Nordic Credit Rating

SECTOR COMMENT

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Norwegian banking market demonstrating strength through pandemic

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The Norwegian banking market remains stable, and Nordic Credit Rating (NCR) expects banks' profitability to increase in 2022 following increased interest rate spreads. We expect Norwegian banks' capital ratios to fall because of increased dividend distributions following the lifting of dividend restrictions in September 2021. However, we consider Norwegian banks to have strong loss absorption capacity and anticipate increases in buffer requirements and new regulations by the end of 2022 to limit the size of distributions.

We apply a score of 'a' for the Norwegian banking market. Our assessment reflects the robust domestic operating environment, with a tight labour market and a strong recovery in consumer spending. We expect announced and projected interest rate hikes by the central bank, combined with an increased countercyclical capital buffer from mid-June 2022, to curb any overheating of the economy. We believe that output growth is unlikely to suffer materially from the measures to contain the Omicron variant of the COVID-19 virus. In our view, the global supply chain disruption will be the main factor constraining economic growth in 2022.

Figure 1. Norway key national metrics, 2018–2023e

%	2018	2019	2020	2021e	2022e	2023e
GDP growth*	2.2	2.0	-2.3	3.6	3.7	2.0
CPI growth	2.7	2.2	1.3	5.3**	2.0	1.6
Unemployment rate	3.8	3.7	4.6	4.0	3.3	3.1
Current account balance/GDP	8.0	2.9	2.0	7.3	7.4	6.9
Monetary policy rate	0.8	1.5	0	0.5**	1.3	1.6

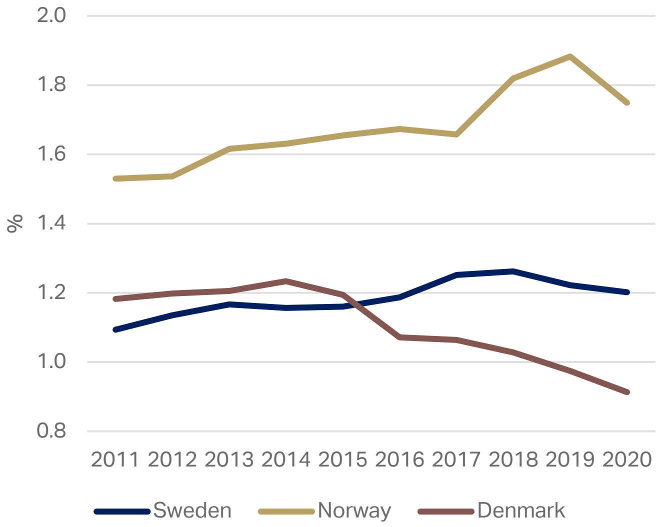
Source: Statistics Norway, the Norwegian central bank & NCR consensus estimates. e–estimate. CPI–consumer price index. *Mainland. **Actual year-end.

Figure 2. Norway key banking metrics and expected development, 2017–2023e

%	2017	2018	2019	2020	Q3 2021	2022e–2023e
Growth in household lending	6.4	5.9	5.0	4.9	5.1	Lower growth
Real housing price growth	5.0	1.4	2.5	3.9	10.6	Lower growth
Net interest margin	1.7	1.8	1.9	1.8	1.9*	Increase
Problem loans/gross loans	1.1	1.3	1.3	1.6	2.0	Decrease

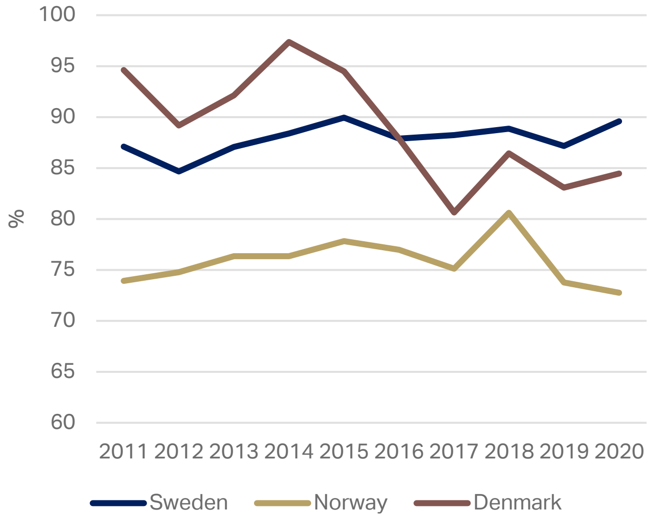
Source: Statistics Norway, the Norwegian Financial Supervisory Authority and aggregated bank reports. *Last 12 months. e–estimate.

