Swedbank dividends boost earnings for Swedish savings banks

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The largest Swedish savings banks increased their earnings and capital positions in the first half of 2021, despite considerable margin pressure, which has been exacerbated by extensive and expensive liquidity positions and intense competitive pressure in the lending market. However, we note that loan-loss reversals, which started in the last half of 2020, continued in the first half of this year, boosting earnings. Commission and fund fees from transfers of loans and savings to Swedbank AB, as well as payments of deferred dividends from Swedbank additionally had a positive impact on pre-provision income (PPI).

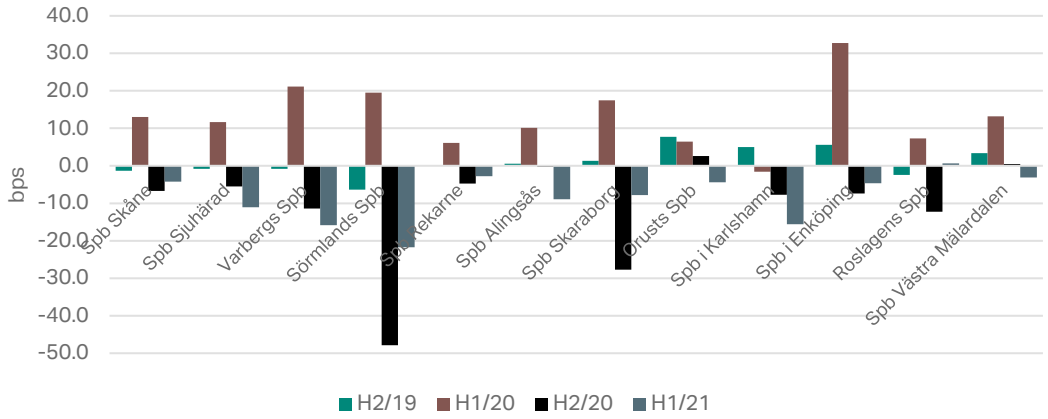
The economic effect of the COVID-19 pandemic has proven less severe than our initial expectations (see *Swedish savings bank get dividend boost after solid 2020*, published 21 Jun. 2021) and we are cautiously optimistic that conditions in the sector are more likely than not to improve. This is reflected in the recent upward revision of our assessment of the Swedish banking market (see *Nordic banking assessments raised on reduced COVID threat*, published 9 Sep. 2021).

In the present review, we assess the 12 largest Swedish savings banks and look at their asset quality, capital, earnings and liquidity positions, and the connection with Swedbank.

LOAN LOSS REVERSALS SIGNAL CLEARER VIEW OF PANDEMIC EFFECTS

All 12 banks in our sample increased their loan-loss provisions in the first half of 2020, in the face of uncertainty due to COVID-19. For many, this consisted of a combination of IFRS9 provisions, modelling based on future expectations, and manual adjustments. In the second half of 2020 and early in 2021, the economic effects of the pandemic became clearer and most of the sample banks started reversing these provisions, in some cases as early as 2020. We note that certain large reversals were partly due to significant legacy exposures which are still under settlement.

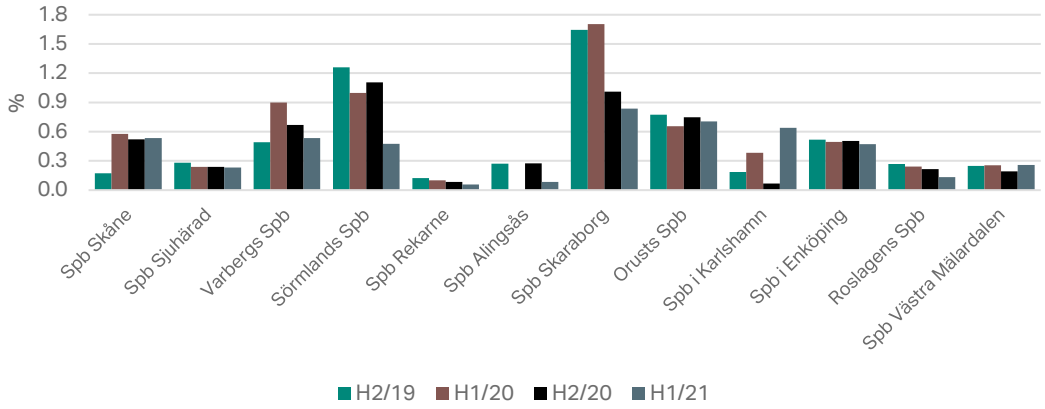
Figure 1. Swedish savings banks' loan loss provisions over net loans, H22019 – H12021



Source: bank reports.

