Norwegian savings banks' margins set to rebound in 2022

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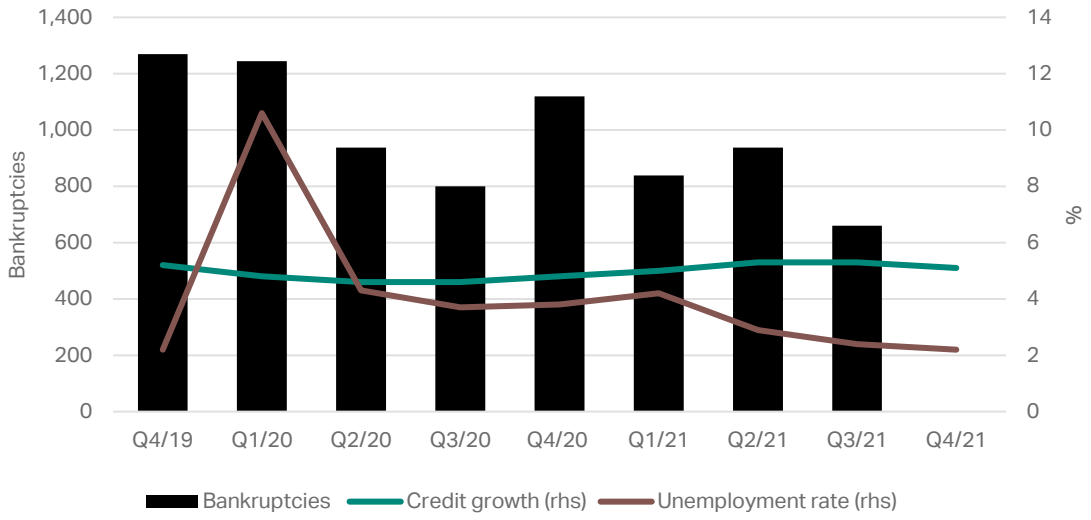
Net interest margins in the Norwegian savings bank sector are likely to rebound in 2022 on the back of higher short-term interest rates. However, increasing loan losses, which are normally late cyclical, remain a major risk factor, in our opinion. Positively, we are less concerned about the sector than we were 12 months ago. Our positive outlook follows a strong performance in 2021, with improving pre-impairment profit and low loan loss impairments, despite margin pressure and the continuing COVID-19 pandemic. In addition, we note that Norwegian banks are generally well capitalised and have access to stable sources of funding.

OPERATING ENVIRONMENT BENIGN

The impact of the pandemic on the Norwegian economy has proven less severe than we initially expected, and the country's banks have outperformed our expectations. In the third quarter of 2021, we revised our score of national factors affecting the Norwegian banking sector back to 'a' from 'a-' to reflect this (see Nordic banking assessments raised on reduced COVID threat, published 9 Sep. 2021). About 90% of the Norwegian population above 18 years of age has been fully vaccinated (two shots) and a third shot is being rolled out. In addition, we believe that the Omicron variant of COVID-19 will have little impact on the anticipated success of the roll-out.

Negatively, we remain concerned about the health of the global supply chain and an ongoing scarcity of essential materials. High energy costs and oil prices are also likely to have a continuing negative impact on the global economy. Moreover, we expect that domestic bankruptcies will increase when government anti-pandemic support schemes are withdrawn. However, this will primarily affect sectors to which banks have low lending exposure, such as hotels, restaurants, and tourism.

Figure 1. Norway bankruptcies, credit growth and unemployment, Q4 2019-Q4 2021



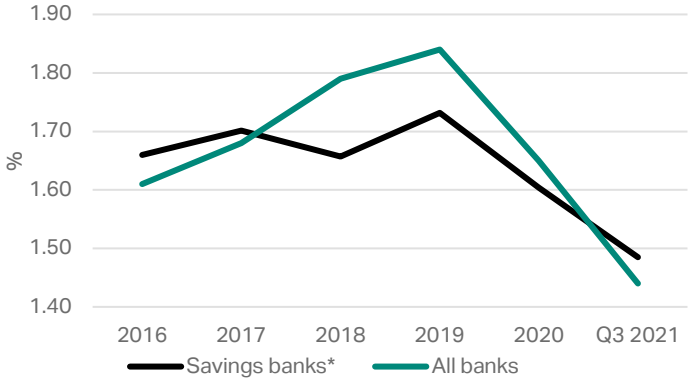
Source: Statistics Norway, Norwegian Labour and Welfare Administration.

