Significant risks remain for Nordic niche banks

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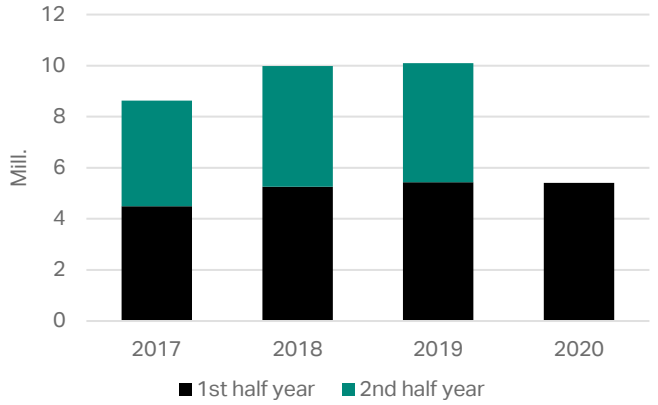
Nordic niche banks focused on consumer lending, like most of the wider regional banking sector, have so far weathered the COVID-19 pandemic better than our earlier expectations. While loan losses in the sector have been positively impacted by government relief packages and delayed amortisation, niche lenders have nonetheless increased their loss reserves against future actual losses. Nordic Credit Rating (NCR) believes that we might have seen a peak in loan loss provisions even if actual loan losses increase in 2021, as appears likely. Loan losses are normally late cyclical, and could be higher than expected once COVID-19 related government support recedes. We also expect increased margin pressure as the sector refocuses on growth. Mitigating factors include cost cutting and a likely increase in lending demand as the cycle turns. In addition, the region's banks are generally well capitalised and an increase in saving during 2020 has generated more than sufficient funding via deposit growth.

OUTLOOK STABLE DESPITE CHALLENGING OPERATING ENVIRONMENT

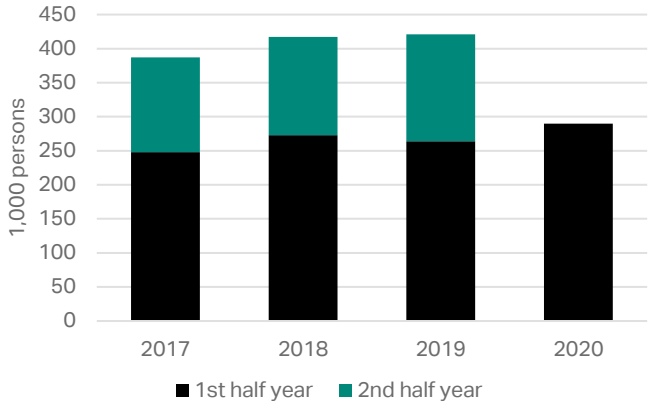
The stable outlook for the wider Nordic banking sector reflects our expectations of a flatter U-shaped recovery rather than the sharp V- or, in the worst case, W-shaped rebound that we anticipated previously. Remaining risk factors include long-term shutdowns or low production levels under which furloughs could become layoffs, effectively reducing the asset quality of consumer loans.

Figure 1. Debt collection cases, Norway



Source: Finanstilsynet (Norwegian regulator).

Figure 2. Applications for enforced payments against private persons, Sweden



Source: Kronofogden (Swedish Enforcement Authority).