Figure 3. Nordic banks' net interest margins, 2011–2020



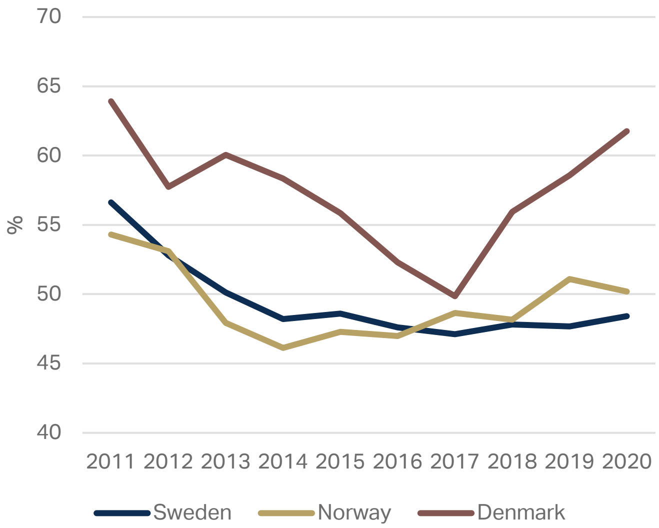
Source: Aggregated bank data.

Figure 4. Nordic banks' net interest and fees to operating income, 2011–2020



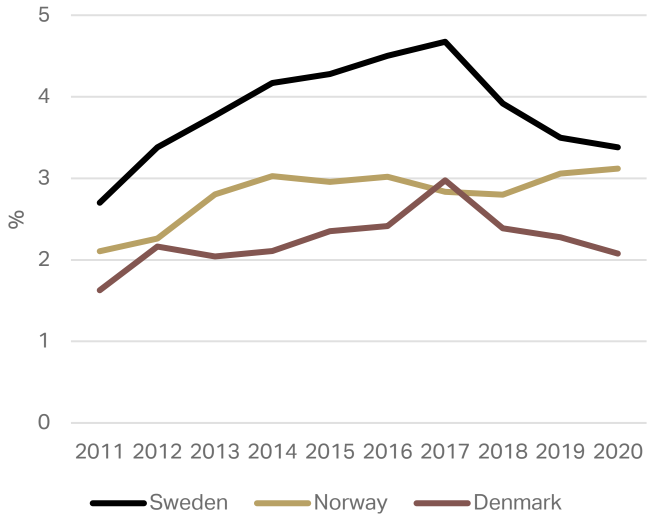
Source: Aggregated bank data.

Figure 5. Nordic banks' cost-to-income ratios, 2011–2020



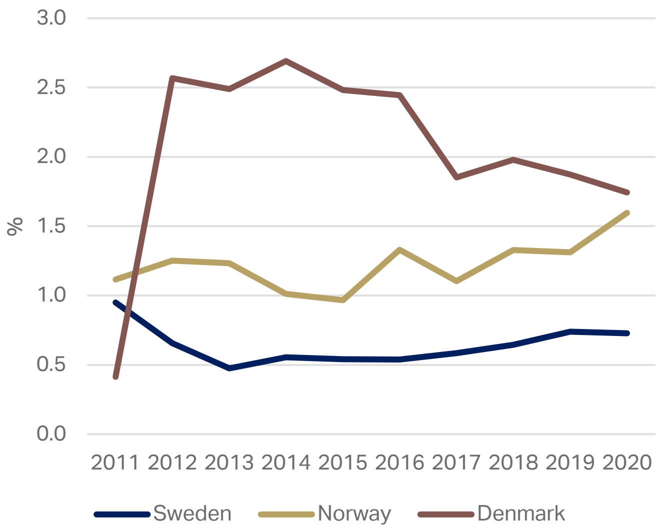
Source: Aggregated bank data.

