Nordic Credit Rating

SECTOR COMMENT

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Norwegian savings banks carry positive momentum into 2023

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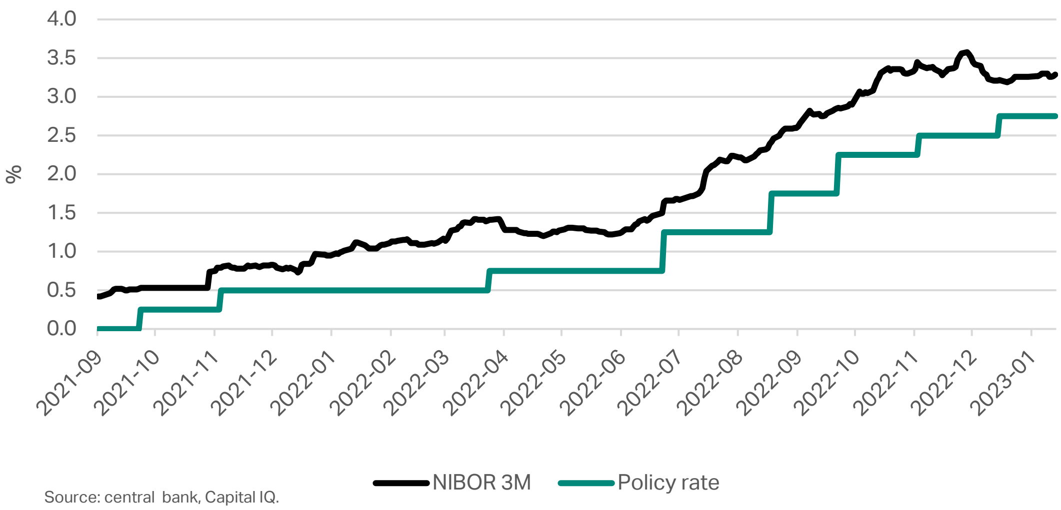
Norwegian savings banks head into an uncertain 2023 with a degree of positive momentum following a relatively strong performance in 2022. Net interest margins have improved materially due to a rebound in interest rates, with the domestic policy rate and three-month NIBOR increasing by 275bps over the past 15 months. We expect the improvement in margins to support pre-provision earnings even as credit growth declines and provide additional buffers as credit losses rise. The implementation of a capital discount for SME customers is helping banks to improve their capital ratios, even though stringent regulatory requirements mean the ratios will remain at already high levels.

Although improved interest rates are supporting earnings, higher borrowing costs are only part of the cost inflation likely to affect households and corporates in 2023. A central bank decision on January 19 to maintain its key policy rate at 2.75% reflects an increasing focus on the country's slowing economy and inflation. However, the central bank has indicated a high likelihood of a rate increase at its March meeting.

As the economy slows, a reduction in consumer spending is likely to impact the asset quality of bank loans to SMEs, a primary focus of commercial lending in Norway. We expect the initial impact of higher loan losses to be offset by pre-provision earnings, resulting in improved profits. However, a long-term decline in economic activity could lead to us to revise this expectation.

We believe that Norwegian savings banks are well positioned to face a harsher economic climate in 2023 and will maintain the strongest credit profile among Nordic banks. Lower risk weights on SME loans were implemented in 2022, improving capital ratios and capital buffers across the sector. In combination with improved earnings and a reduction in non-performing loans (NPLs) as the impact of the COVID-19 pandemic recedes, we believe most banks will record strong performances in 2023.