MARGINS LIKELY TO REBOUND

Savings banks are mainly funded by deposits, and currently low interest rates consequently represent a challenge. However, the central bank has announced its intention to restore policy rates to their pre-pandemic levels. It increased its policy rates twice in 2021 (September and December), and we expect them to continue to rise through 2022. Consensus estimates point to an increase from the current level of 0.5% to an average level of 1.5% in 2023. This is likely to result in higher net interest margins due to increased deposit spreads and higher returns on liquidity and the banks' capital. In our opinion, net

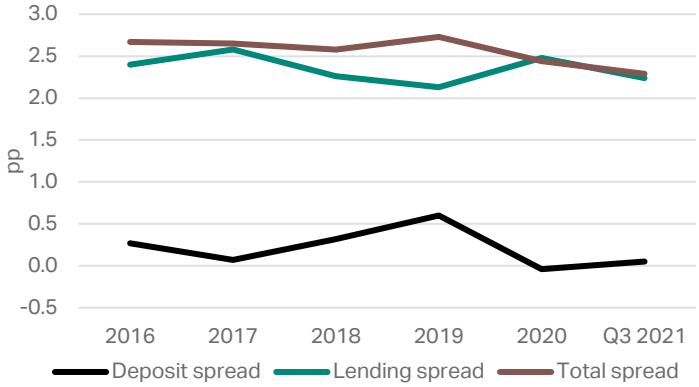
interest margins are likely to return to pre-pandemic levels in the next 12-18 months, taking into account a lag-effect in the repricing of loans.

Figure 2. Norway banks' met interest margins, 2016-Q3 2021



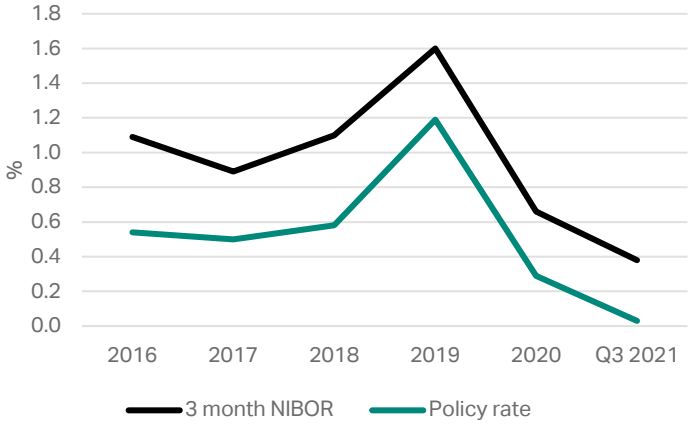
Source: Company data, Finanstilsynet (Financial Supervisory Authority of Norway). *36 largest savings banks.

Figure 3. Interest speads to 3 month NIBOR*, 2016-Q3 2021



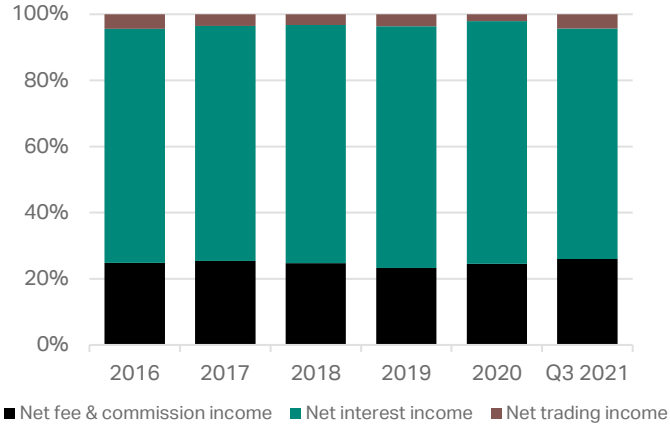
Source: Statistics Norway. Norwegian Interbank Offered Rate.

Figure 4. Norway 3 month NIBOR and central bank policy rate, annual average 2016-Q3 2021



Source: Statistics Norway.

