SECTOR COMMENT
9 Sep. 2021

Nordic banking assessments raised on reduced COVID threat

ANALYSTS
Sean Cotten
+46735600337
sean.cotten@nordiccreditrating.com

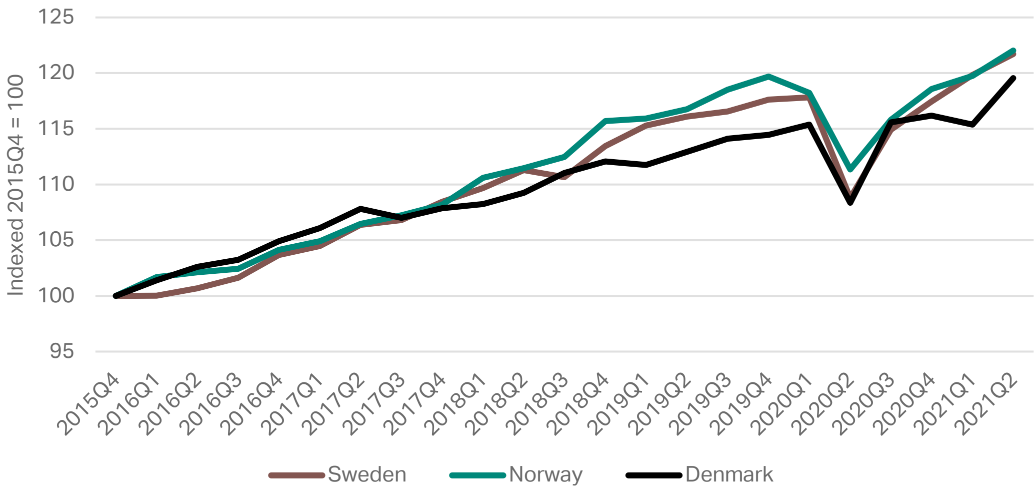
Geir Kristiansen
+4790784593
geir.kristiansen@nordiccreditrating.com

Today Nordic Credit Rating (NCR) raised its assessments of the Swedish, Norwegian and Danish banking markets to reflect the reduced risk of COVID-19 to most banks operating in the three countries. For Sweden and Denmark, we have revised our assessment of the national operating environment to 'a-' from 'bbb+', and for Norway to 'a' from 'a-'. The revisions restore the operating environment assessment of each country to pre-pandemic levels to reflect recovering output and employment, and the resilience of most regional banks' earnings and asset quality.

Most Nordic banks have outperformed our earlier expectations, while accumulating significant loan-loss reserves, in the course of the pandemic. We now expect that increased economic activity will enable them to reduce these reserves together with falling levels of non-performing loans. However, we continue to see risk in specific segments as the pandemic recedes and government support is withdrawn.

We acknowledge that new variants could lead to sporadic lockdowns, but note that rising vaccination rates and pent-up demand are minimising the economic impact of the highly contagious delta variant in the Nordic region. In our view, the pandemic is unlikely to seriously damage the region's banking markets in terms of loan-loss reserves, access to funding, or the economic uncertainty that led to our original decision to revise the assessments downwards in April 2020.

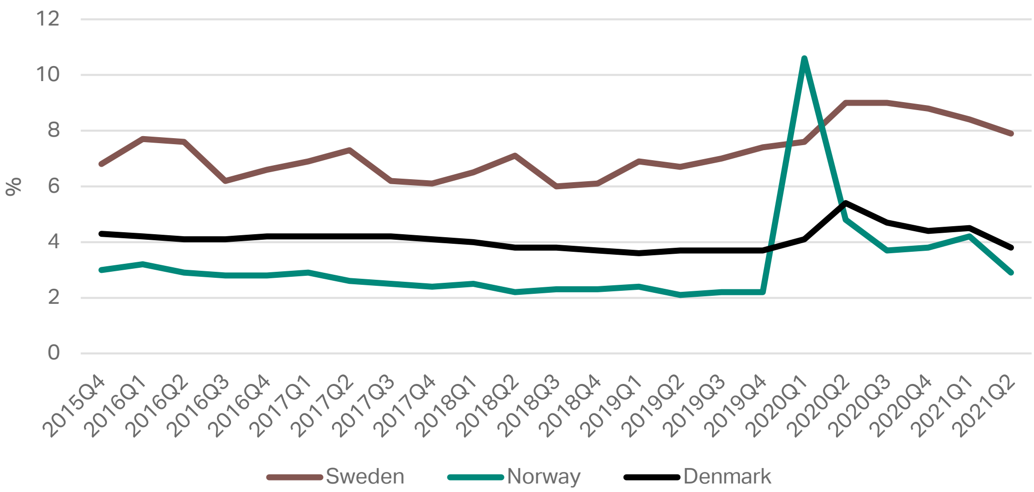
Figure 1. Indexed real GDP in Sweden, Norway and Denmark, 2015Q4-2021Q2



Source: Statistics Sweden, Statistics Norway & Statistics Denmark.

