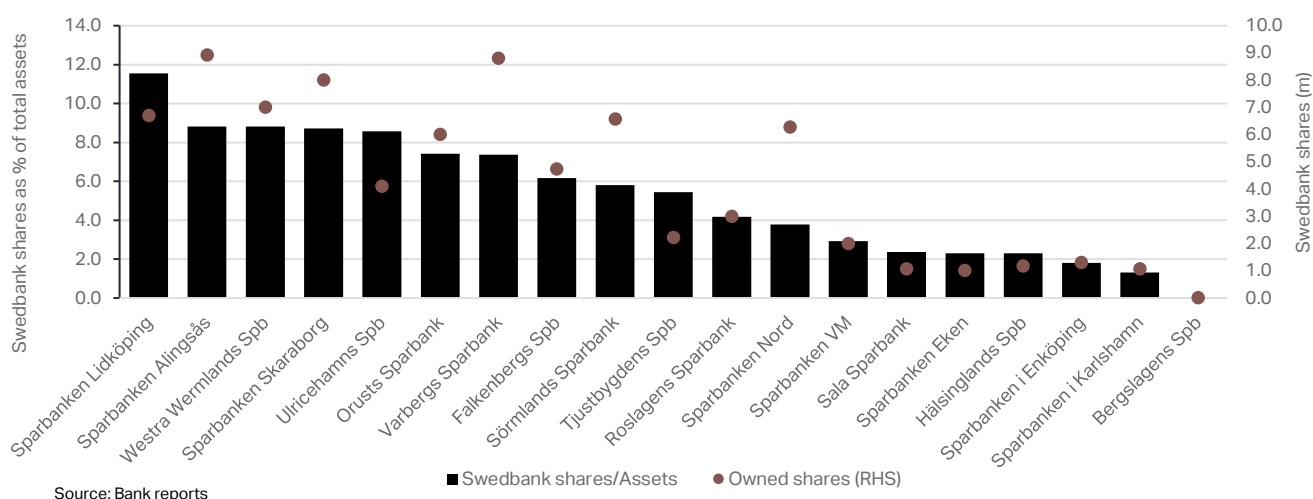


### SAVINGS BANKS' OWNERSHIP OF SWEDBANK

At the top of the list of Swedbank's owners is the Savings Bank Group (Sparbankernas Ägareförening), which owned an 11.0% stake as of 31 May 2020. Most Swedish savings banks own shares in Swedbank, directly and/or via the foundations which own the banks (Sparbanksstiftelser), which in turn own an additional 3.5% of Swedbank.

Most of the banks in this report have increased their holdings in Swedbank as the share price has fallen. Swedbank's current share price could provide further opportunities for domestic savings banks, which are well stocked with capital, to increase their ownership and long-term influence over the bank. This in turn could impact the terms of future cooperation agreements which are often renegotiated before maturity (the current agreements expire in 2024).

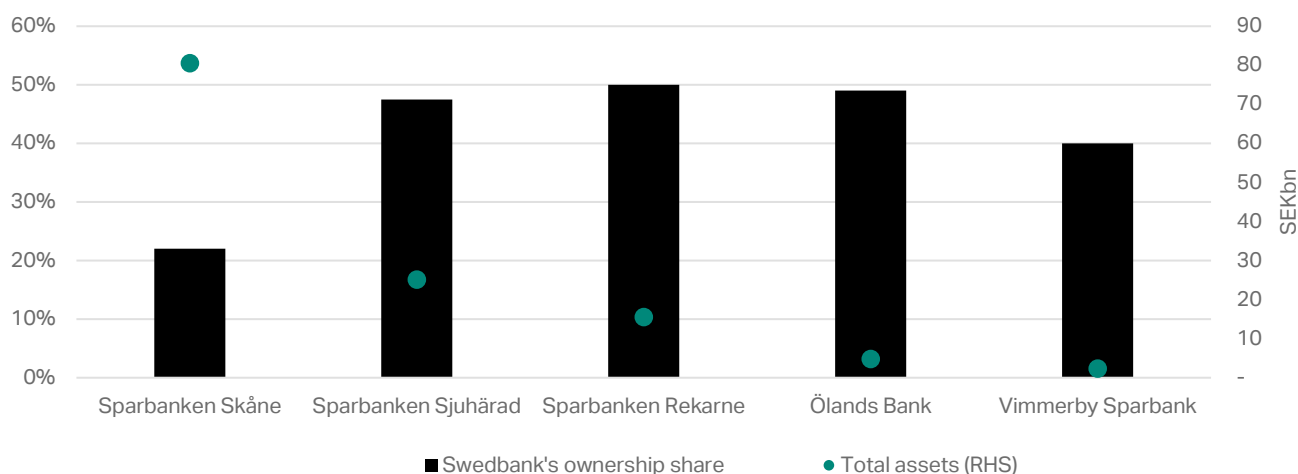
Figure 9. Holdings in Swedbank shares, end-2019



## SWEDBANK'S OWNERSHIP OF SAVINGS BANKS

The five banks in Figure 10 are owned directly by Swedbank and do not hold Swedbank shares on their own balance sheets, though the foundations which own the remaining shares in each of the five banks do hold Swedbank shares. NCR has an issuer credit rating on Sparbanken Rekarne which includes a notch of support given its 50% ownership by Swedbank and the influence Swedbank has on the bank's return requirements and capitalisation.

Figure 10. Savings banks owned directly by Swedbank – ownership share and bank assets, 2019



Source: Swedbank annual report 2019 and bank reports



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### OSLO

Biskop Gunnerus' gate 14A  
0185 Oslo  
Norway

### STOCKHOLM

Engelbrektsgatan 9-11  
114 32, Stockholm  
Sweden