LENDING DEMAND LOW, MARGINS UNDER PRESSURE

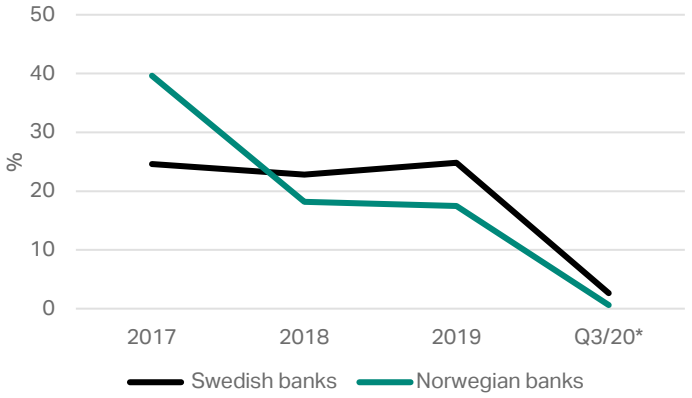
Consumer lending growth has fallen significantly since the outbreak of the COVID-19 pandemic, as both consumers and banks have become more cautious. In Norway, the decrease in lending growth started earlier, albeit from a higher level, due to new regulations and the implementation of a debt registry providing banks with additional information about customers' unsecured debt. According to Finanstilsynet, the Norwegian financial supervisory authority, consumer lending fell by 16% in the first three quarters of 2020. NCR believes that consumer loan growth is already bouncing back as we near the end of the fourth quarter, and that the Swedish market in particular will return to normal growth levels in the second half of 2021. We think a return to growth is also likely in Norway, but expect it to lag the rebound in the Swedish market due to stricter regulatory conditions. We note that the Swedish regulator has increased emphasis on consumer lending and is considering the need for its own mandatory debt register, though such a development would be unlikely to have any impact in 2021.

Most regional niche banks are now active in both the Norwegian and the Swedish markets, and for this reason lending growth does not differ significantly between Norwegian and Swedish niche banks.

However, there is some difference in net interest margins, with higher margins on the Norwegian side. This is explained by different business mixes; Norwegian niche lenders are generally more focused on high-margin consumer lending while their Swedish counterparts have a larger share of lower-margin products with lower risk. An example is Collector Bank AB's growing commercial real estate portfolio. According to Finanstilsynet, the average net interest margin on Norwegian consumer loans fell to 8.9% in the first nine months of 2020 from 9.6% at end-2019.

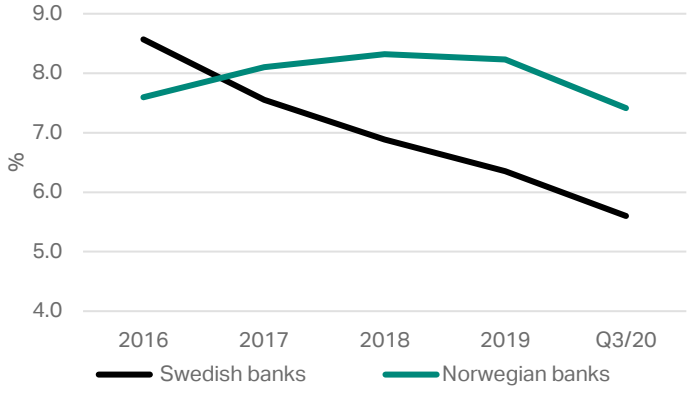
We believe that an increased focus on growth will lead to continued pressure on margins in the consumer lending sector. We expect interest rates to remain low through 2021. This is likely to prove positive for niche banks, which generally have high and relatively inflexible lending rates and are mainly funded by deposits (the average deposit to lending ratio is 95%). Heavy inflows of deposits from Nordic and German savers during 2020 have allowed consumer lenders to lower their published deposit rates, supporting net interest margins. In the longer term, we also expect higher funding costs to put pressure on net interest margins in the sector.

Figure 3. Growth in bank lending, consumer banks



Source: Company data (10 Swedish and 8 Norwegian banks).

Figure 4. Net interest margins, consumer banks

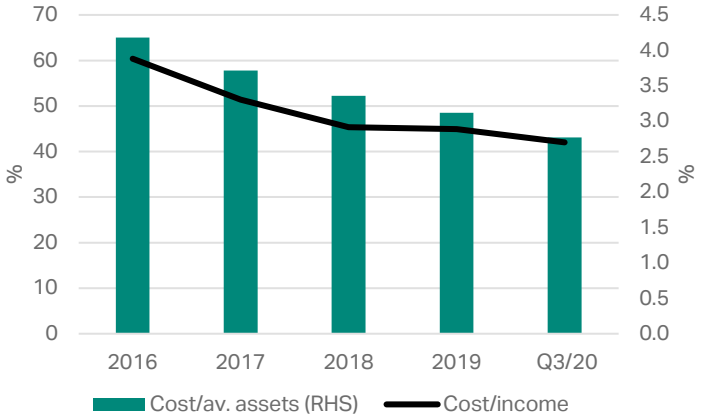


Source: Company data (6 Swedish and 6 Norwegian banks).

