

Swedish savings banks well positioned for economic downturn in 2023

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2022 has been a turbulent year. Starting with a cold winter in Europe, which pushed energy prices far above normal levels, and a new wave of COVID-19, everything changed rapidly when Russia invaded Ukraine in late February. In addition to the humanitarian impact, the war has had a significant effect on economies across Europe, exacerbated by the monetary policy and stimulation throughout the pandemic.

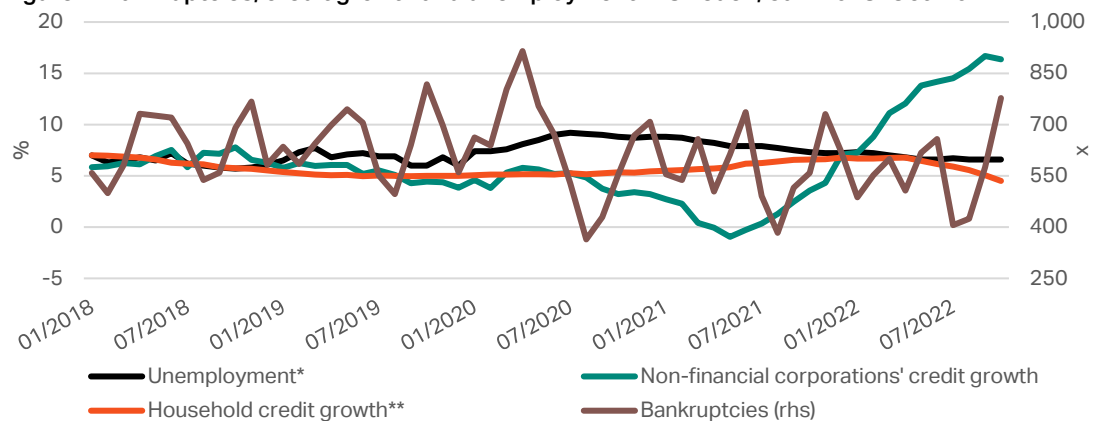
Rising interest rates are hitting both households and companies, but higher interest rates are generally beneficial for banks, as they enable higher margins. Their effect on financial performance, however, is offset by expectations of increasing loan losses, driven by IFRS 9 models responding to negative macroeconomic indicators and real difficulties among customers caused by high inflation, high interest rates and the economic slowdown.

Nordic Credit Rating (NCR) believes its rated Swedish savings banks are well positioned to face a harsher economic climate, as reflected by stable outlooks on rated savings bank.

POSSIBLE RECESSION IN 2023, BUT SWEDISH BANKS EXPECTED TO WEATHER IT WELL

Going into 2023, the operating environment for banks has changed dramatically from a year ago. NCR believes it is likely that Sweden will face a moderate technical recession next year, defined by a decline in GDP, with a subsequent increase in unemployment and bankruptcies. However, we also believe that inflation will abate during the year, easing the pressure on both households and businesses.

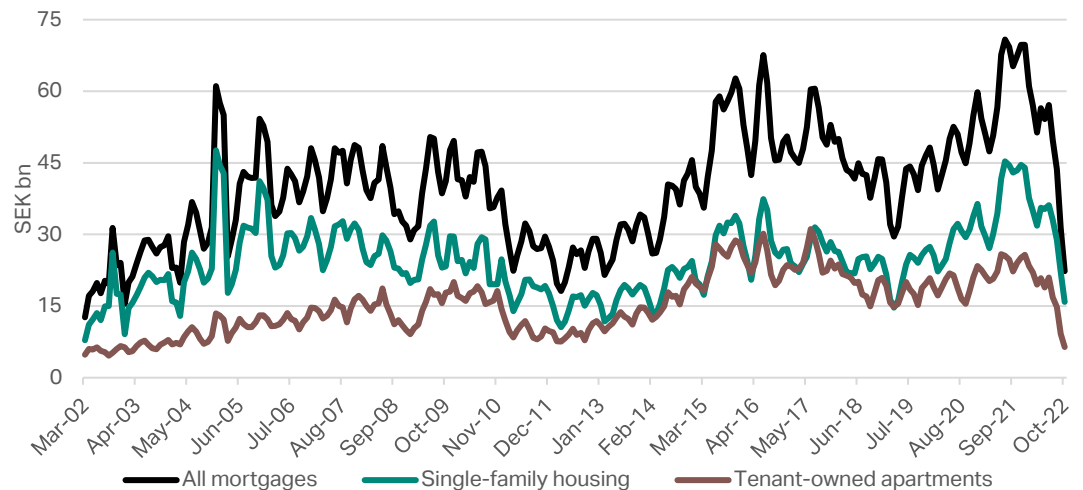
Figure 1. Bankruptcies, credit growth and unemployment in Sweden, Jan. 2018–Oct. 2022