Figure 1. Norway policy and interbank rates, September 2021–January 2023



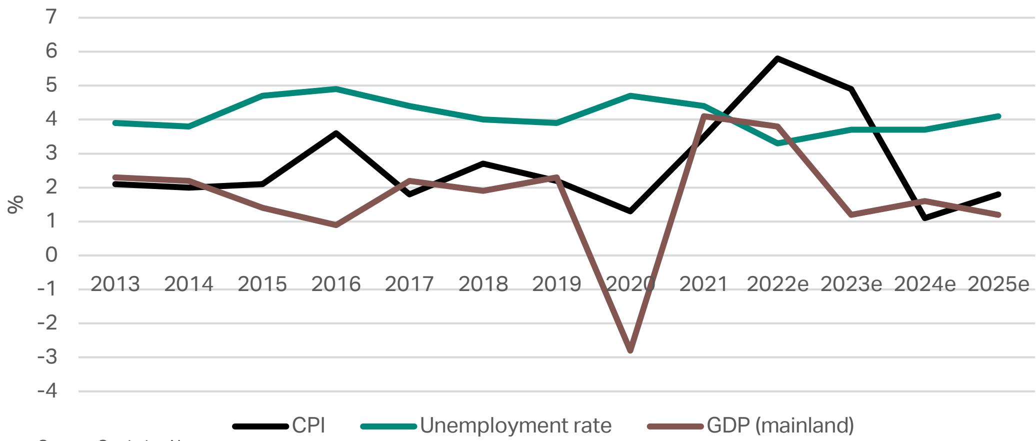
Source: central bank, Capital IQ.

SLOWING ECONOMY OFFSET BY HIGHER INTEREST RATES

As we enter 2023, the operating environment remains positive due to higher net interest margins, which we expect to offset increased loan losses. We believe that a technical recession in Norway is unlikely in 2023, even though geopolitical risk, primarily due to the war in Ukraine, remains significant.

Statistics Norway expects that growth in mainland GDP will fall to 1.2% in 2023 from 3.3% in 2022 (see Figure 2). Increasing costs are putting pressure on corporate margins while rising interest rates and prices are squeezing household consumption. This is likely to lead to higher unemployment in 2023, albeit from a low level. However, anecdotical evidence as well as comments from the central bank governor indicate that cost pressure is levelling out. In addition, we expect interest rates to peak during 2023. Other mitigating factors include a robust housing market and increased public consumption. We also expect high demand for oil and gas and a weak currency (due to sharp increases in EU interest rates) to boost Norwegian exports.

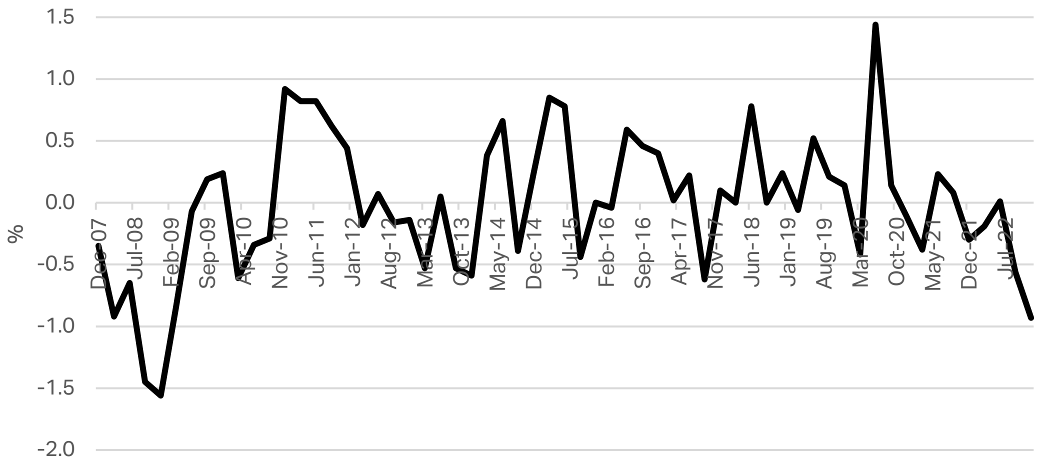
Figure 2. Norway consumer price index, GDP and unemployment, 2013-2025e



Source: Statistics Norway.

We expect that high interest rates will continue to boost savings banks' interest margins over the next few quarters. One risk factor, however, is that a combination of lower lending demand and strong bank capitalisation will lead to margin pressure due to increased competition. Demand for mortgage loans is at its lowest level since the 2008 financial crisis as reflected in steadily declining growth rates for household credit. Despite a sharp increase in mainland corporate credit during 2022, the central bank has indicated that demand for corporate loans has declined in recent months.

