Sparbanken Rekarne AB (publ)

Full Rating Report

LONG-TERM RATING

A-

OUTLOOK

Stable

SHORT-TERM RATING

N2

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RATING RATIONALE

Our 'A-' long-term issuer rating on Sweden-based Sparbanken Rekarne AB (publ) reflects the bank's strong loss history, modest risk appetite and relationship-based funding profile. We view the bank's 50% ownership by Swedbank AB as positive. Cooperation with Swedbank enables material diversification of product offerings, shared IT costs, and the opportunity to finance retail and commercial mortgages.

The rating is constrained by the bank's concentrated exposure to the Södermanland region, which has historically experienced volatility as a key manufacturing region. We project increased credit losses over the next two years as the economy slows and see increasing risk associated with the bank's high levels of real-estate lending.

STABLE OUTLOOK

The outlook is stable, reflecting our expectation that Sparbanken Rekarne will maintain its strong capital buffers and benefit from improvements in earnings as interest rates rise. It also reflects projections of population and economic growth in the region, as well as the bank's modest risk appetite, despite our expectations of higher credit losses as the economy slows. The outlook also takes account of the bank's continuing relationship with Swedbank and the potential for capital support from the larger bank, should the need arise.

POTENTIAL POSITIVE RATING DRIVERS

- An upgrade is unlikely at this time given the uncertain economic environment.

POTENTIAL NEGATIVE RATING DRIVERS

- A sustained reduction in the common equity Tier 1 (CET1) capital ratio to below 18%, combined with reduced ownership by Swedbank.
- A material deterioration in asset quality metrics.
- A long-term economic recession in the bank's operating region that negatively affects economic activity and employment.

Figure 1. Sparbanken Rekarne key credit metrics, 2018–2024e

%	2018	2019	2020	2021	2022e	2023e	2024e
Net interest margin	1.4	1.5	1.4	1.3	1.6	1.8	1.8
Loan losses/net loans	0.01	0.03	0.03	-0.03	0.11	0.20	0.19
Core pre-provision income/REA	2.5	1.7	2.1	2.3	3.0	3.7	3.7
Return on ordinary equity	13.4	11.7	10.3	15.0	10.0	10.7	10.3
Loan growth	18.5	14.2	-4.7	5.5	2.0	3.0	4.0
CET1 ratio	16.3	15.6	18.1	21.2	22.7	23.7	24.6
Tier 1 ratio	16.3	15.6	18.1	21.2	22.7	23.7	24.6

Based on NCR estimates and company data. e–estimate. REA-risk exposure amount. All metrics adjusted in line with NCR methodology.

ISSUER PROFILE

Sparbanken Rekarne is a savings bank, with ownership evenly divided between Swedbank and the Sparbanken Rekarne foundation. Sparbanken Rekarne is based in Eskilstuna, with branches in the municipalities of Strängnäs and Mariefred, in the county of Södermanland on the southern shore of Lake Mälaren. The bank cooperates with Swedbank, which provides material product diversification, shared costs on IT solutions and the opportunity to finance retail mortgages via Swedbank Hypotek, Sweden's largest issuer of covered bonds. However, Swedbank's 50% ownership distinguishes the bank from most other savings banks by increasing its focus on achieving return targets set by its owners.

Figure 2. Sparbanken Rekarne core markets

Municipality	Population, June 2022	Expected population change, 2021–2040	Unemployment, Sept. 2022	Unemployment, Sept. 2021
Eskilstuna	107,956	6.9%	11.7%	12.8%
Strängnäs	38,382	13.1%	6.4%	7.1%
Sweden	**10,487,859**	**8.9%**	**6.6%**	**7.5%**

Source: Statistics Sweden, Arbetsförmedlingen (Swedish Public Employment Service).

OPERATING ENVIRONMENT

Operating environment assessment 'bbb'

We consider a balance of national and regional factors in our assessment of the operating environment. Sparbanken Rekarne operates in a narrow market, with a high level of exposure to the local economy, which has higher unemployment and has proven more volatile than the Swedish average, given the importance of the manufacturing sector.

National economy weakening

National factors 'a-'

Despite slowing economic activity and falling housing prices, we anticipate that Swedish banks will generally benefit from higher interest rates. We expect the economy to slow in 2023 as the country adapts to higher borrowing and energy costs, although strong public finances support our outlook for the wider banking sector. In addition, we expect the government to repeat its recent support for households if energy prices reach unaffordable levels in the months ahead.