FOCUS ON COST CUTTING AND DIGITALISATION TRIGGERS CONSOLIDATION

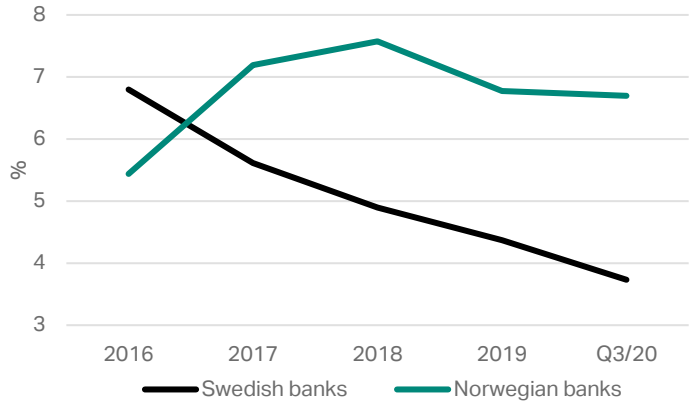
Nordic niche banks are at different stages in their respective life cycles and have different business models. In 2019, cost/income ratios in the sector varied from 24% at Bank Norwegian AS to 65% at Sweden's Marginalen Bank. However, we believe that consumer lenders with more cost-efficient business models are more likely to survive and a drive for efficiency is likely to lead to more mergers and acquisitions in the sector. This year, we have seen a positive impact from reduced marketing costs and travel expenses. But this is likely to prove unsustainable beyond the first half of 2021.

Figure 5. Cost/income ex. trading and cost/av. assets, consumer banks



Source: Company data (6 Swedish and 5 Norwegian banks).

Figure 6. Pre-impairment profit to average REA, consumer banks



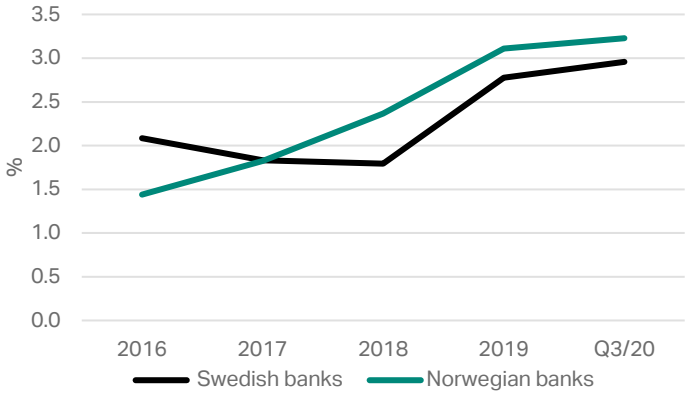
Source: Company data (7 Swedish and 6 Norwegian banks). REA–risk exposure amount.

LOAN LOSSES MIGHT HAVE PEAKED

Regional consumer banks increased their loan loss reserves in the first quarter of the year. However, substantial government support programmes have helped keep a lid on actual losses and non-