Figure 5. Norway savings banks' income composition*, 2016-Q3 2021

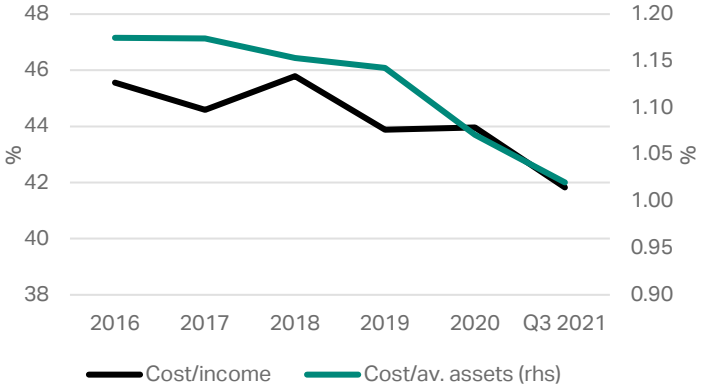


Based on company data. *36 largest savings banks.

COST EFFICIENCY CONTINUES TO IMPROVE

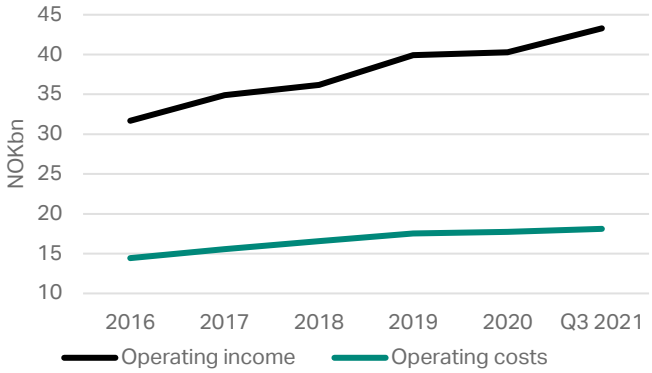
Norwegian banks are relatively cost efficient due to a high degree of digitalisation. Cost-cutting efforts appear to have been motivated by margin pressure and increased uncertainty in the course of the pandemic, resulting in relatively flat operating costs. We expect nominal costs to increase marginally over the next few years, driven by IT development costs and, in the short term, normalisation of marketing and travel expenses. Cost metrics are likely to continue to fall over the long term, partly due to a medium-term improvement in net interest margins.

Figure 6. Norway savings banks cost/income (ex. Trading) and costs/av. assets*, 2016-Q3 2021



Based on company data. *36 largest savings banks.

Figure 7. Norway savings banks operating income vs. operating costs *, 2016-Q3 2021



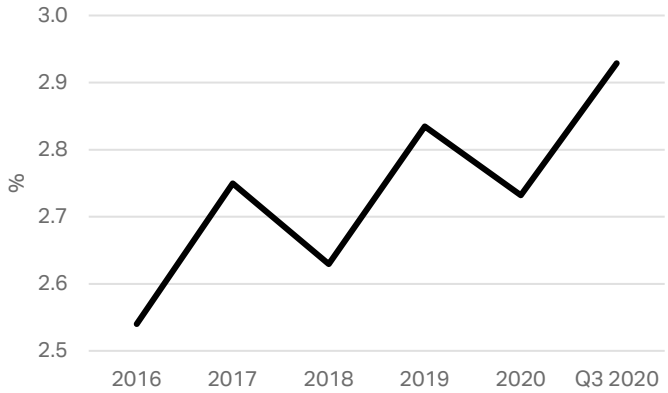
Based on company data. *36 largest savings banks.

PANDEMIC-INDUCED LOAN LOSSES NOW REVERSED

Since the outbreak of the pandemic, Norwegian banks have recorded loan losses based on economic projections and their own exceptional loss reserves, increasing buffers against future actual losses. Most of these, if not all, have now been reversed.