In all three markets we have seen output return to pre-pandemic levels and expect GDP to follow or return to its previous growth trends. We believe that future output will be boosted by an upturn in the international economic cycle, driving continued demand for exports and maintaining oil prices at levels which support future investment. The anticipated cyclical upturn should also boost corporate investment, which has suffered due to uncertainty during the pandemic.

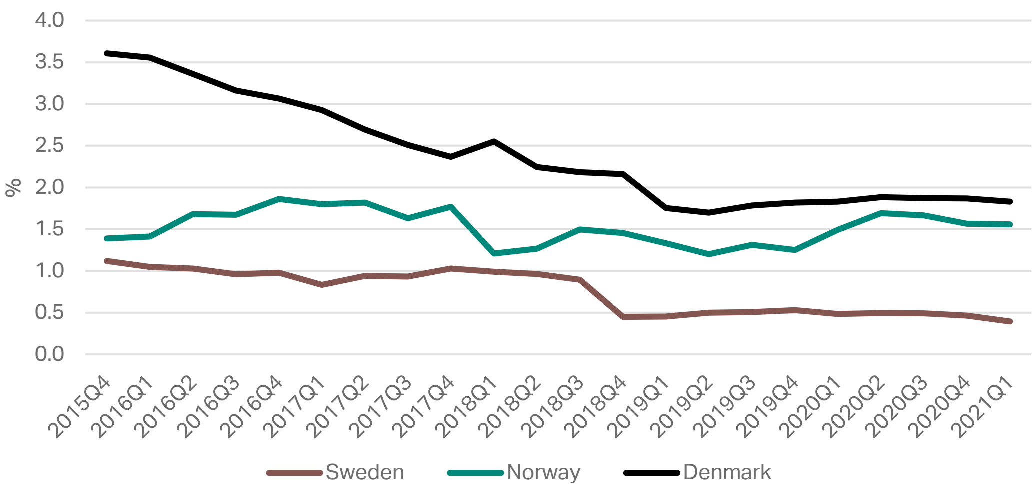
Figure 2. Unemployment in Sweden, Norway and Denmark, 2015Q4-2021Q2



Source: Swedish public employment service & Statistics Sweden, NAV & Statistics Denmark.

We note that unemployment is significantly down from its recent peak across the region. Despite higher unemployment, government support measures and reduced spending over the past 18 months have strengthened corporates' and individuals' ability to service their financial obligations. A reduction of government support measures as the pandemic subsides could reveal weak asset quality in some industries. Nonetheless, most banks are reassessing the need for the extraordinary loan-loss reserves they accumulated in response to the unusual economic conditions of 2020, resulting in reversals of previous credit losses.

Figure 3. Non-performing loans to gross loans in Sweden, Norway and Denmark, 2015Q4-2021Q1



Source: European Banking Authority risk dashboard.

Our expectations for output growth in the region are modest due to lingering uncertainty about the effects of the pandemic. Other factors that dim the prospects of recovery include the prospect of reduced government support and ongoing shortages of basic input materials and semiconductors, leading to delays in industrial production.

Our banking market assessments are a component of the issuer ratings we assign to financial institutions. The assessment can account for up to 20% of a credit rating, depending on the individual issuer's exposure and geographic profile.

Today's revisions indicate an improvement in our expectations for credit strength for most regional banks. These revisions alone have not had an immediate effect on any of our current public ratings or outlooks. Our updated assessments of the respective regional operating environments will, however, be incorporated in the assignment of new ratings to financial institutions as well as future reviews of existing ratings in the sector.

We note continued challenges for financial institutions, including lower profitability and margin pressure, especially in Denmark, due to negative policy rates, and instances of heightened asset quality issues for specific banks. Such issues are captured elsewhere in our analysis of financial institutions. They also include areas which have generally improved during the pandemic, such as capitalisation and liquidity reserves due to increased savings rates.

SWEDEN

NCR has raised its assessment of the Swedish banking market to reflect our expectations that vaccination rates will increase and lead to a reduction in pandemic-related restrictions. Once restrictions are fully removed, we anticipate increased economic activity in cyclical production segments as well as service industries. We also expect that the ongoing economic recovery will result in lower unemployment, especially among young adults, who have been disproportionally affected by a loss of service and seasonal work. Sweden's strong public finances and lower-than-projected budget deficit, together with expansionary monetary policies, provide buffers against threats to economic recovery.

The regulator has indicated an increase in the countercyclical buffer before the end of the year, signalling a more positive outlook for the banking sector. We consider the increased pace of housing price growth during the pandemic as unsustainable and an associated increase in household debt as a threat to economic stability. NCR continues to believe that the pace of housing price growth will align itself with the market's long-term growth rate in the remainder of 2021, in part due to the continued rollout of COVID-19 vaccines, but also due to the reinstatement of amortisation requirements.