Figure 3. Norway demand for mortgage loans, last three months



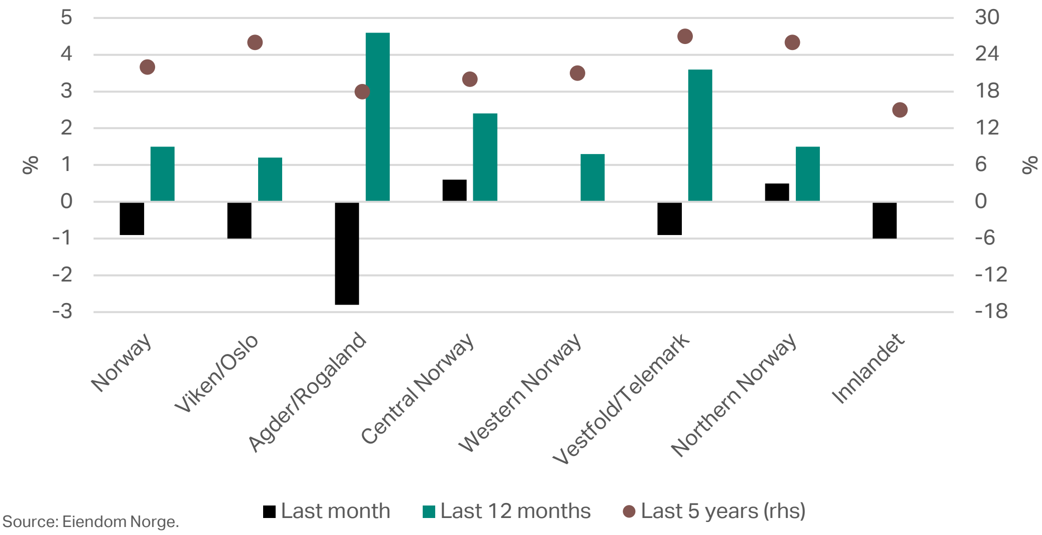
Source: central bank.

HOUSING MARKET LIKELY TO STABILISE AS RATES HIKES SLOW

Housing prices fell sharply during the second half of 2022 as mortgage rates held firm on the back of policy rate increases by the central bank and sellers lowered their expectations to meet reduced buyer demand. However, key indicators suggest an imminent return to pre-pandemic levels in terms of transactions and unsold volumes, rather than a market collapse.

Currently, housing prices remain well above pre-COVID levels and mortgage rates are likely to become more predictable as policy rates stabilise. This could rejuvenate the market in 2023 and add certainty to borrowing costs and price expectations. Increased market liquidity should support savings bank growth, though we expect increasing competition and stable interest rates to pressure household lending margins.

Figure 4. Norway national and regional housing prices

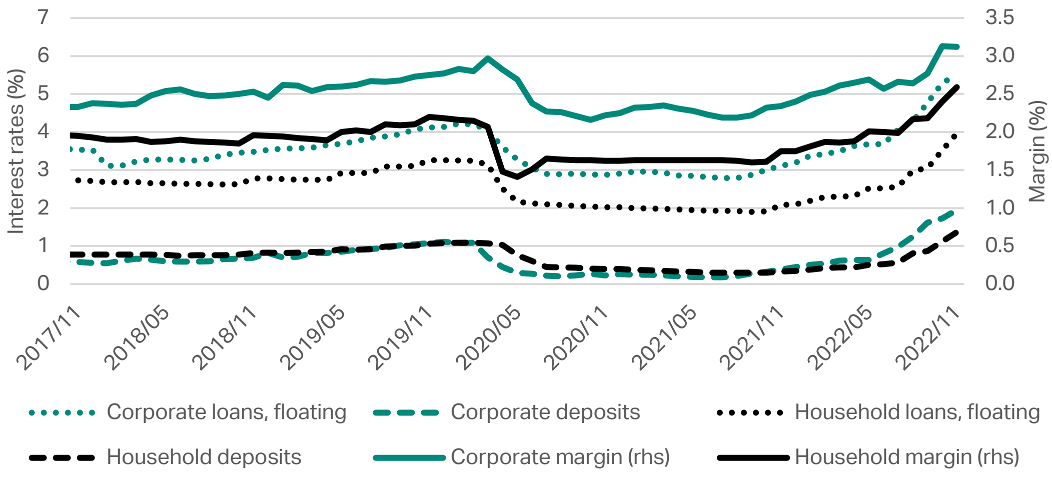


Source: Eiendom Norge.