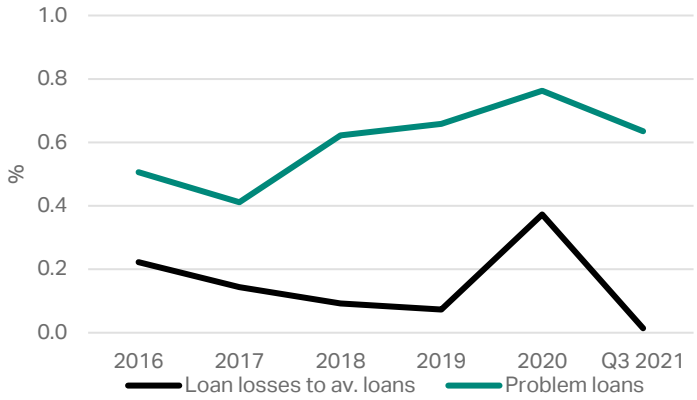
Last year, we warned about supply chain problems, long-term shutdowns or low-production levels (under which furloughs could become layoffs), increasing corporate default, and long-term pressure on commercial property prices. So far, only supply chain problems have materialised, and we see a lower risk of significant loan losses over next 12 months than we did a year ago. However, individual banks could be hit hard, particularly if large corporates default as a result of cost inflation. Exposure to the oil industry remains a risk factor for certain savings banks. In general, however, profitability before loan losses offers strong protection across the sector.

Figure 8. Norway savings banks pre-provision return on average REA*, 2016-Q3 2021



Based on company data. *36 largest savings banks. REA–risk exposure amounts

Figure 9. Norway savings banks loan losses/av. loans and problem loans*, 2016-Q3 2021

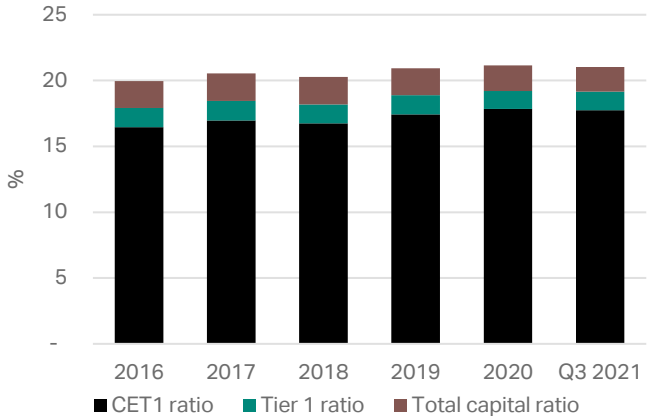


Based on company data. *36 largest savings banks.

CAPITALISATION LIKELY TO REMAIN STRONG

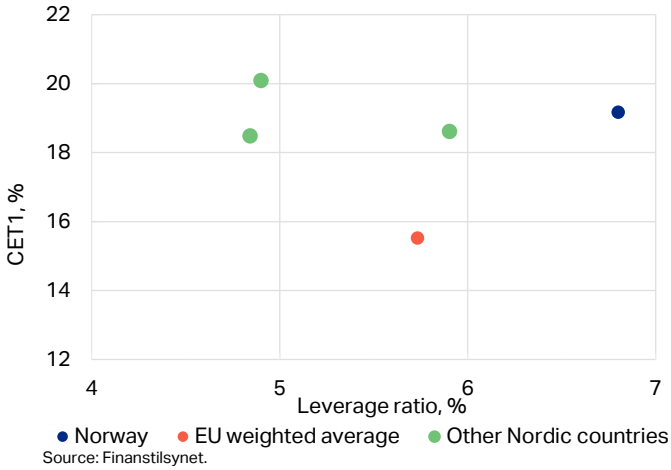
Norwegian savings banks have generally strong capital and leverage ratios and are consequently relatively resilient to increasing loan losses. The jump in Common equity tier 1 (CET1) ratios in the sector in 2019 (see Figure 10) can be explained by the implementation of the EU's Capital Requirements Regulation and Capital Requirements Directive. To compensate, the systemic risk buffer will increase by 1.5pp from end-2022 for all Norwegian banks using the standardised capital model. Moreover, the countercyclical capital buffer, which was cut to 1% from 2.5% in March 2020, will be restored to 2% from end-2022. For this reason, we do not expect Norwegian savings banks to reduce their capitalisation any time soon.

Figure 10. Norway savings banks' capital ratios*, 2016-Q3 2021



Based on company data. *36 largest savings banks.

Figure 11. Norway large banks' capital ratios vs Nordic and European peers', mid-2021



Source: Finanstilsynet.

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