Nordic Credit Rating

SECTOR COMMENT

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Swedish savings banks end turbulent first half of 2022 in good shape

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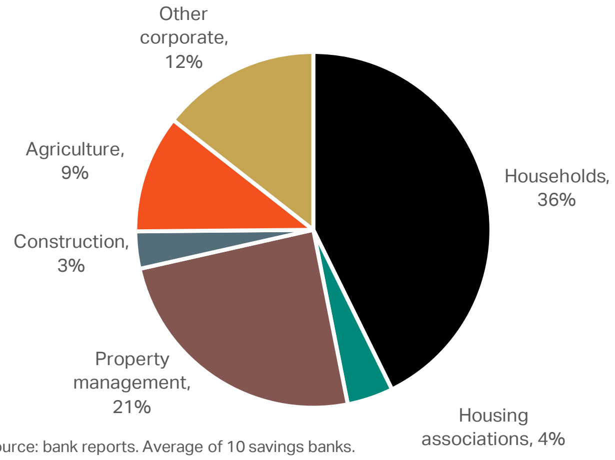
The first half of 2022 has been turbulent for both the economy and society as a whole, and the Swedish savings bank sector has been no exception. The first quarter began quietly, somewhat impacted by a new wave of COVID-19, but with fewer restrictions than previously seen during the pandemic. However, the economic consequences of Russia's invasion of Ukraine quickly became clear, with high inflation and a rapid decision by the Swedish central bank to raise interest rates. Over the course of the first six months of 2022, it has also become apparent that high inflation is not going away any time soon, and that the zero interest rate environment is definitely over in Sweden. However, rising interest rates tend to benefit bank margins, particularly for banks with a high share of customer deposits, and savings banks are well positioned to cope with a downturn in the economy, given their exceptional capital ratios and strong regional positions.

This analysis looks at trends in the Swedish savings bank sector in the first half of 2022, as well as our expectations for the remainder of the year. Our sample consists of 10 of the largest savings banks in Sweden.

SIGNIFICANT REAL-ESTATE EXPOSURE INCREASES VULNERABILITY

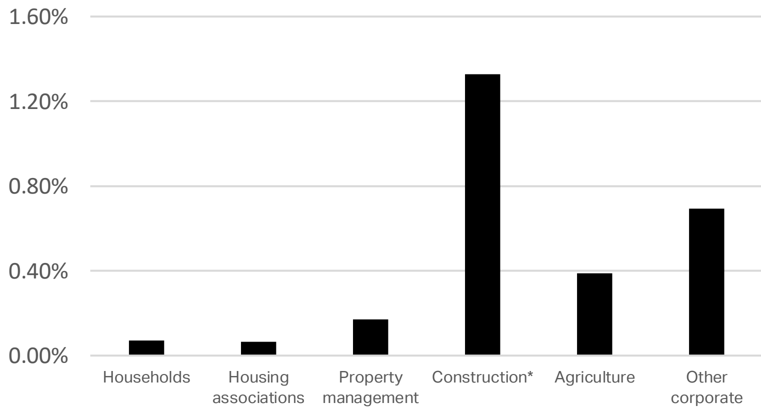
Economic uncertainty is growing as inflation persists amid the war in Ukraine and continued supply limitations. Combined with rapidly rising interest rates, households and companies alike have seen their budgets shrinking and sentiment about future developments is negative among both groups, especially among households. Maintained economic growth and strong unemployment levels suggest a housing market crash is unlikely, although prices are expected to continue to decline from record highs. The real-estate sector has faced deteriorating market sentiment in the first half of 2022, with equity valuations dipping ever since interest rates started rising, and bond spreads widening sharply (see Rising interest rates dampen outlook for Swedish real estate, 13 Jun. 2022). We do not believe Swedish savings banks will materially increase their exposure to the property management sector, both due to internal guidelines and because most of their customers are not present in the bond market and will therefore not need to refinance maturing bonds with bank debt.

Figure 1. Average sector exposure in loan book (net), 30 Jun. 2022



Source: bank reports. Average of 10 savings banks.