EARNINGS IMPROVEMENTS TO CONTINUE INTO 2023

During 2022, Norwegian banks were able to improve earnings by quickly increasing lending rates in line with central bank policy rates while raising deposit rates more slowly. The difference drove significant improvements in net margins on corporate and household lending (see Figure 5) and higher reported net interest margins (see Figure 6).

Figure 5. Norway household and corporate lending rates, deposit rates and net margins, 2017-Nov. 2022

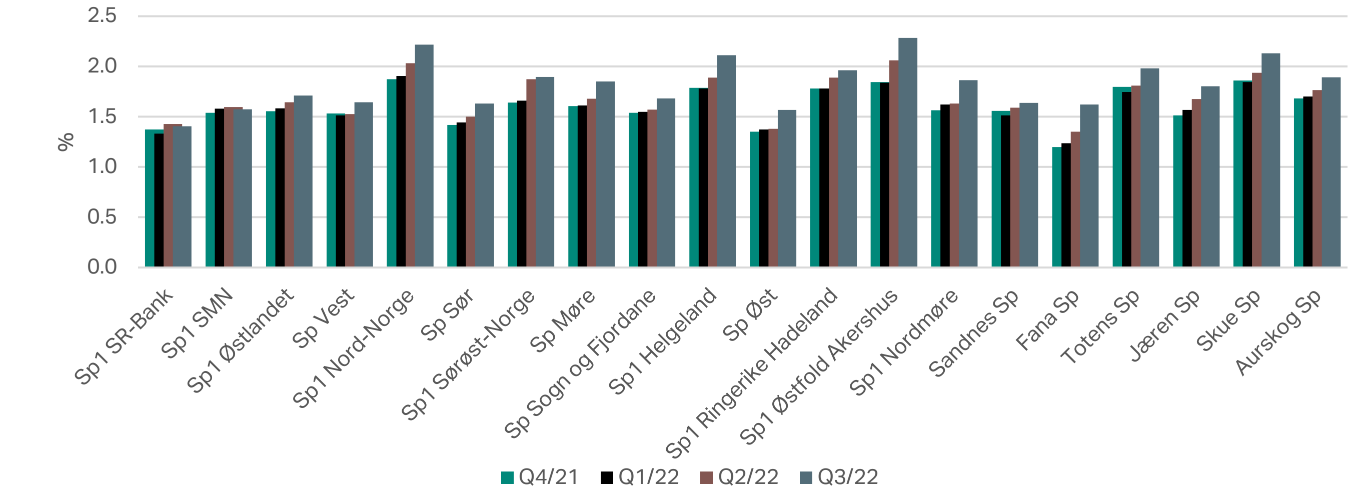


Source: Statistics Norway.

Fee and commission income levels remained virtually flat across the sector in 2022 and had varying impacts on the bottom line profits of the respective banks (see Figure 7). Most banks have reported net losses on their financial positions in 2022 due to falling asset values and higher credit spreads. In total, cost income ratios increased to 43.7% from 42.0% in the four quarters ending 30 Sep. 2022. However, considering interest and fee income only, banks improved their core income efficiency to 48.5% over the previous year from 49.3% previously.