Figure 4. Sweden – scoring of national indicators

Subfactor	Score	Rationale
Sovereign strength	aa	Major credit rating agency average: AAA, minimum: AAA.
Output growth	bbb	We anticipate that the economic rebound will continue through 2022, driven by pent-up demand as a result of COVID-19.
Credit growth	bbb	Credit growth has been running at more than twice GDP growth, and continues to rise at about 5% per year despite COVID-19.
Housing prices	bbb	Housing prices have risen rapidly since May 2020. We expect the market to slow to long-term growth of around 6% with the reinstatement of amortisation requirements.
Unemployment	bbb (bb)	Unemployment has fallen from recent peaks but are much higher than in neighbouring Nordic countries in large part due to high unemployment among recent immigrants. Long-term unemployment is among the highest in the EU, but has not materially affected the banking sector.
Available stable funding	a	Available stable funding in the form of deposits and domestic covered bonds falls short of private-sector lending by monetary financial institutions, but savings rates remain high and access to long-term senior financing remains strong.
International cycle	bbb (bb)	Global growth prospects are improving, partly due to significant monetary stimulus. We expect the rebound to continue through 2022. Asset prices are at or near their peak, in our view.

NORWAY

NCR has raised its assessment of the Norwegian banking market to reflect improvements in the domestic operating environment, with unemployment declining towards pre-pandemic levels despite social distancing measures. The adjustment further reflects our expectations of a recovery in the services industry and increased household consumption driven by pent-up demand as restrictions are lifted.

To combat any risk of overheating, the central bank has advised the Ministry of Finance to raise the countercyclical capital buffer requirement to 1.5% from zero, effective 30 June 2022, with an eventual return to its pre-pandemic level of 2.5%. Despite higher capital requirements, increasing policy rates should help Norwegian banks to continue to outperform their European peers on earnings and efficiency, while higher oil prices and a strong economy should support robust loss performances across the sector. We do not believe that proposed changes in taxation of oil companies will deter the sector from increasing investments from 2023 onwards. We see shortages of basic input materials as a risk to economic recovery, and especially exports. However, solid government finances and expansionary monetary stimulus should counterbalance these effects.

Figure 5. Norway – scoring of national indicators

Subfactor	Score	Rationale
Sovereign strength	aa	Major credit rating agency average: AAA, minimum: AAA.
Output growth	bbb	We expect the economic rebound to continue into 2022 as fewer restrictions should benefit the services sector which has been heavily impacted by the pandemic. We also expect increased oil-related investment to support long-term growth prospects.
Credit growth	bbb	Credit growth has been running at more than twice the rate of GDP growth, but remains stable outside the oil industry, while the effect of COVID-19 has been minimal.
Housing prices	bbb	Supply imbalance and low interest rates combined with low levels of construction activity have affected housing growth positively. We expect growth to start slowing before year-end.
Unemployment	aa (a)	Unemployment is sharply down from a peak in March 2020. The labour market is stabilising, and unemployment is likely to fall further when restrictions are lifted.
Available stable funding	a	Available stable funding in the form of stable deposits and domestic covered bonds exceeds private-sector lending by monetary financial institutions in most predictable market conditions.
International cycle	bbb (bb)	Global growth prospects are improving, partly due to significant monetary stimulus. We expect the rebound to continue through 2022. Asset prices are at or near their peak, in our view.

DENMARK

We have raised our assessment of the Danish banking market to reflect improvements in the domestic operating environment, with fewer social restrictions, high vaccination rates, and a strong rebound in the services sector. The assessment also reflects a return to pre-pandemic unemployment levels, a strong export sector, and a well-capitalised banking sector relative to other European countries. We believe that solid government finances and available support packages together with a flexible labour market should counterbalance any temporary turbulence.

Consolidation of the banking sector continues, with recent merger and acquisition activity much higher than in Sweden and Norway. In our view, this is partly a result of negative policy interest rates to protect the Danish krone peg to the euro. In addition, domestic banks have reported higher volumes of non-performing loans and loan-loss reserves than in Sweden and Norway, partly due to more conservative regulatory loss-provisioning expectations.

Figure 6. Denmark – scoring of national indicators

Subfactor	Score	Rationale
Sovereign strength	aa	Major credit rating agency average: AAA, minimum: AAA.
Output growth	bbb	We expect GDP to return to pre-pandemic levels in 2022 amid high rates of vaccination and increased activity in cyclical sectors.
Credit growth	bbb	Credit growth has been lower than GDP growth in recent years, but housing price increases during the pandemic have temporarily increased mortgage debt growth. We expect deleveraging to continue as the economy grows.
Housing prices	bbb	Housing prices are currently above their historical trend and we expect them to slow.

Subfactor	Score	Rationale
Unemployment	a (bbb)	Indicators point towards lower unemployment as the services sector recovers due to easing restrictions. We expect unemployment to fall to pre-pandemic levels.
Available stable funding	aa	Available stable funding in the form of deposits and domestic covered bonds exceeds private-sector lending by monetary financial institutions.
International cycle	bbb (bb)	Global growth prospects are improving, partly due to significant monetary stimulus. We expect the rebound to continue through 2022. Asset prices are at or near their peak, in our view.

DISCLAIMER

NORDIC CREDIT RATING AS

nordiccreditrating.com