Domestic inflation rates remain exceptionally high, which, combined with rising interest rates and high energy prices, is putting significant pressure on many households. However, unemployment remains moderate despite expectations of a recession in 2023. This strengthens our belief that housing prices are falling back from recent unjustified highs, with buyers and sellers reluctant to accept higher borrowing costs. We expect housing prices to decline in the immediate term before levelling out later in 2023, allowing for some regional differences.

Despite some concern about their significant real estate exposures, Swedish savings banks are currently in good health both in terms of earnings and capital (see *Swedish savings banks end turbulent first half of 2022 in good shape*, 12 Sep. 2022). Rising interest rates have only started to translate into higher interest margins, but we expect margins to improve significantly given interest rate expectations, even as the banks start raising deposit rates.

Regional economy likely to grow less than the national average over the next few years

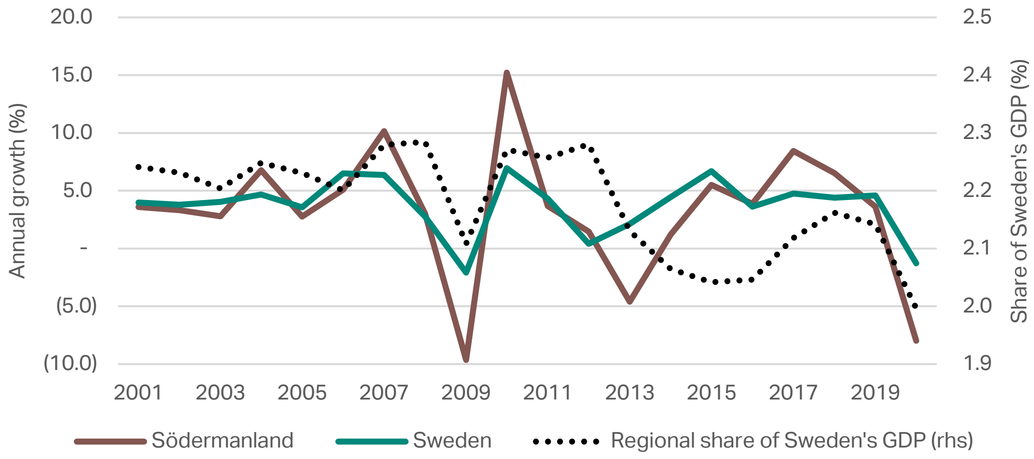
Regional, sectoral, and cross-border factors 'bbb-'

The economy of Södermanland County, where Sparbanken Rekarne operates, has historically been more volatile than the wider Swedish economy, given cyclicality in demand for vehicles and heavy equipment. The county has nearly 300,000 inhabitants, half of whom live in locations with a Sparbanken Rekarne branch.

The bank's core markets are reliant on manufacturing, which has been negatively affected by rising commodity prices, disruptions in the global supply chain, and sanctions against Russia. The municipalities of Eskilstuna and Strängnäs have 14–16% of workers employed in manufacturing (compared with 12% at national level) and an above-average share of employment in the education sector, owing to the presence of Mälardalen University. The bank's core markets have also seen growth in the construction of residential housing and public transport to accommodate the expected population expansion and reduce travel time to Stockholm, which has driven recent economic growth. For this reason, construction is another important, yet cyclical, source of employment in the region.

The county, which accounts for about 2% of the Swedish economy, has had three periods of declining GDP in the last 15 years but was making a strong recovery from the COVID-19 pandemic. Unemployment levels in the bank's core markets have improved since 2020, but remain high in Eskilstuna, due to a relatively large proportion of immigrants, among whom unemployment is high. We expect the regional economy to grow less than the national average in 2023 and 2024 as economic activity slows.

Figure 3. Södermanland's annual economic growth and regional share of Sweden's GDP, 2001–2020



Source: Statistics Sweden

RISK APPETITE

Risk appetite assessment 'a-'

Sparbanken Rekarne has improved its capital ratios, though it operates with a more leveraged capital profile than most Nordic savings banks. As a regional bank, it has natural portfolio concentrations in its local market, particularly in the real-estate sector.