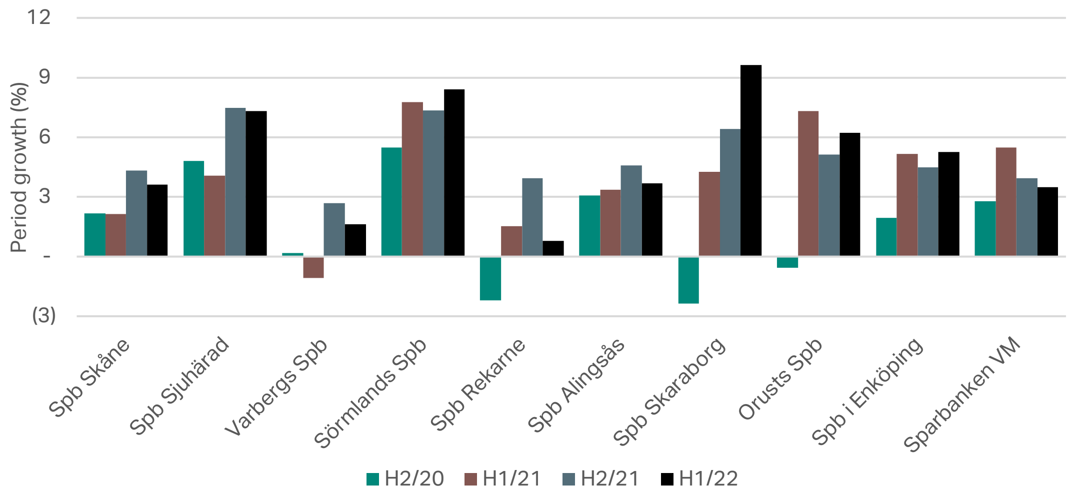
Figure 2. Average loan provision ratios by sector, 30 Jun. 2022



Source: bank reports. Average of 10 savings banks. Loan provisions over gross loans.
*Average is elevated by extraordinarily large provisions by Orusts Spb and Sparbanken VM.

Net loan growth varied between the banks in our sample in the first half of 2022. The mortgage market was red hot in the first quarter, but cooled quickly in the second as the cost of borrowing rose dramatically. We expect that loan growth will be slower in the second half of 2022, due to a continued sluggish housing market (albeit with less pronounced price decreases in the savings banks' regions than in the larger cities) and companies' reluctance to make major investments.

Figure 3. Net loan growth, H2 2020–H1 2022

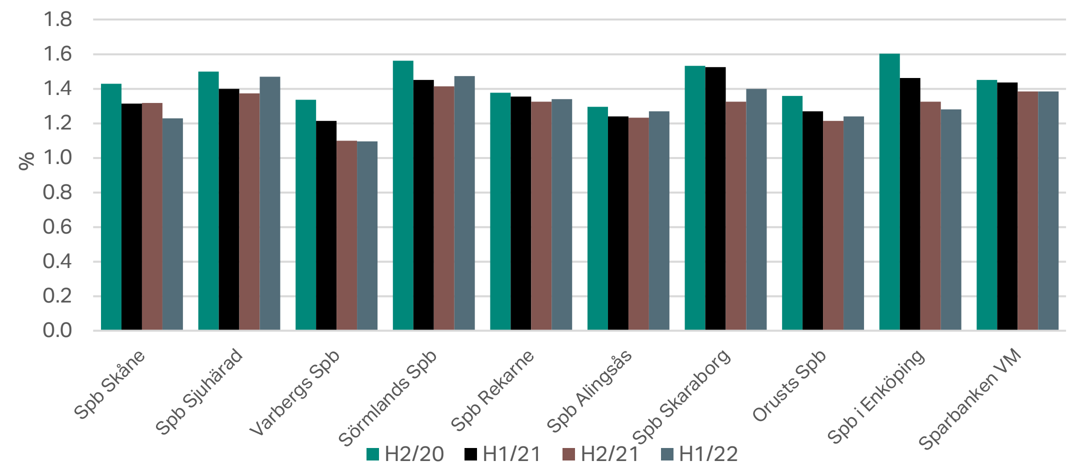


Source: bank reports.