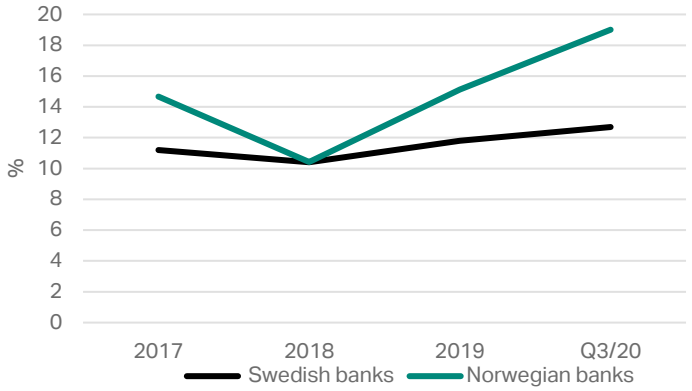
performing loans in the course of the COVID-19 pandemic so far, and a positive trend in containing the pandemic in the middle part of the year allowed several banks to write back some of the provisions. Nonetheless, we see increasing loan losses as a major risk factor for 2021, particularly when the support programmes eventually end. We also note an announcement by Finanstilsynet that non-performing consumer loans by Norwegian niche banks increased from 16% to 20% in the first nine months. While we expect loan losses over the next few years to be somewhat higher than in recent years, our base-case scenario is that regional consumer banks' average loan loss provisions will be somewhat lower in 2021-2022 than in 2020. Moreover, strong pre-impairment profitability (see Figure 6) acts as a cushion against moderate increases in loan losses. However, individual banks could be hit hard, particularly if they find that their credit score models have been wrongly calibrated. In addition, introduction of a so-called prudential backstop or weaker secondary markets for non-performing loans are factors that could lead to an underestimation of loss reserves, thereby affecting 2021 provisions (see *Nordic niche banks face uncertain future for nonperforming loans*, 22 Mar. 2020).

Figure 7. Loan losses to average REA, consumer banks



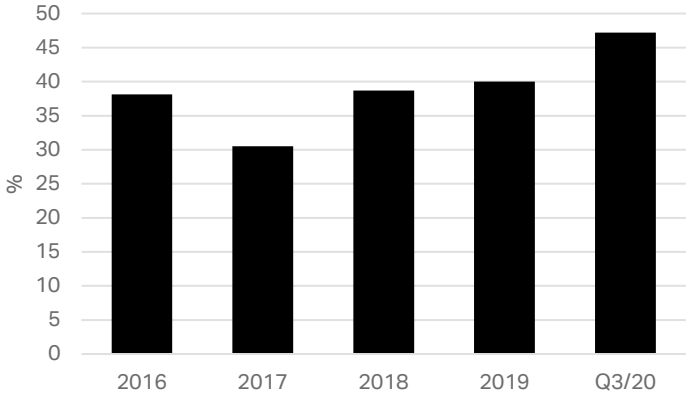
Source: Company data (7 Swedish and 6 Norwegian banks).

Figure 8. Net Stage 3 non-performing loans to net loans, consumer banks



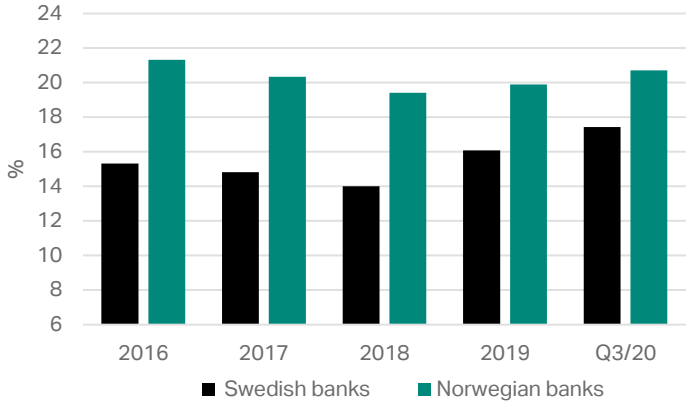
Source: Company data (6 Swedish and 4 Norwegian banks).

Figure 9. Loan loss provisions to problem loans (Stage 3), consumer banks



Source: Company data (10 banks).

Figure 10. Common equity Tier 1, consumer banks



Source: Company data (8 Swedish and 6 Norwegian banks).

CAPITALISATION LIKELY TO REMAIN STRONG

Nordic niche banks are generally well capitalised, especially Norwegian lenders, which have high Pillar 2 requirements imposed by Finanstilsynet. We expect capital requirements to increase further in Norway due to an impending increase in the systemic risk buffer by 1.5pp from end-2022 for all banks using the standardised capital model. We also expect that the countercyclical capital buffer, which was cut to 1% from 2.5% in Norway and to zero in Sweden in March 2020, will be increased again when the impact of COVID-19 has subsided. In our view, regional niche banks can rapidly rebuild their capital if they stop extending new loans, given the high turn-around of their consumer loan portfolios. This obviously assumes that related losses do not eat into their capital.

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