While all banks in our sample have followed a similar trend in their handling of provisions, their handling of non-performing loans has varied. The average ratio of net Stage 3 non-performing loans in the sample stood at 17 bps at mid-year compared with 23 bps a year earlier and 24 bps a year before that. The implication is that the pandemic has not had an aggregate negative impact on non-performing loans across our sample. This can mostly be explained by the recent resolution of several large exposures, which pre-dated the pandemic.

Figure 2. Swedish savings banks' net stage 3 non-performing loans/total net loans, H22019 – H12021



Source: bank reports.

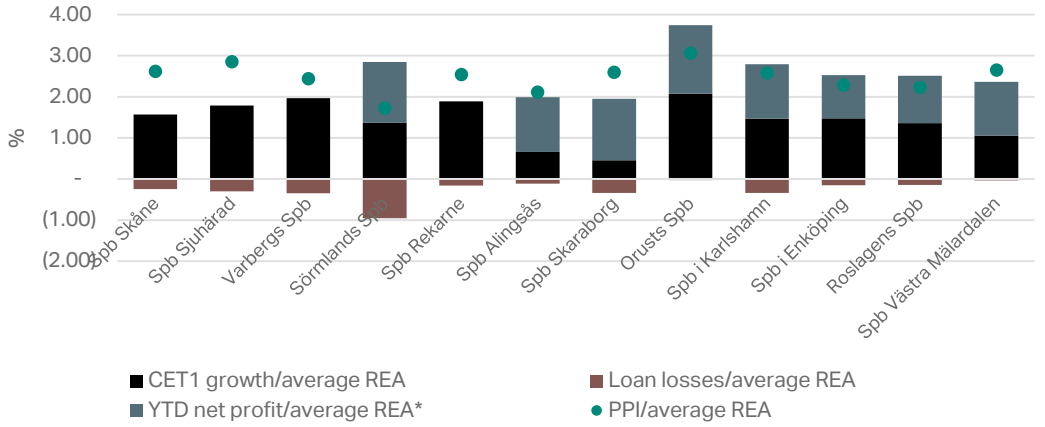
CAPITAL GROWTH AMID STRONG RESULTS AND NEGATIVE LOAN LOSSES

All 12 banks in our sample saw their Common Equity Tier 1 capital (CET1) grow over the 12 months to June, when adjusted to include half-year net profits (see Figure 3). Among the banks in the sample that own Swedbank shares (all except Swedbank-owned Sparbanken Skåne, Sparbanken Sjuhärad, and Sparbanken Rekarne), earnings were boosted by the reinstatement of Swedbank dividends. A dividend of 25% of 2019 net profit was paid retroactively early in 2021, followed by a dividend of 25% of 2020 net profits a few months later. Given a regulatory decision not to extend restrictions on bank dividends beyond 30 Sep. 2021, we expect Swedbank to pay an additional dividend of 25% of 2019 and 2020 net profits before year-end, in line with its stated dividend policy of paying 50% of net profits. This would double the payments made in the first quarter, boosting the income and capital levels of savings bank shareholders further by year-end.

In the 12 months to June, pre-provision income over risk exposure amount (REA) was high for all 12 banks, indicating strong core business performance throughout the worst of the pandemic. While most of the banks use the standardised model for calculating REA, some use internal ratings-based models, meaning calculations differ somewhat between banks.

All 12 banks made net reversals of loan-loss provisions in the 12 months to June. In addition to reversing the equivalent of their pandemic-related provisions, they improved the credit quality of their portfolios compared with pre-pandemic levels, although for some the improvement was negligible.