MARGINS EXPECTED TO IMPROVE AS INTEREST RATES RISE

The interest rate trajectory shifted rapidly in the first half of 2022, from expectations of continued zero rates throughout 2022 and the next few years, to increasing expectations of rate hikes at each central bank meeting. These expectations have so far been realised. Over the past decade or so, savings banks, along with larger financial institutions, have generally floored retail deposit rates at 0%. However, interest margins have been squeezed as low market rates limit banks' lending rates, especially given the strong competition in mortgage lending. Consequently, we now expect savings banks' margins to improve as interest rates rise. This has not yet been seen in most banks' mid-year reports, as funding costs have increased faster than lending rates. However, we expect bank interest margins to improve over the remainder of 2022, with the full effect not expected to be seen until funding costs stabilise.

Figure 4. Net interest margin, annualised, H2 2020–H1 2022



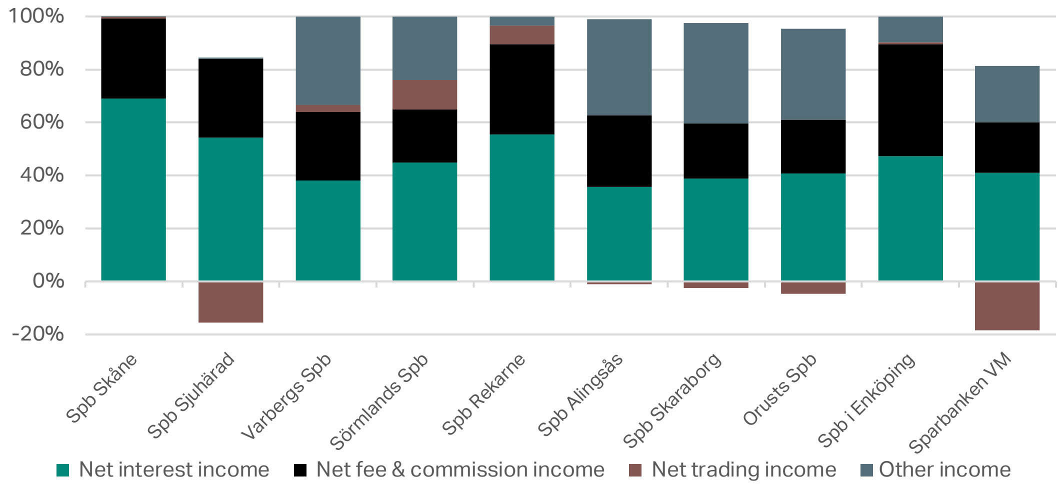
Source: bank reports.

EARNINGS BOOSTED BY SWEDBANK DIVIDENDS

Net fee and commission income decreased overall in the first half of 2022, largely driven by lower fund commission as falling values in the capital markets have driven down asset values during the period. In addition, margins on loans transferred to Swedbank Hypotek AB decreased, since the fees received lag funding costs as market rates rise.

A number of the savings banks in our sample view dividends from Swedbank AB as a core part of their earnings. However, payments have been irregular over the past few years due to restrictions during the pandemic. Swedbank paid dividends for 2021 earnings as expected in the first half of 2022, and we anticipate stable dividends for the foreseeable future. Net trading income accounted for a large share of earnings in the period for a couple of the banks, due to adverse movements in their interest rate derivatives and the revaluation of liquidity portfolios. As much of this effect is related to valuation changes on interest rate hedges, we expect most positive and negative developments to level out over time.