Figure 6. Nordic banks' pre-provision profit to avg. RWAs, 2011–2020



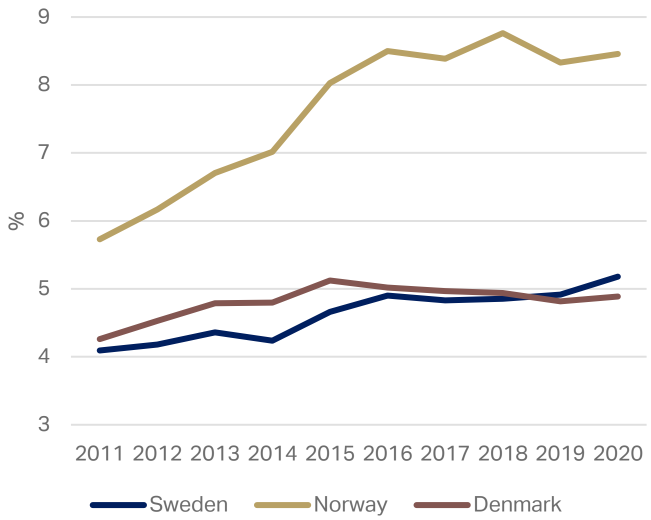
Source: Aggregated bank data. RWA–risk-weighted assets.

Figure 7. Nordic banks' problem loans to gross loans, 2011–2020



Source: Aggregated bank data.

Figure 8. Nordic banks' leverage ratios, 2011–2020



Source: Aggregated bank data.

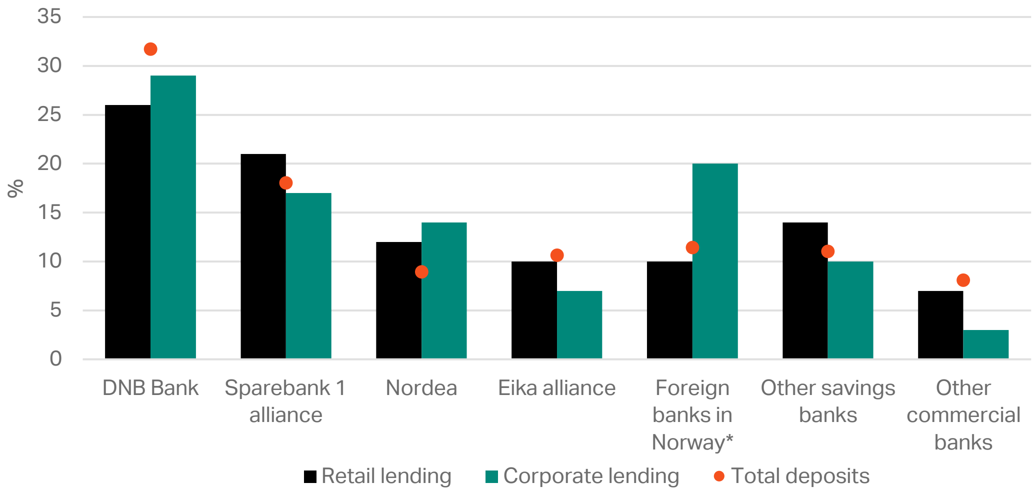
INCREASED INTEREST RATE MARGINS AND STRICTER CAPITALISATION REQUIREMENTS AHEAD

The Norwegian banking market is more fragmented than the other Nordic markets and we are seeing a trend of consolidation among Norwegian savings banks, in part to gain synergies in governance and other regulatory costs and to take advantage of increased cross-selling opportunities. The number of savings banks has been declining steadily, with more mergers in 2021. We expect Norwegian savings banks to continue to consolidate in 2022.

Norwegian savings banks' net interest margins are likely to rebound in 2022 and approach pre-pandemic levels in the next 12–18 months as a result of increased interest rate spreads stemming from interest rate hikes by the central bank. For further details about the 2022 outlook for Norwegian savings banks, see Norwegian savings banks' margins set to rebound in 2022, 14 Jan. 2022.

In the third quarter of 2021, Komplett Bank announced additional loan losses and other one-off losses, following a review of its entire loan book. We believe this suggests that other Nordic niche banks might need to review their own reserves for Stage 3 non-performing loans. The bank noted that the revision was attributable to lower recoverability of big-ticket loans. We see this as an indication of niche banks needing to adjust their provision practices, with higher reserves for unsecured big-ticket loans (see Nordic niche banks well-prepared for continued uncertainty in 2022, 17 Jan. 2022). We expect larger Norwegian banks and savings banks, which recorded loan loss reversals in 2021, to face lower revaluation risk due to a higher proportion of collateralisation and the robustness of their loan portfolios. Increasing loan losses remains a major risk factor through 2022 for niche banks, but we anticipate strong economic growth and low employment levels to partially offset this risk. We expect corporate bankruptcies in Norway to rise when government pandemic-related support schemes are withdrawn.