Risk governance in line with mid-sized savings banks

Risk governance 'a-'

Sparbanken Rekarne has a relatively high standard of internal reporting of its risk appetite and limits, and provides monthly reports to the board of directors. After creating its own tools for many years, the bank is increasingly cooperating with Swedbank and other regional savings banks with respect to compliance risk oversight and use of anti-money laundering and know-your-customer tools.

Sparbanken Rekarne incorporates environmental, social and corporate governance (ESG) factors using sustainability criteria in its credit decisions and is part of a savings-bank-driven pilot project for using sector-based ESG evaluation tools. The bank is hiring a sustainability manager and is in the early stages of developing a green bond framework and evaluating the environmental impact of its customers' operations and physical and transitional risk in its real estate exposure.

Improvements to capital buffers continue

Capital 'a'

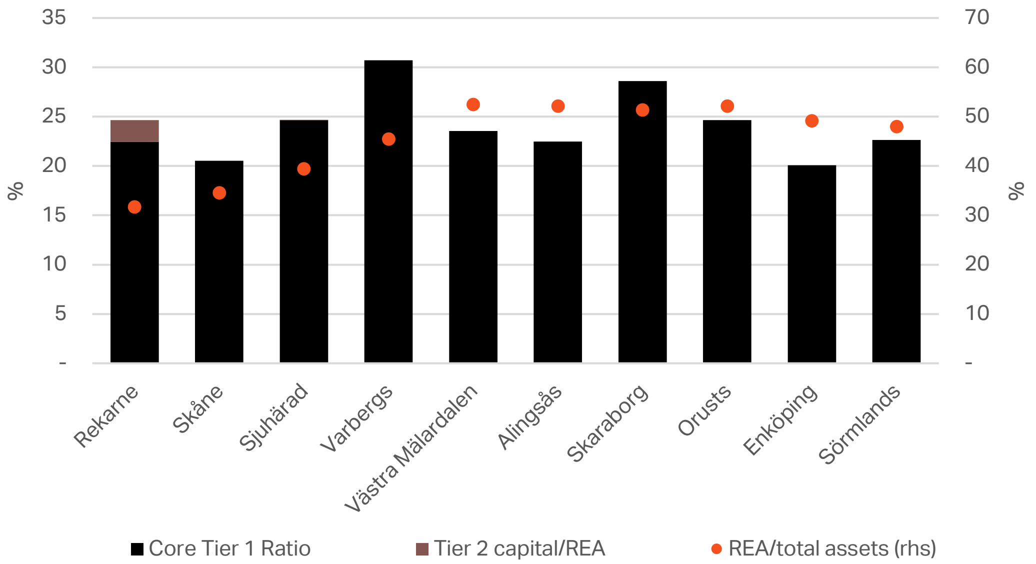
Sparbanken Rekarne's capital ratios have improved materially in recent years. The CET1 ratio was 22.4% as of 30 Sep. 2022 (about 23% including third quarter profits), 6.8pp higher than at end-2019. Improvements in the ratio have been driven by a strategic reduction in specific corporate exposures and the withholding of dividend payments for 2019 and 2020. In our view, these capital improvements have repositioned the bank well to meet future changes in capital requirements and enabled it to close the gap with its Nordic peers.

Sparbanken Rekarne's capital ratios are difficult to compare with those of its regional peers and mask the bank's higher leverage. This is because the bank uses internal capital models, which result in much lower average risk weights than for peers using standard capital models. In addition, the bank has ambitious return-on-equity targets due to Swedbank's 50% ownership stake. In our view, the combination of these factors explains why Sparbanken Rekarne's leverage is higher than that of other Swedish savings banks.

To improve comparability within the peer group, we consider an adjusted ratio and the bank's relatively high leverage in our assessment of capital and earnings. Our adjustment takes into account the fact that the bank's average REA of 32% is well below the 47% average among its closest peers. Our assessment considers that the bank's CET1 ratio would be 20% lower with an average risk weight of 40%. For this reason, our forecast CET1 ratio of 23-24% is comparable with an adjusted CET1 ratio of 18.4%-19.2%.

Our forecast projects further improvement in the bank's capital ratios. Our projections reflect loan growth of 2-4% through 2024 and improved margins and cost efficiency, resulting in a projected CET1 ratio of over 24% by end-2024. Our projections include a dividend pay-out ratio of 30%, which adds some capital flexibility.