Figure 3. Swedish savings banks' capital growth, loan losses, and earnings, 12 months to June 2021



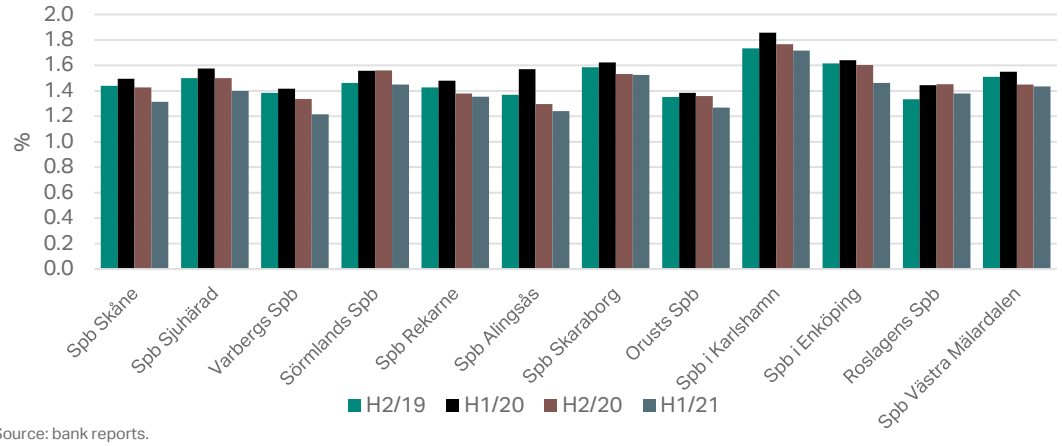
Source: bank reports. *Year-to-date net profit, included only for banks which do not report half-year profits in CET1.

EARNINGS IMPACTED BY INTEREST MARGIN PRESSURE AND SWEDBANK DIVIDENDS

Continued zero interest rates have had a material effect on earnings across the sector. With the exception of an increase in the first half of 2020 following a central bank decision to increase the

repurchase rate to 0.0% from minus 0.25%, margins have declined. We identify two main causes in addition to zero interest rates. The first is an upswing in deposits in the 12 months to June, widely attributed to an increase in savings by individuals and companies during the pandemic. Swedish savings banks generally avoid passing on negative or zero interest rates to deposit customers, which pushes down interest margins as interest costs increase. The second is increasing competition on lending rates, particularly for mortgage loans, which pushes down interest income. The fact that deposits are growing faster than lending in the sector puts further pressure on margins.

Figure 4. Swedish savings banks' net interest margins, H22019–H12021



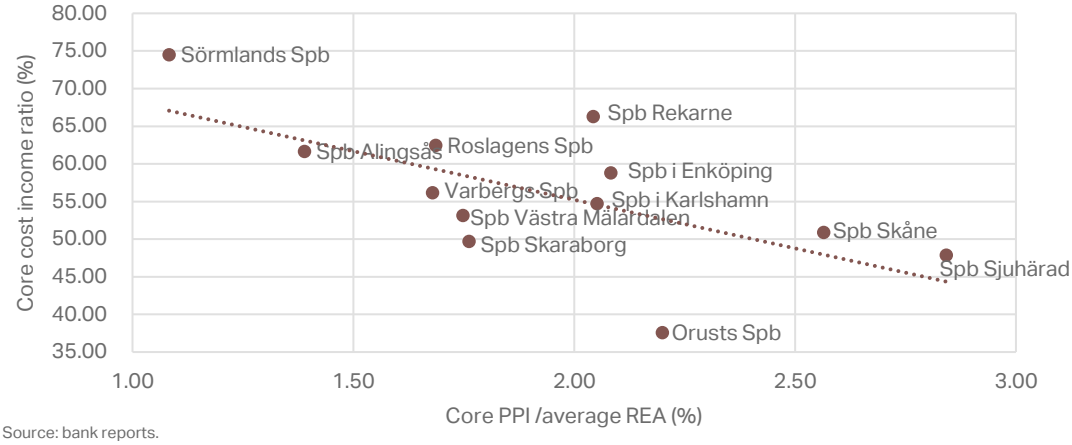
Source: bank reports.

In addition to net interest income, Swedish savings banks obtain a large proportion of their core banking business revenue from net fees and commissions, largely driven by loans and savings transferred to Swedbank. Accordingly, core PPI (excluding dividends and other income) was robust for most banks in the sample over the 12 months to June.