Source: Statistics Sweden, Swedish Public Employment Service. *Calculation method changed, numbers updated from 01/01/2020.
**Consumption and mortgage loans.

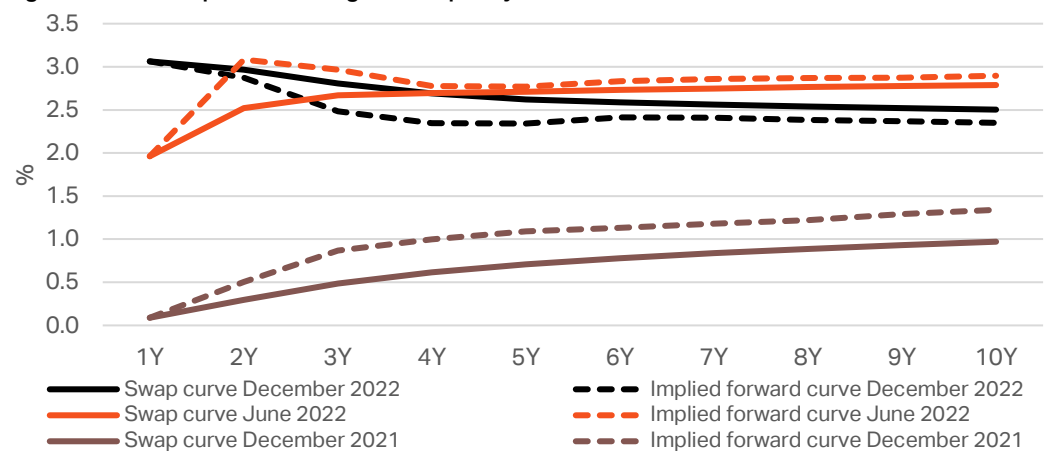
Although pressure is increasing on household budgets, especially heading into the winter amid high energy prices, mortgage defaults have historically been low in Sweden, and savings banks have the additional protection of low average loan to value (LTV) in their mortgage loan books. Nevertheless, pressure on household budgets, combined with uncertainty over future interest rates, might impact loan growth for banks, as housing prices fall and transaction volumes decrease. The third quarter saw quarterly volume growth in Swedish residential mortgage loans fall to its lowest level since 2013, due to difficulties for buyers and sellers in matching price expectations. For more about our view of the Swedish mortgage market in our quarterly summaries, see [The Swedish mortgage market](#), last updated 31 Oct. 2022.

Figure 2. Quarterly mortgage growth in Sweden, Mar. 2002–Oct. 2022



We see increasing challenges for the commercial real-estate sector, which constitutes a large part of Swedish savings banks' commercial loan books (21% of total loans on average, with an additional 3% in construction at 30 Jun. 2022). We expect higher financing costs to have a negative impact on property managers' interest coverage and property values to decline, putting pressure on LTV ratios. Falling property values are also likely to impact LTV ratios in banks' own loan books. For further details of our view of the Swedish real-estate sector, see our recent outlook ([Sweden's real-estate sector faces growing challenges](#), published 13 Dec. 2022). We do not believe Swedish savings banks will materially increase their exposure to the commercial real-estate sector, and note that they primarily lend to smaller companies that are not in need of refinancing market debt with banks.