Figure 4. Sparbanken Rekarne and domestic peers' capital ratios and REA/total assets, 30 Jun. 2022



Source: bank reports.

Bond financing lower due to increased deposits

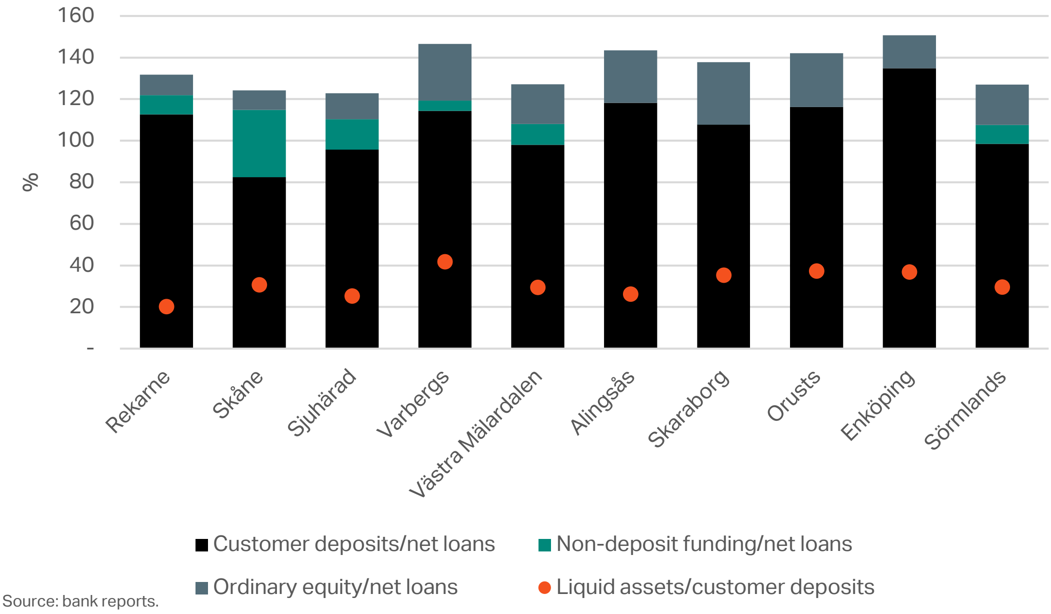
Funding and liquidity 'a'

We regard Sparbanken Rekarne's funding and liquidity position as strong. It has a high share of relationship-based retail deposits and the ability to transfer mortgage loans to Swedbank's mortgage arm, Swedbank Hypotek. As of 30 Sep. 2022, the bank's net stable funding ratio was nearly 150% and the liquidity coverage ratio is regularly above 300%, well above regulatory and internal limits. As a result of slower growth in the loan book and strong deposit growth, the loan-to-deposit ratio had fallen below 90% as of 30 Sep. 2022, down from 111% at end-2019.

Sparbanken Rekarne's currently strong liquidity position has enabled the bank to repay recently maturing bonds, reducing its outstanding debt by nearly 50% from its peak to SEK 1.2bn as of 30 Sep. 2022. We anticipate that the bank will refinance SEK 0.8bn in outstanding senior unsecured bonds maturing during 2023, possibly issuing a first green bond in the course of the year. In addition, the bank has a SEK 400m credit facility from Swedbank and retains the ability to transfer mortgage loans to Swedbank Hypotek in exchange for commission. The bank's internal liquidity stress testing and survival horizon support our view that its liquidity is adequate.

Sparbanken Rekarne's cooperation with Swedbank provides various funding benefits. The bank has transferred SEK 7.7bn in residential mortgages to Swedbank Hypotek, which pays commission in return. Transfers to Swedbank Hypotek have decreased by SEK 2bn since end-2017, in large part due to a reduction in transferred commercial real estate loans, but we continue see the relationship as supportive of the bank's liquidity management.

Figure 5. Sparbanken Rekarne funding profile vs Swedish savings bank peers', 30 Jun. 2022



Source: bank reports.