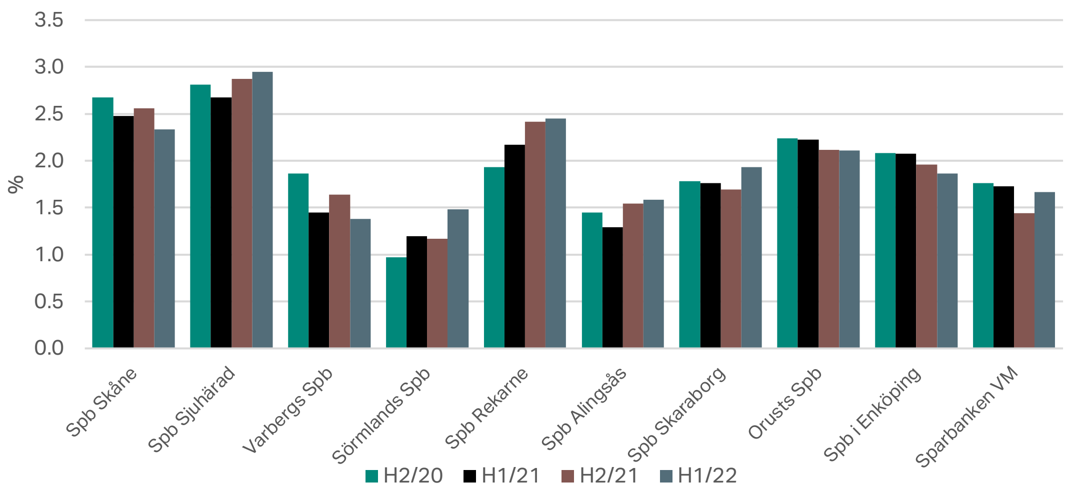
Figure 5. Distribution of earnings, H1 2022



Source: bank reports. Sparbanken Skåne, Sjuhärad and Rekarne are partly owned by Swedbank and do not own shares in Swedbank.

There is no clear trend among our sample of savings banks in the development of core pre-provision income (defined as net interest income plus net fee and commission income, less operating expenses) as a percentage of risk exposure amount (REA). However, all banks remain roughly in line with their risk-adjusted earnings over the past year and a half. Savings banks generally have lower risk-adjusted earnings due to favouring stability over maximising profit, but we expect improvements going forward due to higher margins as interest rates increase.

Figure 6. Core pre-provision income as a percentage of REA, H2 2020–H1 2022

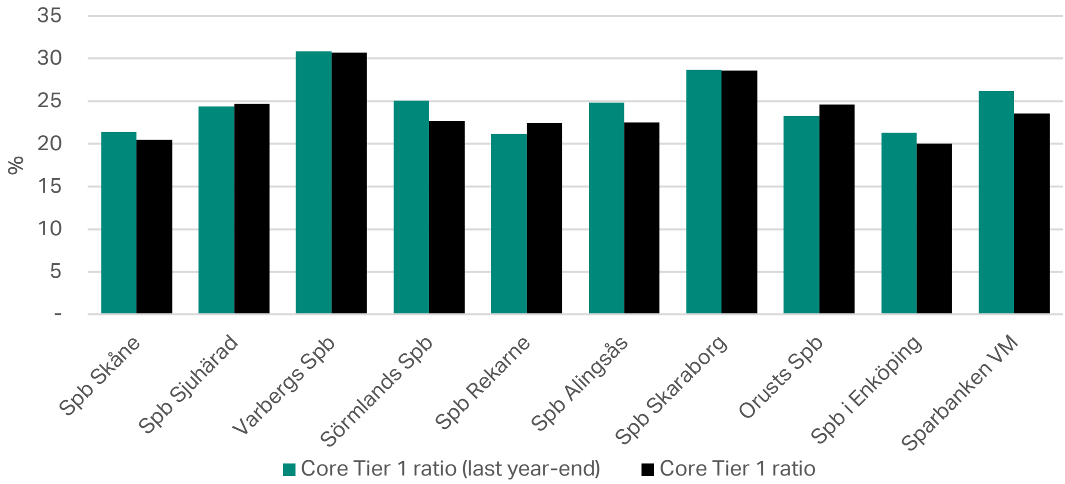


Source: bank reports. REA–Risk exposure amount.

CAPITAL VERY STRONG DESPITE FALL IN SWEDBANK SHARE PRICE

Swedish savings banks generally have exceptionally strong core capital ratios. Ratios were boosted in 2021 by the implementation of the 'SME rebate', which allocated lower risk weights to smaller and medium enterprises for banks using the standardised model. Banks owning Swedbank shares were negatively affected in the period by the decline in Swedbank's share price, though most of the pricing impact does not affect capital and capital ratios, which remained very strong and in line with year-end 2021.