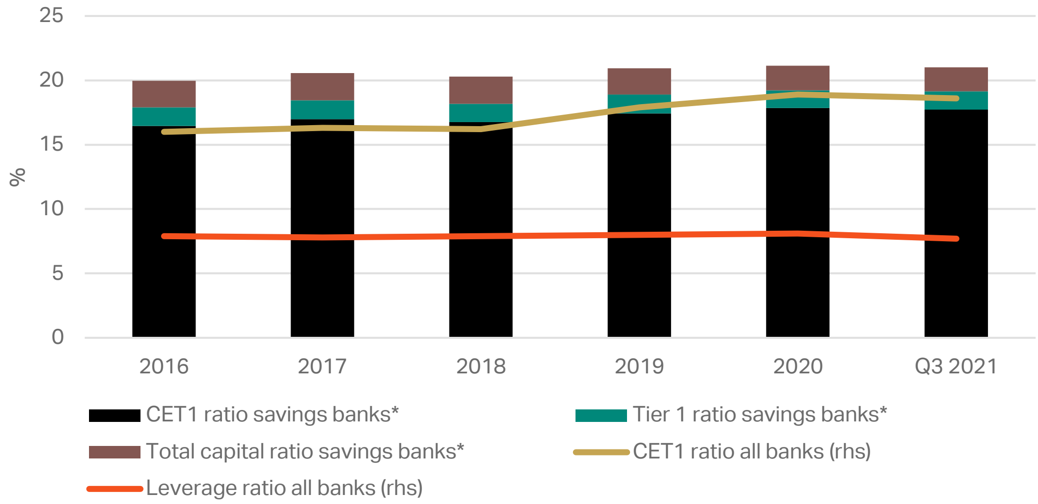
Figure 9. Market share of Norwegian banks in lending and deposits, Q2 2021



Source: the Norwegian central bank. *Excluding Nordea.

Tighter capital requirements for Norwegian banks have contributed to an improvement in capital ratios and higher loss absorption capacity since the financial crisis of 2008. The significant jump in common equity Tier 1 (CET1) ratios for savings banks in 2019 (see Figure 10) is attributable to the implementation of the EU's Capital Requirement Regulation and Capital Requirements Directive. This led to Norwegian regulators imposing stricter systemic risk buffers on banks using the standardised capital model. By the end of 2022, the buffer will increase by 1.5pp for all banks using the standardised capital model, while it is already in effect for internal ratings-based banks. We expect the increased systemic risk buffer, together with a gradual reinstatement of the countercyclical buffer, to reduce dividend distribution capacity over the coming years. We expect capitalisation ratios to fall from currently high levels as dividend restrictions during the pandemic were removed at the end of September 2021. Another factor we believe could reduce capital ratios is the new internal ratings-based requirements.

Figure 10. Reported CET1 ratios and leverage ratios for Norwegian banks, 2016–Q3 2021



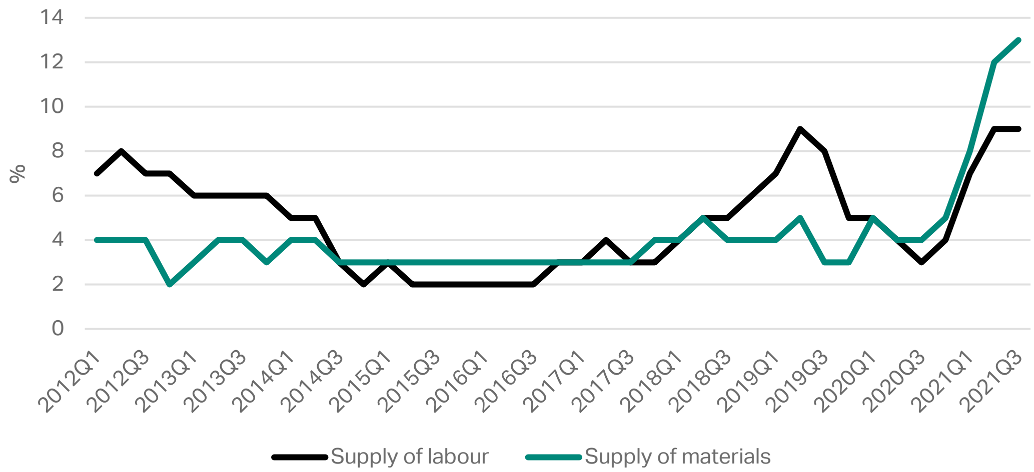
Source: company data and Norwegian Financial Supervisory Authority. CET1–common equity Tier 1. *36 largest savings banks.