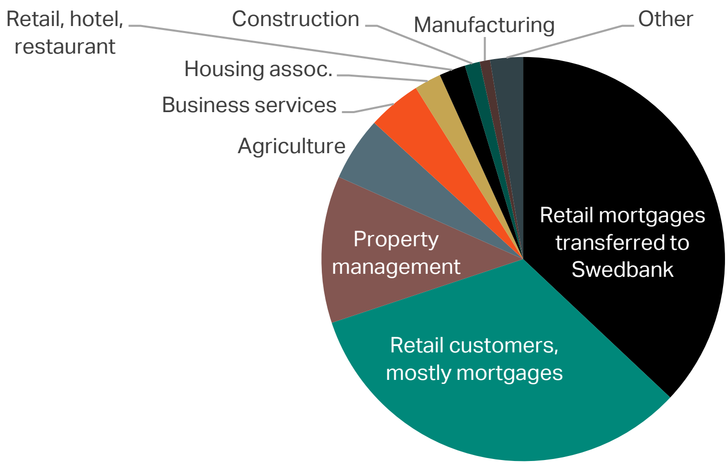
Credit risk concentration in regional real-estate lending

Credit risk 'bbb-'

Sparbanken Rekarne's regional profile creates geographic risk concentrations, as well as a material concentration of real-estate collateral in and around Eskilstuna and Strängnäs. The bank's lending exposures are associated with retail and commercial mortgages on existing property, with 85% of on-balance-sheet loans associated with residential, commercial or agricultural properties (see Figure 6), as well as an additional SEK 7.7bn in transferred mortgages. We are increasingly concerned about risk in the commercial real estate sector due to sharply higher interest rates and tenants facing high inflation and recession risk.

The bank has made a targeted reduction in loan exposure to commercial real-estate development, particularly in housing associations since 2020, in an effort to improve its capital position and diversify its corporate loan book. It has also increased the share of retail mortgage and SME loans on its own balance sheet and reduced its volume of loans transferred to Swedbank. The bank has a first-loss risk associated with the transferred loans that results in a reduction in paid commission when write-downs of transferred loans occur. The maximum risk on transferred loans is SEK 40–45m per year, or the amount of reported loan commission income.

Figure 6. Sparbanken Rekarne total net lending by segment, 30 Sep. 2022



Source: company.

The high concentration of local real estate collateral could be negatively affected by significant climate events or flooding in the region's lakes and waterways, which in turn could pressure collateral values. In addition, increased climate volatility and higher temperatures could affect the performance of farming and forest operations in the region.

The bank's lending is focused on individuals and SMEs with operations in their core markets, which leads to geographic concentration. The manufacturing industry is a significant employer in the region and, despite a low proportion of loans extended to manufacturing, many of the bank's exposures could be affected by volatility at the region's largest manufacturers as the economy slows.

Low market risk tolerance

Other risks 'a'

In our view, market risk is not a material risk factor for Sparbanken Rekarne, given the lack of a trading portfolio, low limits on interest rate risk, and insignificant foreign currency exposure. The bank proactively transfers loans with longer maturities to Swedbank to reduce interest risk on its own books. The liquidity portfolio contains some spread and counterparty risk, but most of the exposure is to highly rated counterparties.

Sparbanken Rekarne has strategic ownership stake in Indecap Holding AB and Sparbankernas Försäkring AB (jointly owned with other savings banks) and holds 20% of the shares in Portfolio Försäkra AB and two smaller ownership stakes.

COMPETITIVE POSITION

Competitive position 'bbb'

Sparbanken Rekarne has a strong position in its core markets and among local individuals and SMEs. The bank claims a market share of 40–50% among retail and corporate customers in Eskilstuna and 28–35% in Strängnäs. However, at national level, the bank accounts for only about 0.4% of retail deposits and residential mortgage loans, including loans transferred to Swedbank. Recent growth has been focused on Strängnäs, where the bank has a smaller share of the market and which is experiencing strong growth due to its proximity to Stockholm. The bank faces local competition from all of Sweden's national banks, and the largest corporations in the region are typically served by the country's larger banks.

We consider Sparbanken Rekarne's meaningful role and contributions to its local market as a positive rating factor given its strong sense of social responsibility to its local communities.

PERFORMANCE INDICATORS

Performance indicators 'a'

We expect Sparbanken Rekarne's core earnings to improve materially due to higher interest rates and improving net interest margins. The bank maintains strong asset quality, despite an increase in reported non-performing loans in the third quarter of 2022 due to implementation of the EU's New Definition of Default (NDoD). We project increased credit losses as the economy moves towards possible recession in 2023 but expect an overall improvement in net profit due to increased net interest income.