Figure 7. Core Tier 1 ratios, 30 June 2022

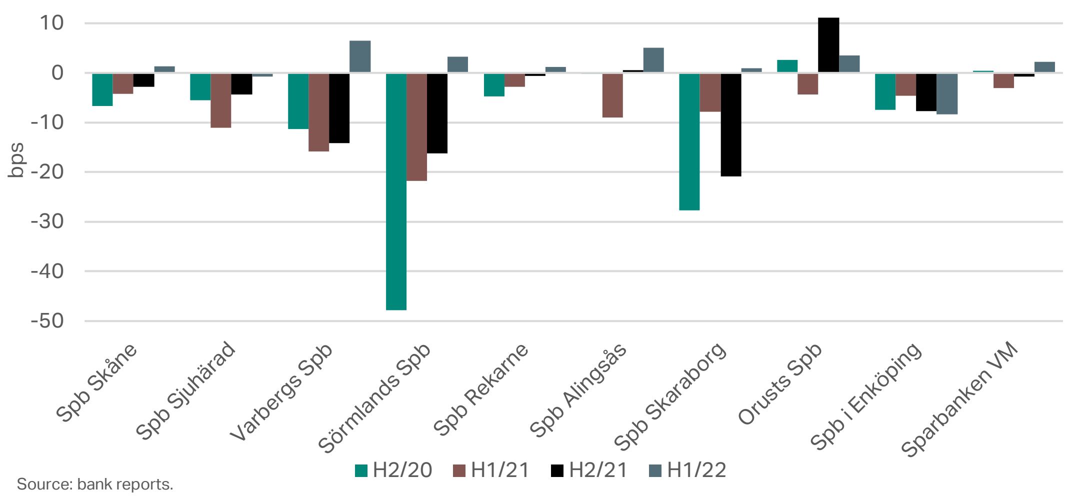


Source: bank reports.

PROVISIONS REMAIN VERY LOW

During the COVID-19 pandemic, most banks made extra provisions beyond those stemming from macroeconomic models and individual exposures. As the economic impact of the pandemic proved smaller than initially feared, these provisions have been reversed. At the beginning of 2022, we saw 'business-as-usual' provisions in bank reports. In the second quarter, however, several banks once again added model-based provisions to insure against a potential downturn following the outbreak of the war in Ukraine. We believe higher borrowing costs and inflation impacts will become more difficult for cyclical businesses, as well as those that have been struggling throughout the pandemic, as economic activity slows. We expect this to result in a higher risk of defaults and bankruptcies among bank clients. However, the savings banks are well capitalised and, in our opinion, their close relationship with customers should help them weather a harsher economic climate.

Figure 8. Bi-annual loan loss provisions as a percentage of net loans, H2 2020–H1 2022