STRONG CONSUMER SPENDING RECOVERY BUT BOTTLENECKS CONSTRAINING GROWTH

Following a brief rebound in consumer spending on services following the initial reopening of the economy after lockdown in 2021, the embattled services sector faces fresh headwinds as new restrictions were introduced in mid-December to combat the resurgence in COVID-19 infection rates. Norway had been seeing high economic activity and faced growing production constraints due to labour and materials shortages before the new restrictions were brought in. In particular, the release of pent-up demand from households resulted in an upside surprise in consumer spending on goods and services in 2021, which has contributed to shortages. As pandemic-related restrictions are now gradually being lifted, we could see an upside surprise in consumer spending similar to 2021. If global supply chains improve in 2022, lower inflation would also help boost consumption.

Benign economic conditions aside from the pandemic have contributed to a tightening labour market, which is spurring wage growth and pushing up inflation. The reduced flow of international labour as a result of tighter cross-border controls has likely contributed to labour shortages. Growing domestic and international cost pressures are translating into higher inflation, although we expect inflation to be dampened by interest rate hikes, the restriction of credit supply through capital buffer increases and the resolution of bottlenecks for high-demand materials.

Figure 11. Limiting factors for manufacturing production, 2012–Q3 2021

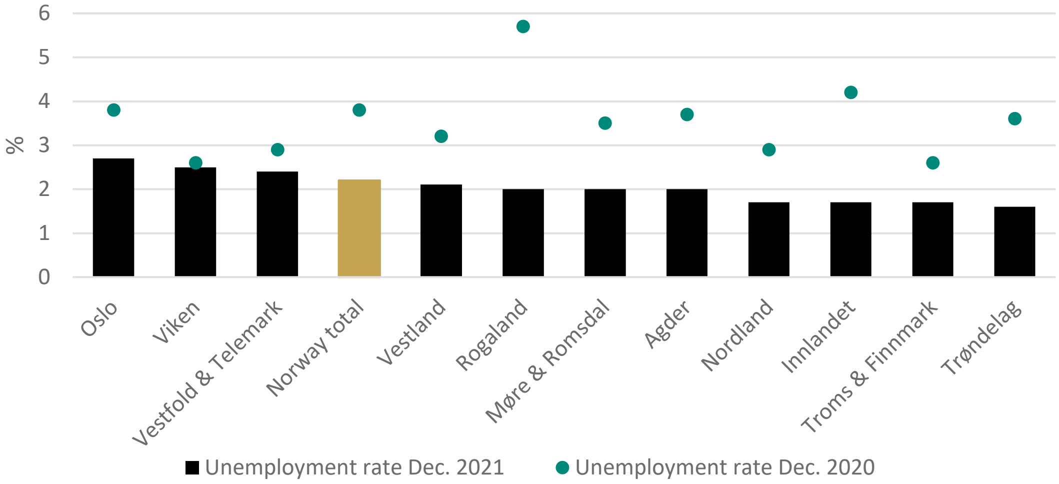


Source: Statistics Norway.

There have been significant variations in the economic performance of Norway's different regions due to the impact of the pandemic on their particular industrial make-up, such as differences in exposure to the oil and tourism sectors. Unemployment rates across all Norwegian counties fell in 2021, with total registered unemployment decreasing from 3.8% in December 2020 to 2.2% in December 2021.