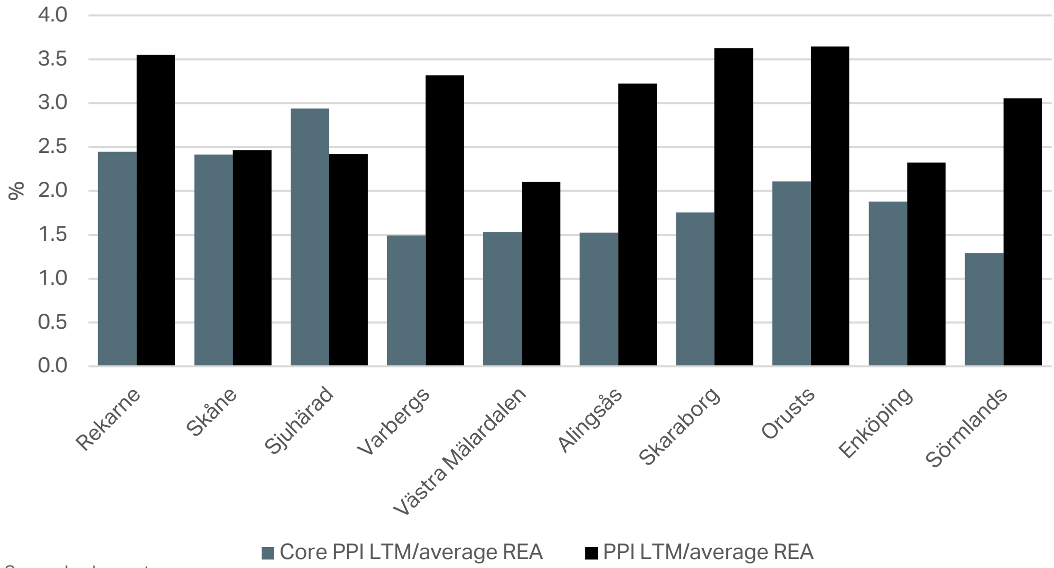
Higher margins drive core earnings and efficiency

Earnings 'a-'

We expect rising interest rates to improve Sparbanken Rekarne's net interest margins significantly after years of margin pressure due to low interest rates and tough competition for mortgage loans. We also expect that higher interest rates will eventually improve margins on loans transferred to Swedbank, which have fallen in the course of 2022 due to a lag between the realisation of higher lending rates and the more immediate impact of Swedbank's STIBOR-linked funding costs.

Sparbanken Rekarne's core earnings metrics are set to improve as a result of higher lending margins. We project cost efficiency will enable the bank to achieve internal goal of a 50% cost-income ratio by the end of 2023. We project the bank's core risk-adjusted earnings will improve to 3.7% in 2023 and 2024. In our earnings assessment, we make a similar adjustment for the bank's REA as described in the capital section above and project core pre-provision income on REA of just below 3.0% for 2023 and 2024.

Figure 7. Swedish savings banks' PPI to REA, LTM to 30 Jun. 2022



Source: bank reports.

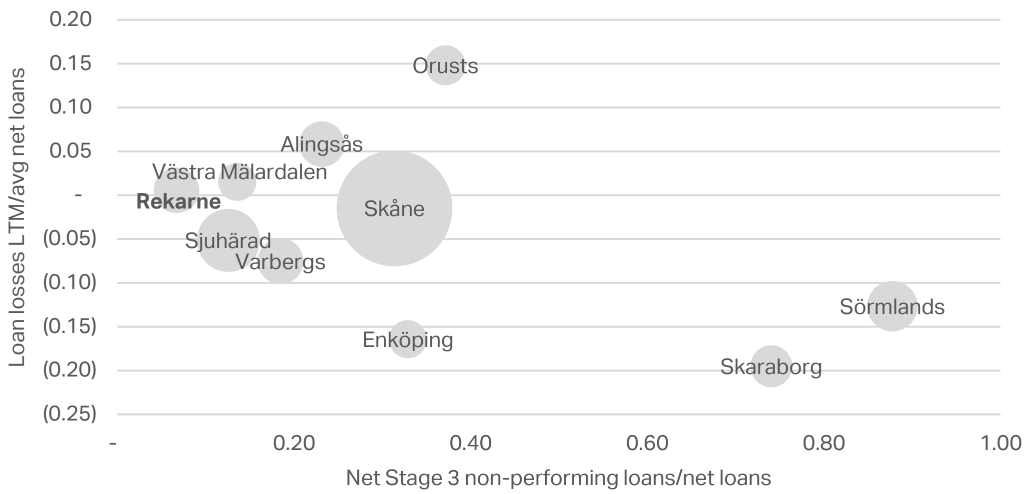
Non-performing loans and credit losses likely to rise

