Nordic Credit Rating

SECTOR COMMENT

19 Oct. 2020

NPL backstop creates challenges for Nordic niche banks

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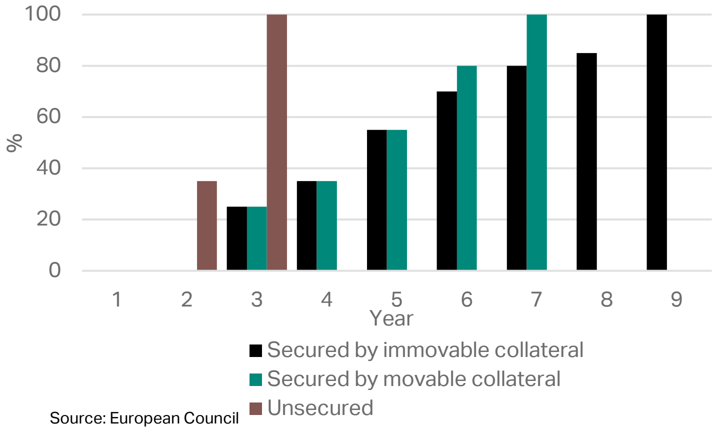
Nordic Credit Rating (NCR) believes that if the COVID-19 pandemic continues indefinitely, non-performing loans (NPLs) will begin to accumulate across the banking sector from the third quarter of 2020 onwards. More likely than not, NPLs will remain at above their historical levels for several years, both due to higher unemployment and lower lending growth. This is particularly likely to affect niche banks offering mainly unsecured consumer loans. Proposed EU regulation, expected to take effect on 1 Jan. 2022, could lead to massive write downs of NPLs across the Nordic region. This prudential backstop could close the secondary NPL market in Norway altogether, while Denmark would likely be forced to make it easier for banks to sell NPLs.

EU PRUDENTIAL BACKSTOP A PROSPECTIVE CHALLENGE FOR NORDIC CONSUMER LENDERS

Accounting regulations under International Financial Reporting Standards 9 (implemented in 2018) require banks to make earlier recognition of loan losses on impaired loans. The EU's prudential backstop regulation (see proposal here) mandates that unsecured loans extended after April 2019 that have been nonperforming for three years or more must be written down in full (see Figure 1). The proposed backstop would begin to affect the book value of NPLs in October 2022, three years after bad loans dating back to April 2019 have been delinquent for 90 days. The proposal is less challenging for Nordic providers of secured loans, as the backstop would kick in after seven or nine years. However, elsewhere in Europe, the situation is different as many banks still have high levels of NPLs dating back to the financial crisis of 2008-09.

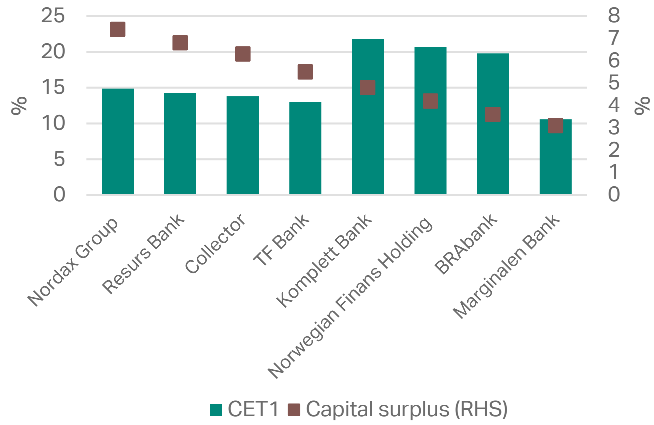
The aim of the proposed prudential backstop is to force European banks to offload NPLs onto debt purchasers. Unlike Nordic banks, banks elsewhere in Europe have been reluctant to do this because secondary market prices are lower than book values, owing in part to lower creditor protections.

Figure 1. Prudential NPL backstop–CET1 deductions as % of non-performing exposure



Source: European Council

Figure 2. CET1 ratio and capital surplus, 2019 and H2 2020



NCR based on company data

While NCR believes that this regulation will also increase the importance of the secondary market for most Nordic banks, it should have no effect on the market for NPLs in Sweden. However, it is likely to create special problems in Denmark, where banks are allowed to sell bad debt only after an often lengthy legal process.

The market in Norway is also likely to be affected, for three specific reasons:

- Norwegian banks can sell loans only to domestic finance companies or debt collectors;
- Norwegian finance companies have capital requirements, typically 14.5%; and
- Norwegian debt collectors need consent from every borrower before acquiring loans.