The vaccine roll-out contributed to the economic upswing in 2021, benefitting in particular those regions with large hospitality and tourism sectors. Closed borders and reduced air travel have resulted in fewer foreign tourists over the pandemic. However, there has been a domestic tourism boom, with higher spending on domestic services, supporting regional economies. A rebound in oil prices has benefitted Rogaland County in south-western Norway, which experienced the biggest unemployment rate fluctuations in 2021. OPEC+ is in the process of reversing the production cuts made in 2020, while the US and China and others have agreed to release oil reserves, which we expect to reduce oil prices slightly in 2022 and contribute to a weakening of NOK, despite interest rate hikes. A weaker NOK would benefit demand for Norwegian exports, supporting regional fishing, salmon farming, business services and export sectors.

Figure 12. Registered unemployment rate in Norway by county, Dec. 2021 and Dec. 2020

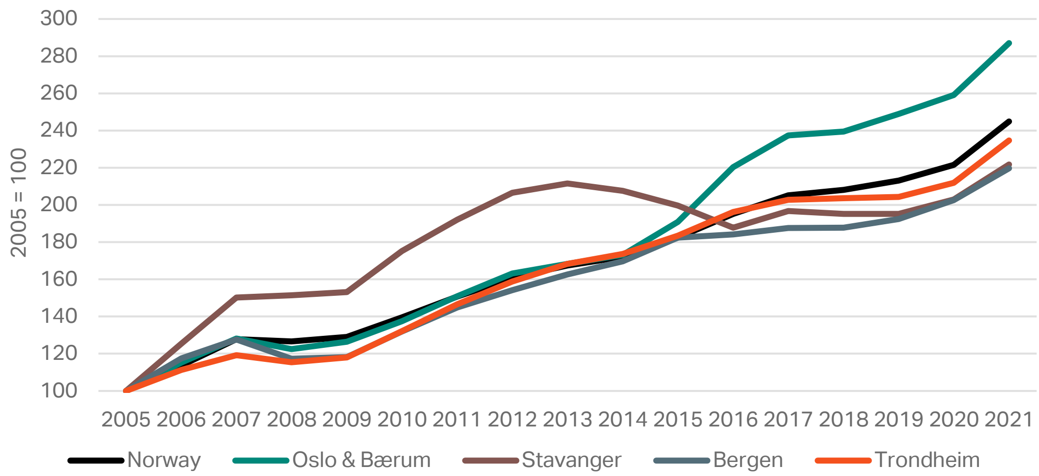


Source: Norwegian Labour and Welfare Administration.

HOUSING PRICE GROWTH SET TO SLOW IN 2022

Norwegian housing price growth accelerated above trend levels in 2021, at 10.5% for the full year. Pandemic-related restrictions have tilted household spending towards housing because of limited spending opportunities and remote working arrangements. Housing price growth has been supported by low mortgages rates, limited stock of unsold homes and high transaction volumes. We consider current price development as unsustainable over a prolonged period, due to the rapid outpacing of wage growth. We expect increased construction of new buildings to improve available housing supply, which has been stalled by delays and high building costs, and interest rate hikes from the Norwegian central bank to moderate price development in 2022. We expect consumer spending patterns to normalise when pandemic-related restrictions are removed, and this further points to lower growth over the next few years.

Figure 13. Norwegian regional housing price indices, 2005–2021



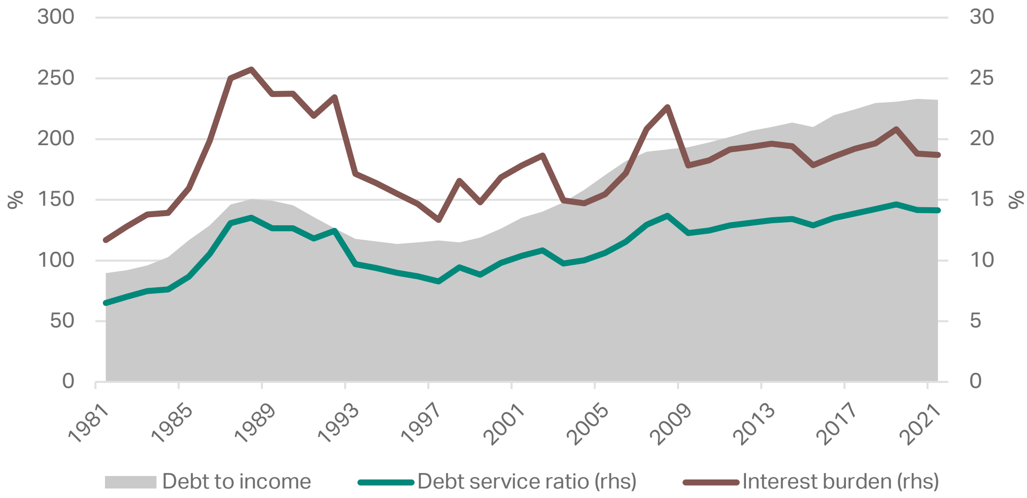
Based on data from Statistics Norway.