Loss performance 'a+'

Sparbanken Rekarne's loss performance has been outstanding in recent years. However, during the third quarter the bank implemented the EU's New Definition of Default regulation, resulting in an increase in net Stage 3 non-performing loans to 23bps from 7bps a quarter earlier. The implementation, which standardises the definition of forbearance and cross-default for a borrowers' loans, led the bank to report 7bps of loan provisions in the third quarter.

We project that Sparbanken Rekarne will have higher credit losses in 2023 and 2024 (around 20bps) due to a slowing economy and the possible negative impact on regional customers.

Figure 8. Swedish savings banks' asset quality metrics (%), 30 Jun. 2022



Source: bank reports. LTM-last 12 months.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS

Moderately positive aggregate ESG impact

We consider ESG factors throughout our analysis, where they are material to the credit assessment (see Figure 9). In aggregate, we view the bank's ESG profile as having a moderately positive impact on its creditworthiness.

Figure 9. Sparbanken Rekarne priority ESG factors

Issue/area	Risk/opportunity	Impacted subsections (impact on credit assessment*)
Physical climate risk to collateral	Climate-related damage to real estate collateral (closely linked to supervision of insurance). Longer-term term effects on market values in flood risk areas.	Credit risk (-) Loss performance (0)
Social engagement in local community	Close connection to narrow regional markets provides a benefit.	Competitive position (++) Funding & liquidity (+) Earnings (+)
Anti-money laundering capacity	Risk of sanctions and fraud. Insufficient control of customers.	Risk governance (0)
Control of sustainability issues	Risk of overlooking sustainability impacts on underwriting, operations, and customer base.	Risk governance (0) Credit risk (0)

*Defined on a 5-step scale ranging from double minus (--) to double plus (++), with (--) representing the most negative impact and (++) the most positive. See ESG factors in financial institution ratings.

ADJUSTMENT FACTORS

Support analysis

Support analysis neutral

Sparbanken Rekarne's ownership is split 50/50 between Swedbank and the Sparbanken Rekarne foundation. We view the benefit of Swedbank's ownership as valuable, but do not include an additional notch in excess of our already strong 'a-' standalone assessment of Sparbanken Rekarne. While the foundation could also provide additional capital from its liquid assets, we note that a majority of its assets are invested in shares in Swedbank and Sparbanken Rekarne, likely reducing their value during a period of stress.

ISSUE RATINGS

Our rating on Sparbanken Rekarne's unsecured senior debt is in line with the issuer rating, i.e. 'A-'. We also rate issues under a medium-term note programme 'A-'. We rate an outstanding Tier 2 instrument 'BBB+', reflecting its subordination to senior debt instruments.