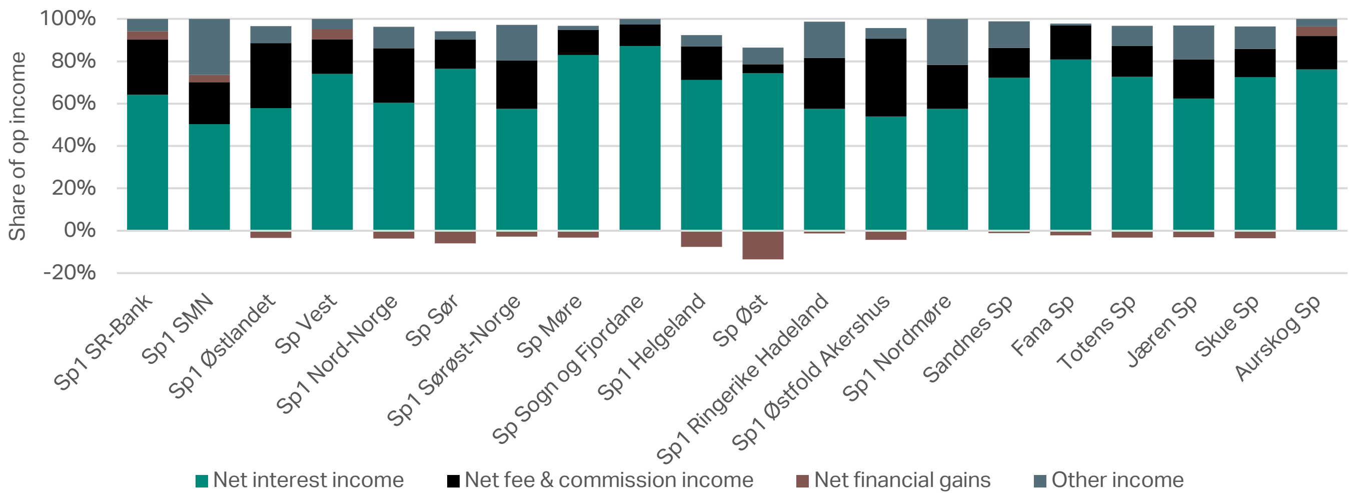
We expect higher margins to continue to improve earnings into 2023 due to rate increases announced late in 2022 but expect the gains to level off as deposit rates improve. We also anticipate margin compression due to increased competition for strong clients and lower credit growth by year-end.

Figure 6. Norwegian savings banks' annualised net interest margins, Q4 2021–Q3 2022



Source: bank reports.

Figure 7. Norwegian savings banks' operating revenues by type, Q1 2022–Q3 2022



Source: bank reports.

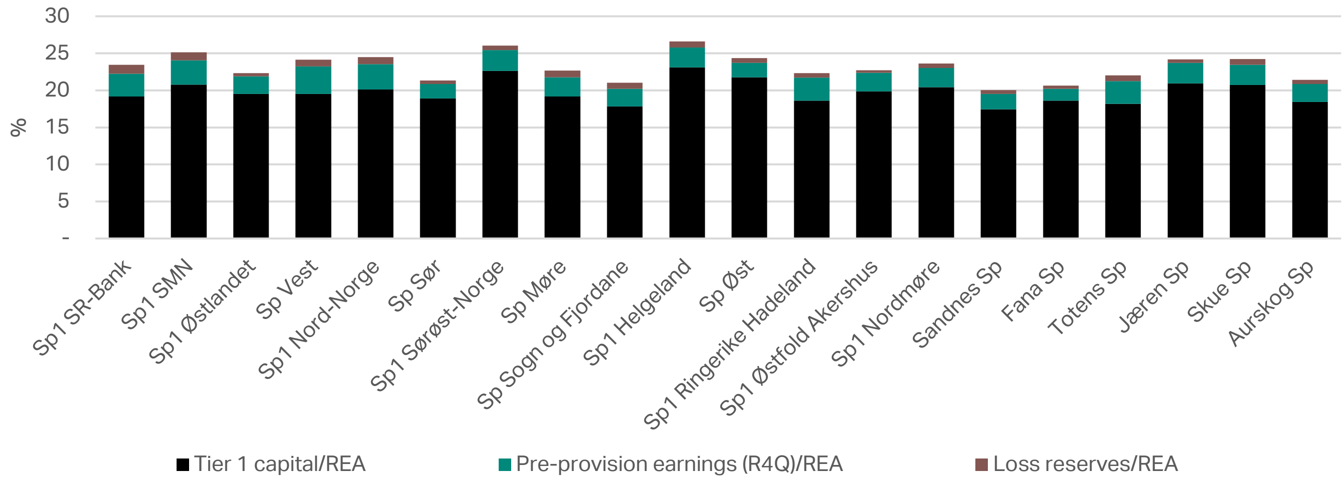
CAPITAL RATIOS TO REMAIN STRONG AS GROWTH SLOWS