LOWER CREDIT GROWTH AHEAD

The high level of home ownership in Norway means housing prices are the main driver of household borrowing. The strong price appreciation in 2021 has contributed to higher debt-to-income ratios and increased financial vulnerability as households' debt-servicing capabilities become more sensitive to interest rates and loss of income. Most Norwegian households have floating-rate mortgages, which could result in a simultaneous slowdown in consumer spending, with negative implications for the economy. Norwegian household wealth is mostly tied up in housing, which could amplify economic downturns in a stressed scenario, reducing households' financial resilience.

The Norwegian central bank raised the policy rate to 0.5% in December 2020 and signalled a further increase in March 2022. According to its projections, there should be two more hikes in 2022, which means the policy rate will converge towards 1.75% by the end of 2024. The central bank also raised the countercyclical capital buffer to 2.0% as of 31 Dec. 2022, and indicated that the buffer will be fully reinstated at 2.5% by mid-2023. We expect these measures to dampen growth in mortgage-fuelled credit to households over the next few years and prevent the economy from overheating.

Figure 14. Norwegian household debt burden and interest burden, 1988–2021*



Source: Statistics Norway and the Norwegian central bank. *Norwegian central bank estimate for year-end 2021.

NORWEGIAN BANKS HAVE GOOD ACCESS TO STABLE FUNDING

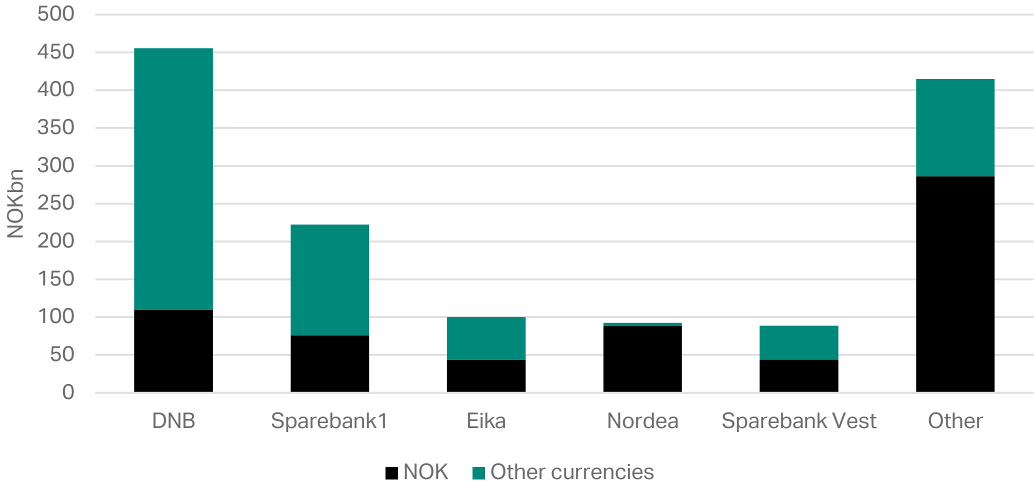
Given the large proportion of private savings managed by institutional investors via mutual funds and pension assets, the loan-to-deposit ratio of Norwegian banks is not an ideal measure of the market's stable funding. Our evaluation of Norwegian bank funding therefore considers, in particular, domestic covered-bond financing, given the demonstrated resilience, perceived support and liquidity of domestic covered bonds. We note, however, that an increase in savings during the COVID-19 pandemic has led to a fall in the loan-to-deposit ratio, from 199% before COVID-19 to 177% in the third quarter of 2021, despite sustained credit growth.

Partly because of investment restrictions on the NOK 10,000bn Government Pension Fund Global, Norwegian banks are reliant on international investors for a material proportion of issued covered bonds. A significant proportion of covered bonds are therefore issued in foreign currencies, which we consider a less stable source of funding. Norway has 25 issuers with outstanding covered bonds, resulting in more significant differences in liquidity and pricing among Norwegian covered-bond issuers than Nordic peers. This is a factor that could be exacerbated in a stressed scenario, when investors may flock to more established, liquid issuers.