Figure 10. Sparbanken Rekarne key financial data, 2017–Q3 2022 YTD

Key credit metrics (%)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	Q3 2022 YTD
INCOME COMPOSITION						
Net interest income/op. revenue	42.3	46.0	57.9	58.7	49.0	62.2
Net fee income/op. revenue	53.8	48.1	37.6	36.2	35.2	33.0
Net trading income/op. revenue	3.3	4.1	2.3	2.2	5.6	2.3
Net other income/op. revenue	0.6	1.8	2.2	2.9	10.1	2.4
EARNINGS						
Net interest margin	1.4	1.4	1.5	1.4	1.3	1.5
Pre-provision income/REA	3.2	3.0	2.0	2.4	3.4	3.2
Return on ordinary equity	11.7	13.4	11.7	10.3	15.0	10.4
Return on assets	0.8	0.9	0.8	0.7	1.0	0.8
Cost-to-income ratio	64.9	64.3	68.7	61.4	53.1	53.3
Cost-to-income ratio, ex. trading	67.1	67.0	70.3	62.8	56.3	54.5
CAPITAL						
CET1 ratio	18.6	16.3	15.6	18.1	21.2	22.4
Tier 1 ratio	18.6	16.3	15.6	18.1	21.2	22.4
Capital ratio	21.6	18.7	17.6	20.1	23.3	24.6
REA/assets	33.2	35.0	38.3	33.9	32.3	31.9
Dividend payout ratio	33.0	30.8	29.0			30.0
Leverage ratio	5.9	5.5	5.7	5.9	6.6	7.0
GROWTH						
Asset growth	6.7	17.1	10.7	9.7	2.8	-1.3
Loan growth	6.0	18.5	14.2	-4.7	5.5	1.4
Deposit growth	6.1	4.2	6.1	13.9	8.9	1.3
LOSS PERFORMANCE						
Credit provisions to net loans	0.03	0.00	0.03	0.01	-0.03	0.09
Impaired loans to gross loans	0.18	0.14	0.19	0.14	0.11	0.30
Net impaired loans to gross loans	0.06	-0.01	0.04	0.02	0.01	0.15
Net problem loans to equity	0.72	-0.08	0.53	0.21	0.10	1.50
Non-performing loan coverage ratio	64.56	104.44	77.90	86.86	91.05	49.30
Stage 3 loans/gross loans	0.17	0.14	0.19	0.14	0.11	0.30
Net stage 3 loans/net loans	0.10	0.08	0.12	0.08	0.05	0.23
FUNDING & LIQUIDITY						
Loan/deposit ratio	90.4	102.9	110.8	92.8	89.9	89.9
Net stable funding ratio	125.0	141.0	129.0	126.0	147.3	149.9
Liquidity coverage ratio	329.0	328.5	296.5	348.4	323.2	337.4

Key financials (SEKm)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	Q3 2022 YTD
BALANCE SHEET						
Total assets	11,945	13,988	15,490	16,992	17,461	17,238
Total tangible assets	11,911	13,966	15,490	16,992	17,461	17,238
Total financial assets	11,273	12,580	14,635	15,081	15,832	16,157
Net loans and advances to customers	9,443	11,190	12,785	12,188	12,861	13,036
Total securities	1,182	1,226	1,340	1,522	1,577	1,649
Customer deposits	10,442	10,876	11,538	13,136	14,303	14,495
Issued securities	120	1,470	2,468	2,419	1,819	1,319
of which covered bonds	–	–	–	–	–	–
of which other senior debt	–	1,350	2,348	2,299	1,699	1,200
of which subordinated debt	120	120	120	120	120	120
Total equity	839	924	994	1,106	1,284	1,317
Total ordinary equity	839	924	994	1,106	1,284	1,317
CAPITAL						
Common equity tier 1	737	797	925	1,041	1,193	1,234
Tier 1	737	797	925	1,041	1,193	1,234
Total capital	857	917	1,045	1,161	1,313	1,354
REA	3,969	4,891	5,940	5,764	5,640	5,504
INCOME STATEMENT						
Operating revenues	361	367	343	364	419	288
Pre-provision operating profit	127	131	107	141	197	134
Impairments	4	1	4	4	-4	9
Net Income	95	118	112	108	179	101

Source: company. FY–full year. YTD–year to date.

Figure 11. Sparbanken Rekarne rating scorecard

Subfactors	Impact	Score
National factors	10.0%	a-
Regional, cross border, sector	10.0%	bbb-
Operating environment	20.0%	bbb
Capital	17.5%	a
Funding and liquidity	15.0%	a
Risk governance	5.0%	a-
Credit risk	10.0%	bbb-
Market risk	-	-
Other risks	2.5%	a
Risk appetite	50.0%	a-
Market position	15.0%	bbb
Earnings	7.5%	a-
Loss performance	7.5%	a+
Performance indicators	15.0%	a
Indicative credit assessment		**a-**
Transitions		Neutral
Peer comparisons		Neutral
Borderline assessments		Neutral
Stand-alone credit assessment		**a-**
Material credit enhancement		Neutral
Rating caps		Neutral
Support analysis		Neutral
Issuer rating		**A-**
Outlook		Stable
Short-term rating		**N2**

Figure 12. Capital structure ratings

Seniority	Rating
Senior unsecured	A-
Tier 2	BBB+

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