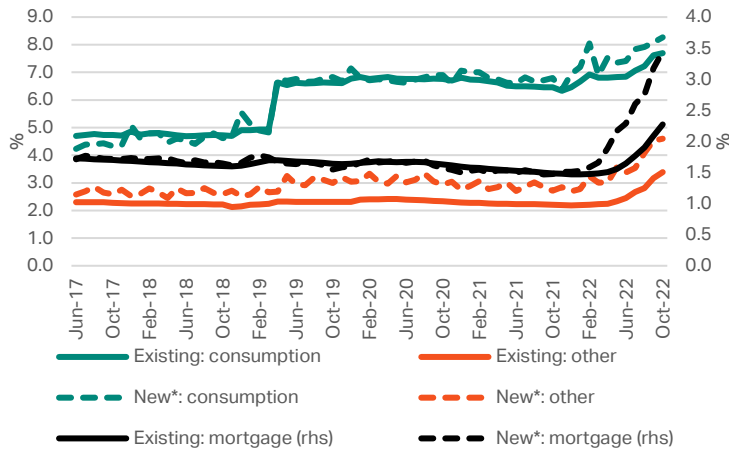
Figure 3. SEK swap rates, changes over past year



EARNINGS TO RECEIVE A BOOST FROM HIGHER INTEREST RATES

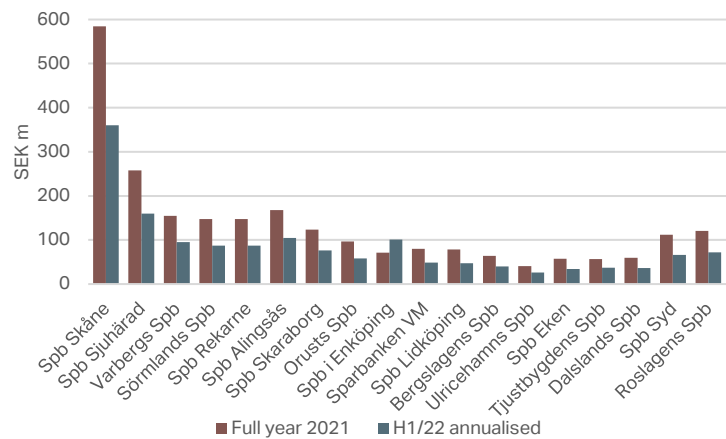
Although we believe that most of the interest rate hikes by the Swedish central bank are behind us, higher market rates have yet to be fully reflected in margins for savings banks. We therefore believe we will see improved earnings for the banks in 2023, driven primarily by higher net interest income. We also expect a positive impact on net fee and commission income as commission income catches up with the more rapid increase in fees, driven by funding costs at Swedbank Hypotek. Net fee and commission income has fallen so far this year, due to margins decreasing on transferred loans and commission on transferred savings decreasing as capital market falls led to significant declines in market values.

Figure 4. Average lending rates to Swedish households, all banks, Jun. 2017–Oct. 2022



Source: Statistics Sweden. *New or renegotiated.

Figure 5. Swedish savings banks' net fee & commission income, year-end 2021 vs half-year 2022