The implementation of reduced risk weights on SME loans in 2022 improved capital ratios and capital buffers across the sector. We expect lower loan growth and strong capital generation to continue to build capital buffers during 2023.

The domestic regulator has been clear that the SME discount must not result in outflows of capital from the banking system and accordingly raised banks' capital requirements via a 1.5pp increase in the systemic risk buffer. Banks using standardised models for their capital requirements were allowed a one-year delay in increasing the buffer in December, effectively deferring the new requirement until end-2023. Despite the higher buffer requirement, regulatory capital positions are stronger now than a year ago, providing the potential for further lending capacity and additional loss buffers.

The central bank can recommend a reduction in the systemic risk and countercyclical capital buffers to the Finance Department. On 31 Mar. 2023, the countercyclical buffer will return to its 2.5% historical maximum. If the economy deteriorates, we would expect the central bank to act quickly, as it did by reducing the countercyclical buffer to 0% at the onset of the COVID-19 pandemic, to reduce the buffers to support banks' ability to supply credit to their customers and support continued economic growth across Norway.

Figure 8. Norwegian savings banks' capital, earnings and loss buffers, 30 Sep. 2022

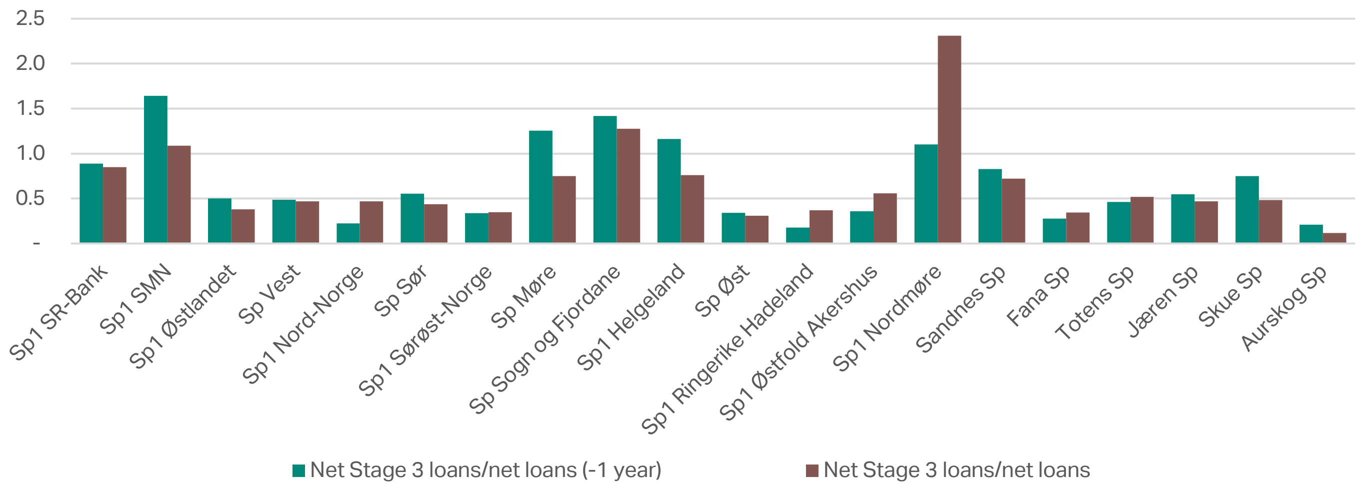


Source: bank reports. R4Q: rolling 4 quarters.