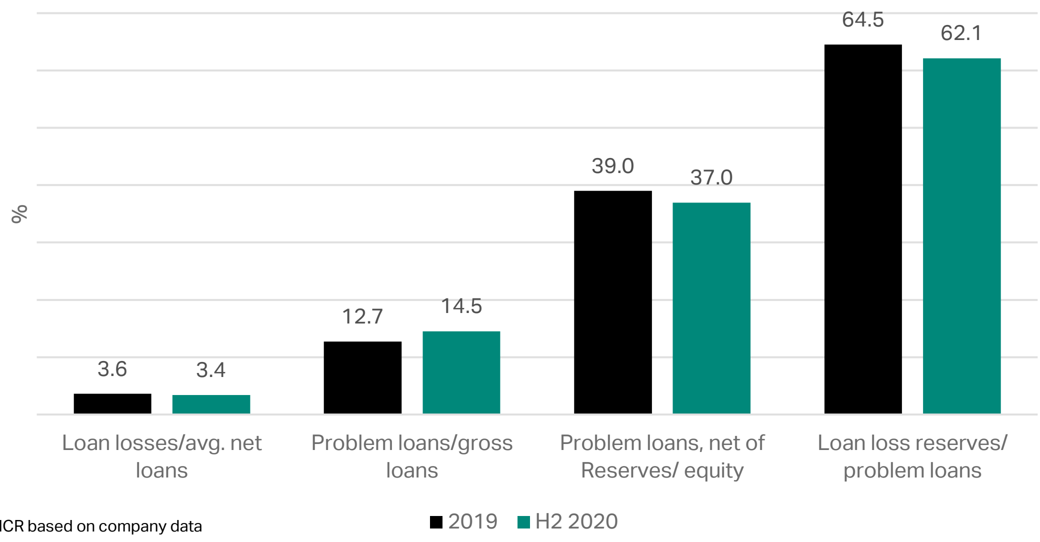
Unlike Swedish debt purchasers, which have a special licence to act as finance companies without capital requirements, a Norwegian debt purchaser which buys a fully written-down portfolio of consumer loans (say in 2023) will for capital requirement purposes immediately have to write it down to zero if the loans have been nonperforming for more than three years. This would obviously impose a heavy burden on a finance company's capital adequacy and, in the case of Norway, could virtually close down the non-performing debt market. Licensed debt collectors could take over some of the market, since they face no capital requirements and would not be required to make write-downs, but the need to obtain consent from individual borrowers makes it unlikely that they would bid for portfolios of multiple small loans. Neither would non-regulated investors such as international private equity funds be able to fill the gap in the market as they would need to set up a Norwegian operating entity and would subsequently become subject to the constraints on domestic operators listed above.

The Norwegian Ministry of Finance is considering not applying the backstop regulations to purchasers of NPLs, but the Norwegian financial supervisory authority has advised against this idea (see the authority's advice in Norwegian here). In addition, a proposal for a new EU directive on credit services, credit purchasers and recovery of collateral could force Norway to open its market to foreign debt purchasers in a few years. If the proposal is approved, the issue could become more of a question of distortion of competition between Norwegian and foreign debt purchasers, and Norway may be forced to remove its capital requirement for debt purchasers. The proposed directive is at an early stage and it is uncertain what it will eventually contain, but it will probably also open up the market for NPLs in Denmark.

SIGNIFICANT DIFFERENCES IN LOAN LOSS PROVISIONS EXIST BETWEEN NICHE BANKS

The effect of COVID-19 on Nordic niche banks' asset quality metrics was limited in the first half of 2020 (this article is a follow up to *Nordic niche banks face uncertain future for nonperforming loans*, published 22 Mar. 2020). However, we would be surprised if NPLs do not increase significantly from the third quarter onwards, when such loans have qualified as nonperforming for more than 90 days. Some of these credit losses have already been considered in banks' unspecified reserves in 2020. However, we believe that it could take some time before the level of NPLs normalises, and the "new normal" might be higher than previously in part due to the proposed NPL backstop affecting resale values which are considered in banks' loss reserves. Stricter loan loss and capital requirements could stall lending growth and cause some banks to violate capital requirements.

Figure 3. Average asset quality of eight niche banks, 2019 and H2 2020

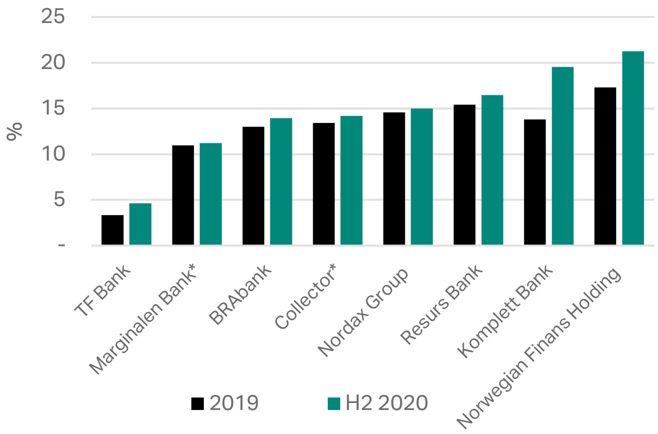


NCR based on company data

There are significant differences in loan loss provisioning between Nordic niche banks (see figures 4 and 5). Some 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 2 and 6).