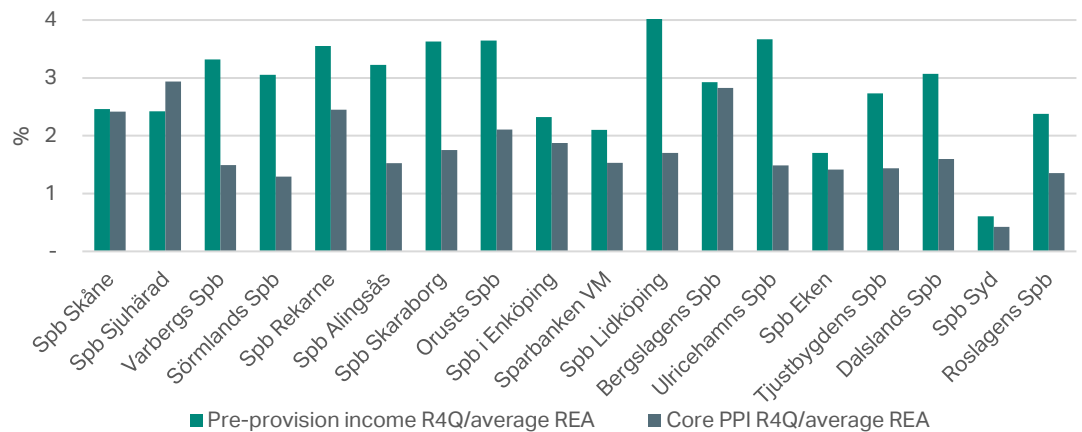


Source: bank reports.

Danske Bank received a SEK 22bn fine from both the U.S. and Danish authorities relating to its role in money laundering. Swedbank has already paid SEK 4bn to the Swedish FSA, and we believe Danske Bank's fine provides some indication that Swedbank might soon receive a decision from the U.S. and Estonian authorities. We therefore believe there is the potential for Swedbank's dividend for 2022 to be reduced or even cancelled. Our credit analyses of Swedish savings banks focus on core income, which excludes dividends received, but our projected capital ratios would be marginally affected if the Swedbank dividend were cancelled.

You can read more about the importance of Swedbank to Swedish savings banks here: [Swedish savings banks get dividend boost after solid 2020](#), 21 Jun. 2021 for further details of the impact of Swedbank's dividends; and [Q&A: Swedbank judgement and share price impacts on Swedish savings banks](#), 23 Mar. 2020 for details of how movements in the Swedbank share price affect savings banks.

Figure 6. Risk-adjusted earnings, with and without other income (incl. dividends), 30 Jun. 2022



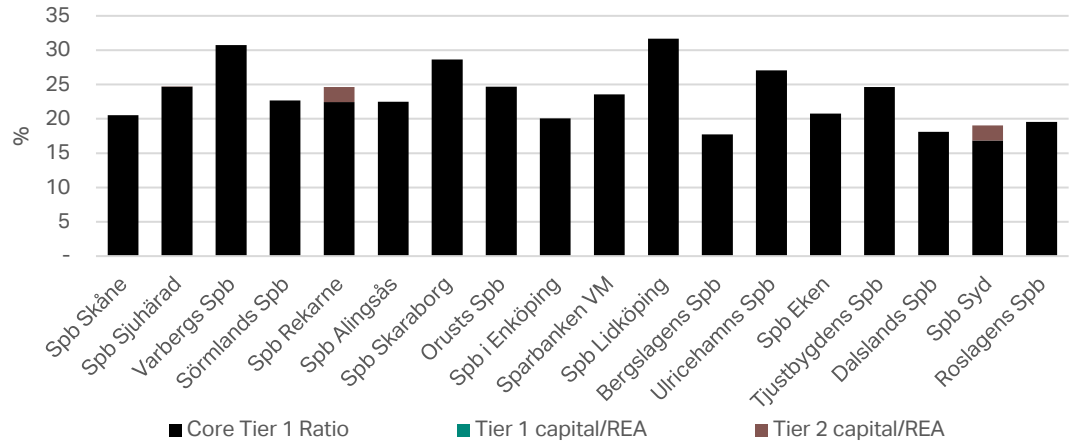
Source: bank reports. PPI-pre-provision income. REA-risk exposure amount. R4Q-rolling four quarters. Core PPI excludes other income, incl. dividends.