Core cost-to-income varies greatly between the banks in our sample, and we note that many should expect increases in IT costs. Owing to widespread system sharing, IT infrastructure in the sector is mostly controlled by Swedbank, and the smaller players have little control over costs. Some banks have launched significant IT investments, which we expect to continue in the years ahead.

While Swedbank dividends have traditionally been a reliable source of additional income in the sector, they were suspended in 2020 in response to the pandemic. The suspension indicates that savings banks cannot wholly rely on such dividends for income, especially during adverse market conditions. In addition, Swedbank's dividend policy target was reduced to 50% of net profit from 75% in 2019. Accordingly, we take the view that core earnings in the sector should be analysed excluding such dividends. We expect the banks in our sample to benefit from the reinstatement of regular dividend payments, further strengthening their respective positions as they emerge from what appears to be the worst of the pandemic.

Figure 5. Swedish savings banks' core earnings and cost efficiency, 12 months to June 2021

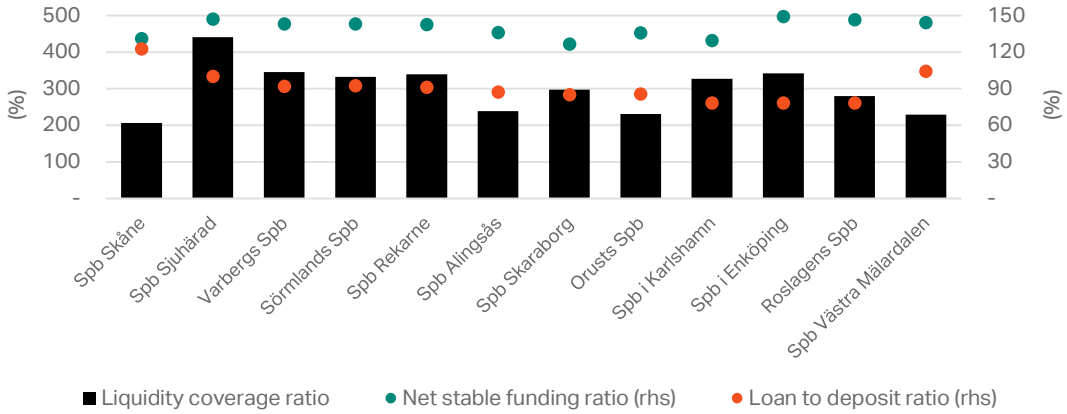


Source: bank reports.

VERY STRONG AND STABLE LIQUIDITY POSITIONS FOR ALL BANKS

The 12 banks in our sample report strong and stable liquidity and funding positions, partly owing to the nature of their business models and partly due to an increase in savings during the pandemic. As the banks generally fund their operations through deposits and tend to have a stronger focus on stability than profitability, we expect their respective liquidity and funding metrics to be at higher levels than those of other domestic banks. However, given their reluctance to pass on negative or zero interest rates to depositors, their liquidity buffers are expensive, as reflected in their net interest margins.

Figure 6. Swedish savings banks' funding and liquidity positions, Jun. 30 2021



Source: bank reports.

NCR-RATED SAVINGS BANKS

Figure 7. NCR ratings on Swedish savings banks

	Sparbanken Rekarne AB (publ)	Sparbanken Västra Mälardalen	Sörmlands Sparbank	Varbergs Sparbank AB (publ)
Long-term issuer rating	A-	BBB+	BBB+	A-
Outlook	Stable	Stable	Stable	Stable
Subfactors:				
Operating environment (20%)	bbb	bbb-	bbb-	bbb+
Risk appetite (50%)	a-	a	a	a
Market position (15%)	bbb	bb+	bbb	bbb+
Performance indicators (15%)	a-	bbb+	bb+	bbb+
Ownership adjustment	+1	n/a	n/a	n/a

See NCR's company reports for details. n/a–not applicable. On 9 Sep. 2021, NCR revised its view of the operating environment for Swedish banks and will apply the new scoring in upcoming reviews. So far, only our assessment of Varbergs Sparbank has been updated. This revision has not affected the ratings on the other savings banks.

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