We anticipate that Norway's implementation of the bank recovery and resolution directive (BRRD) will further bolster the strong protection for covered-bond investors by excluding them from bail-in. In addition, the use of long-term senior unsecured financing is a key fixture of Norwegian bank financing, in part as an alternative to covered bonds, leaving qualifying mortgages available for contingency financing via issuance and repurchase agreements with the central bank. NCR believes the markets have a strong interest in Norwegian financing at long maturities and reasonable spreads.

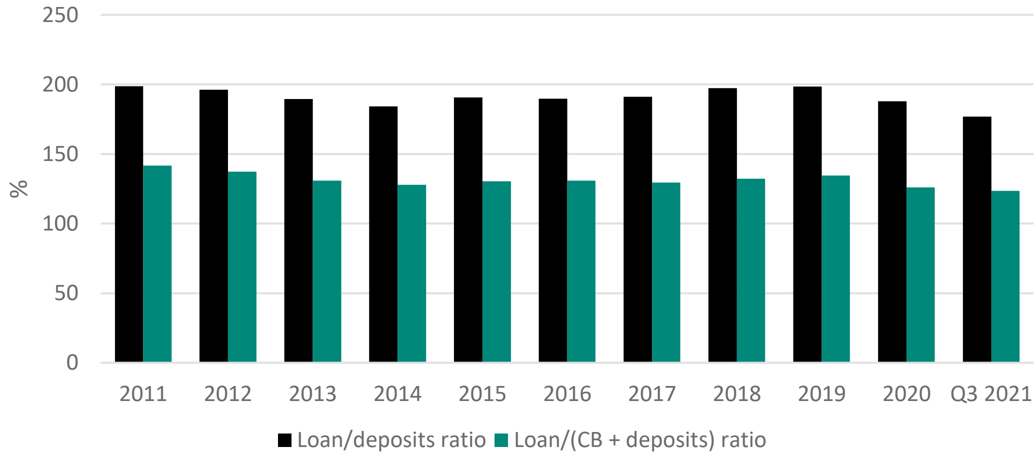
During the financial crisis of 2008, the Norwegian government demonstrated its willingness and ability to establish liquidity facilities for the Norwegian banking sector during a credit crunch. Moreover, Norwegian banks have lower gearing than international peers and a large part of market funding is long term, which makes the banks less vulnerable in a short-lived credit crunch.

Figure 15. Norwegian covered-bond issuers' outstanding volumes as of Q3 2021



Source: Finance Norway.

Figure 16. Loans as percentage of deposits and covered-bond financing for Norwegian banks, 2011–Q3 2021



Source: Statistics Norway and Finance Norway.

NORWEGIAN BANKING MARKET ASSESSMENT

The banking market score of 'a' for Norway is a component of NCR's issuer ratings for financial institutions operating in the Norwegian banking market. Depending on the nature of a rated entity's exposure and geographic profile, the score can affect up to 20% of an issuer's overall credit rating. For further information, please refer to Financial Institutions Rating Methodology, 13 Aug. 2018.

Figure 17. Norway: scoring of national indicators

SUBFACTOR	SCORE	RATIONALE
Sovereign strength	aa	Major credit rating agency average: AAA, minimum: AAA.
Output growth	bbb	Normalisation of consumption pattern has resulted in increased GDP growth over 2021. We expect labour and materials shortages, in combination with new COVID-19 restrictions, to dampen growth in 2022.
Credit growth	bbb	Credit growth has outpaced GDP over 2021 due to high housing price growth. We expect credit growth to decelerate in 2022 because of interest rate hikes and a slower housing market.
Housing prices	bbb	We foresee housing prices returning to long-term trend levels after a surge in 2021.
Unemployment	aa	Unemployment levels are sharply down and the labour market is expected to remain tight throughout 2022.
Available stable funding	a	Available stable funding in the form of stable deposits and domestic covered bonds exceeds private-sector loans in most foreseeable market conditions.
International cycle	bbb	Global growth prospects have weakened following widespread lockdowns. We expect supply chain disruptions to be the major theme for 2022.

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