LOAN LOSSES EXPECTED TO INCREASE

Under IFRS 9, banks are required to set aside loan loss provisions based on macroeconomic indicators. Consequently, credit loss provisions for banks will increase as the economy slows. In addition, the EU's New Definition of Default (NDoD) regulation came into effect this summer and, among other requirements, states that all relief on loans, such as mortgage payment holidays or lower payments, should result in loans being classified as non-performing. This is expected to lead to an increase in both stage 3 loans and in volatility in this category. Banks may have different views on whether this covers temporary amortisation relief (as expected over the winter for mortgages). The Swedish FSA has encouraged households to discuss the option of pausing amortisation of mortgage loans if they cannot afford electricity and other bills, but seems unlikely to repeat the nationwide requirement to allow amortisation relief initiated in response to the COVID-19 pandemic.

In addition to higher macroeconomic provisions, which might not translate into definite losses, we also believe actual losses and non-performing loans will increase, primarily in commercial lending. As stated above, we see increasing risks in the commercial real-estate sector, to which savings banks have significant exposure. We also believe that bankruptcies will continue to increase across Sweden, which might not impact banks' customers initially but could have secondary effects on bank customers. However, Swedish savings banks are well capitalised and have improved earnings, providing strong buffers against a potential increase in credit losses and non-performing loans.

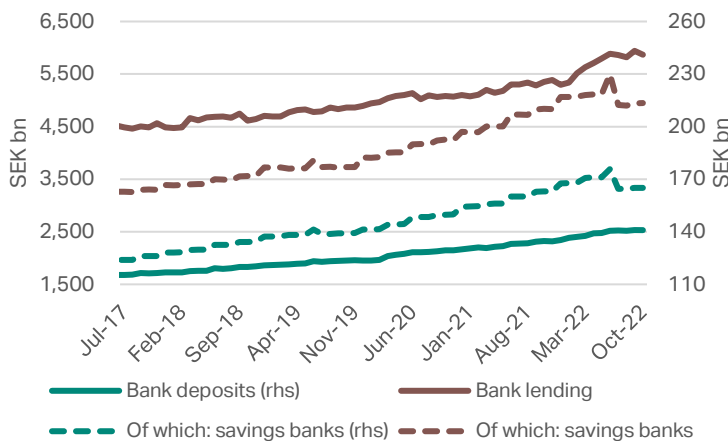
Figure 7. Swedish savings banks' capital ratios, 30 Jun. 2022



Source: bank reports. REA=risk exposure amount.

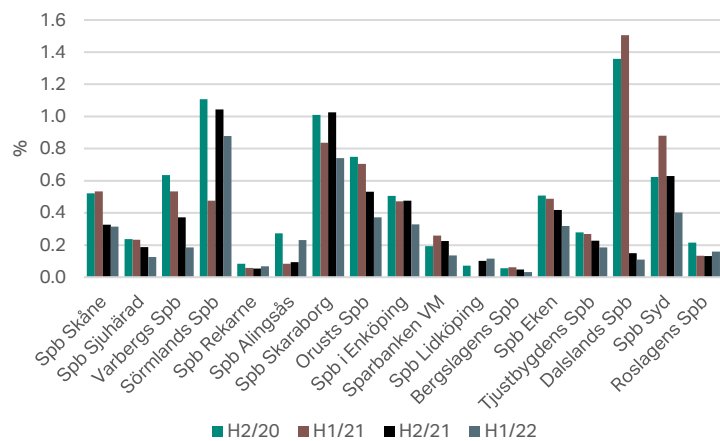
In terms of loan growth, mortgage growth is dropping rapidly (Figure 2), and we also believe consumer loans are likely to decline as household budgets tighten. Swedish savings banks have low exposure to companies present in bond markets and consequently are not expected to see as much of the transfer of debt from capital markets to banks at maturity. At the same time, investments are expected to decrease in a slower economy. On aggregate, we forecast credit growth in 2023, but to a lower degree than in recent years.

Figure 8. Loan and deposit growth, Swedish banking market, Jul. 2017–Oct. 2022



Source: Statistics Sweden

Figure 9. Net stage 3 loans as % of net loans, Swedish savings banks, H2 2020–H1 2022



Source: bank reports. Excl. Ulricehamns Sparbank, which does not report net stage 3 loans.