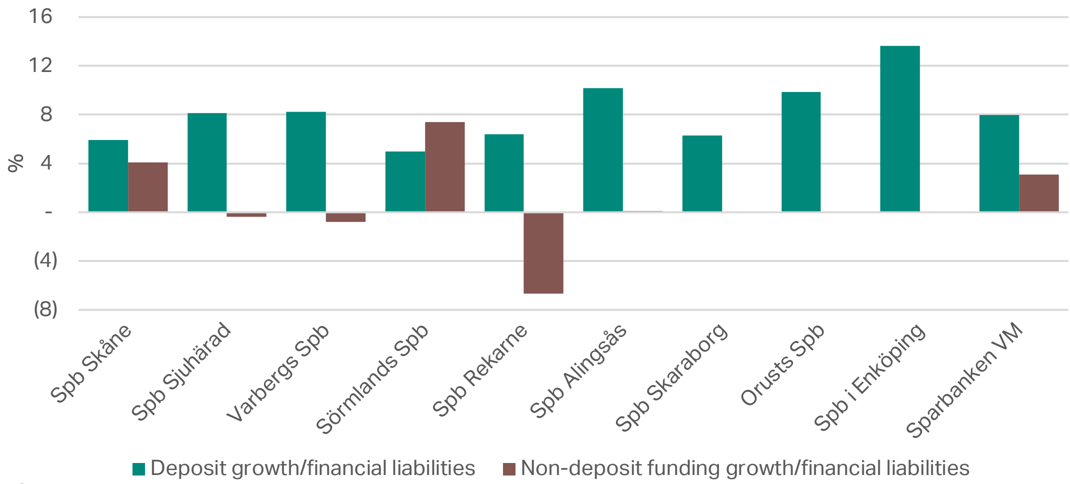


Source: bank reports.

COMPETITION FOR DEPOSITS INCREASING FUNDING COSTS

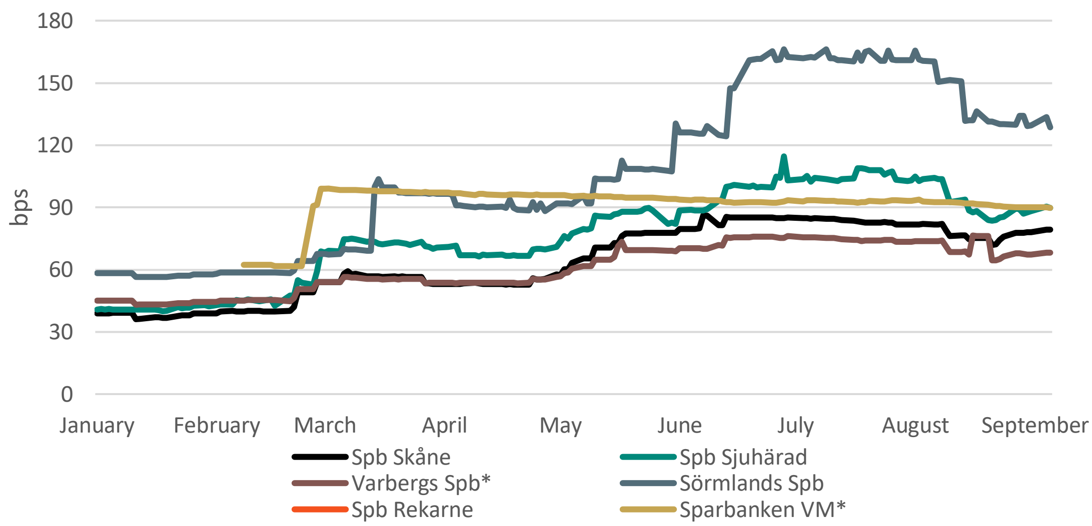
Funding costs have increased faster than lending rates, but there is little cause for concern over the ability of the banks in our sample to access funding. Many of the savings banks have so far kept the 0% interest on current accounts, but we expect this to change in the second half of the year as more and more banks raise deposit rates. Although the savings banks are generally well funded, demand for deposit funding is growing in the broader sector, given the instability and widening spreads in the capital markets. In addition, higher borrowing costs and inflation could eat into what have been historically high savings rates in Sweden over the past decade and reduce the supply of deposits. The savings banks generally hold a strong position in their local markets, with strong customer loyalty, which has helped them keep deposit rates down and lending rates up, and we expect them to avoid the fiercest price competition even as deposit rates climb above zero.

Figure 9. Funding source growth over the last 12 months



Source: bank reports.

Figure 10. Bond spreads on a selection of instruments maturing in 2024, 3 Jan. 2022–9 Sep. 2022



Source: Capital IQ. *Issued under a green framework.

NCR-RATED SAVINGS BANKS

Figure 11. 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	Positive	Stable
Subfactors:				
Operating environment (20%)	bbb	bbb-	bbb	bbb+
Risk appetite (50%)	a-	a	a	a
Competitive position (15%)	bbb	bb+	bbb	bbb+
Performance indicators (15%)	a	a-	bbb-	bbb+
Ownership adjustment	n/a	n/a	n/a	n/a

See NCR's company reports for details. n/a–Not applicable.

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