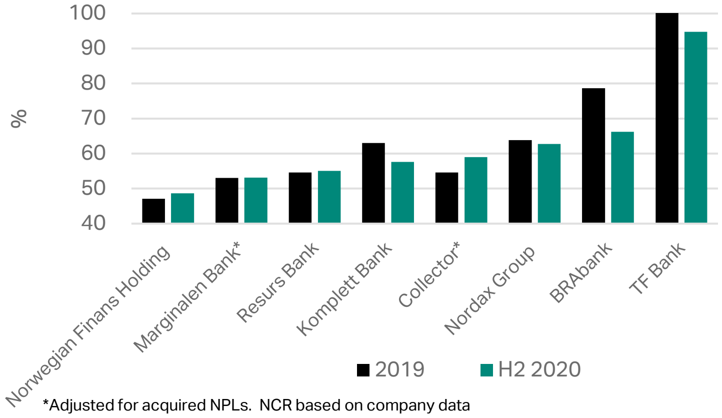
Reduced counter-cyclical buffers (to zero from 2.5% in Sweden and to 1% from 2.5% in Norway) have increased banks' capital surplus above requirements. We note that Norwegian consumer lenders have received Pillar 2 requirements typically in the 4-6% range while Swedish niche banks have been exempted altogether. However, on 25 Sep. 2020, the Swedish financial supervisory authority [proposed amended rules and a change in the application of banks' capital requirements](), which open the way for Pillar 2 guidance for smaller, specialised banks. Such banks could receive higher Pillar 2 guidance than the expected 1-1.5% for most banks, and this could significantly reduce the excess capital for Swedish consumer lenders. We note that Pillar 2 requirements will have to be covered by CET1 capital.

Figure 4. Problem loans to gross loans, 2019 and H2 2020



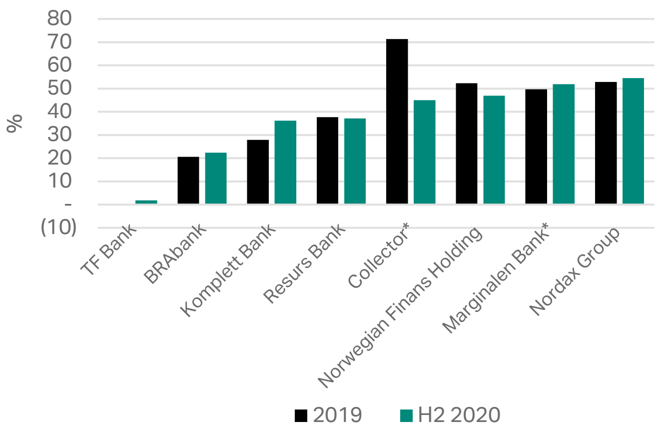
*Adjusted for acquired NPLs. NCR based on company data

Figure 5. Loan loss reserves to problem loans, 2019 and H2 2020



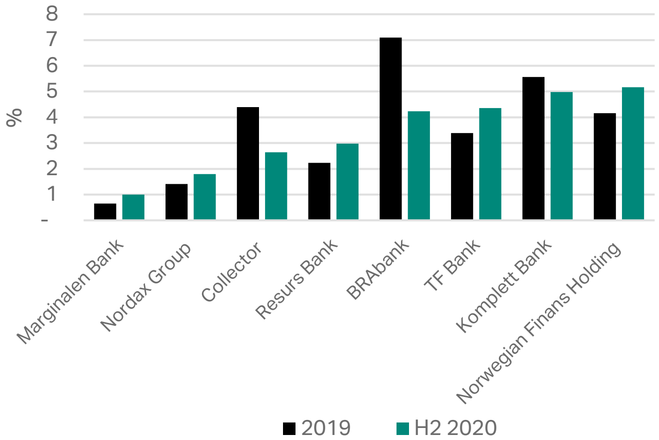
*Adjusted for acquired NPLs. NCR based on company data

Figure 6. Problem loans, net of reserves, to equity, 2019 and H2 2020



*Adjusted for acquired NPLs. NCR based on company data

Figure 7. Loan losses to net loans, 2019 and H2 2020



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