ESG TREND EXPECTATIONS IN 2023

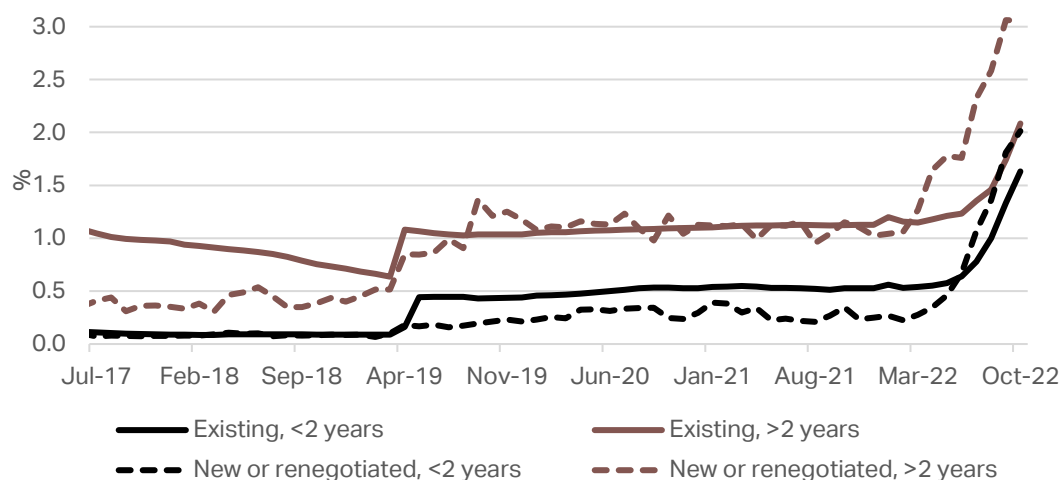
The banking sector as a whole, including Swedish savings banks, has made major efforts within environmental, social, and governance (ESG) areas during the year. All Swedish savings banks rated by NCR have, to varying extents, started integrating ESG factors into their credit assessments, and some are involved in developing sustainability assessment tools with Swedbank. We understand that these tools are expected to be rolled out to the savings banks in 2023. In addition, we expect the banks to continue developing their ESG efforts in 2023, both in dialogue with their customers and by assessing their own risks. European authorities have begun looking into new reporting and capital requirements

on climate-related risks, and we believe expectations will also increase on smaller financial institutions to improve their risk management and reporting in this area.

FUNDING EXPECTED TO REMAIN STABLE

Deposit volumes have grown steadily in recent years, even more so during the pandemic as consumption fell (see Figure 8). However, as households come under increasing financial pressure and disposable income drops, we expect them to save less and dip into savings to cover rising monthly costs. Swedish savings banks, however, are well funded with deposits and a number of banks have demonstrated access to wholesale funding. They also maintain strong regulatory ratios, with an average liquidity coverage ratio of 278% and an average net stable funding ratio of 139% at 30 Jun. 2022. We believe competition for deposit customers might increase, but current accounts, as well as deposits from commercial clients, imply that savings banks will retain the bulk of their market share of deposits.

Figure 10. Average deposit rates for Swedish households, Jul. 2017–Oct. 2022



Source: Statistics Sweden.

NCR-RATED SAVINGS BANKS

Figure 11. NCR ratings on Swedish savings banks

	<u>Sparbanken</u> <u>Rekarne AB</u> <u>(publ)</u>	<u>Sparbanken</u> <u>Västra</u> <u>Mälardalen</u>	<u>Sörmlands</u> <u>Sparbank AB</u> <u>(publ)</u>	<u>Varbergs</u> <u>Sparbank AB</u> <u>(publ)</u>
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
Competitive position (15%)	bbb	bb+	bbb	bbb+
Performance indicators (15%)	a	a-	bbb	bbb+
Ownership/peer adjustment	n/a	n/a	n/a	n/a

See NCR's [company reports](#) for details. n/a–Not applicable.

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