ASSET QUALITY LIKELY TO DECLINE AS ECONOMY SLOWS

Savings banks have entered 2023 with a modest proportion of NPLs on their balance sheets. In the sample of the 20 largest banks (see Figure 9), Stage 3 NPLs stood at 84bps on 30 Sep. 2022 on a gross basis, and 65bps net of loss reserves, reflecting an average 25% loss reserve. Nearly two-thirds of banks reported lower than average NPL levels and just three reported net NPLs over 1% of loans. The highest level of NPLs among the sample was at SpareBank 1 Nordmøre, which doubled its net Stage 3 ratio from a year earlier to 2.3%. We note that the bank reported a decline in Stage 3 loans and reserves in the third quarter of 2022.

Figure 9. Norwegian savings banks' net Stage 3 loans compared with a year earlier, 30 Sep. 2022

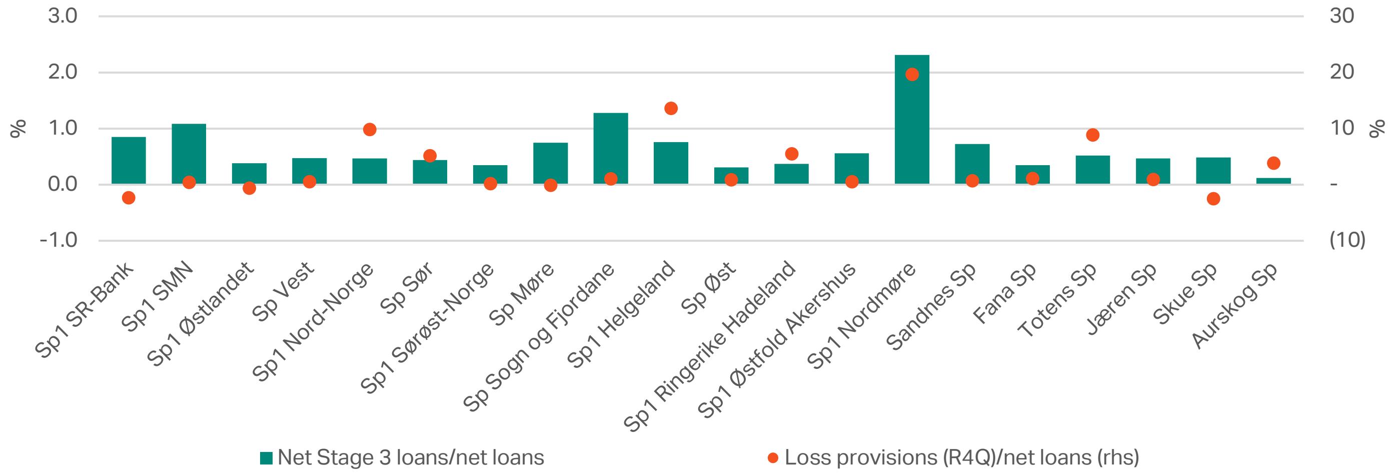


Source: bank reports.

Loan losses over the four quarters ending 30 Sep. 2022 averaged a low 3bps. SpareBank 1 Nordmøre (20bps) and SpareBank 1 Helgeland (14bps) were the only banks to report provisions of more than 10bps during the year. Four banks had net reversals of previous loss provisions during the year. In our view, the low reported losses in 2022 were supported by loss reserves made in 2020 at the onset of the COVID-19 pandemic.

We expect losses to increase in 2023 and 2024 due to a slowing economy, which could lead banks to increase provisions in respect of specific customers or increase group reserves based on theoretical modelling according to IFRS 9. We include losses of 14-20bps over the next two years in our forecasts for the savings banks we rate, namely SpareBank 1 Østfold Akershus and Jæren Sparebank. We note that some banks continue to maintain pandemic-related loss reserves, which could be used to dampen the impact of declining credit quality in 2023.

Figure 10. Norwegian savings banks' asset quality metrics, 30 Sep. 2022



Source: bank reports.

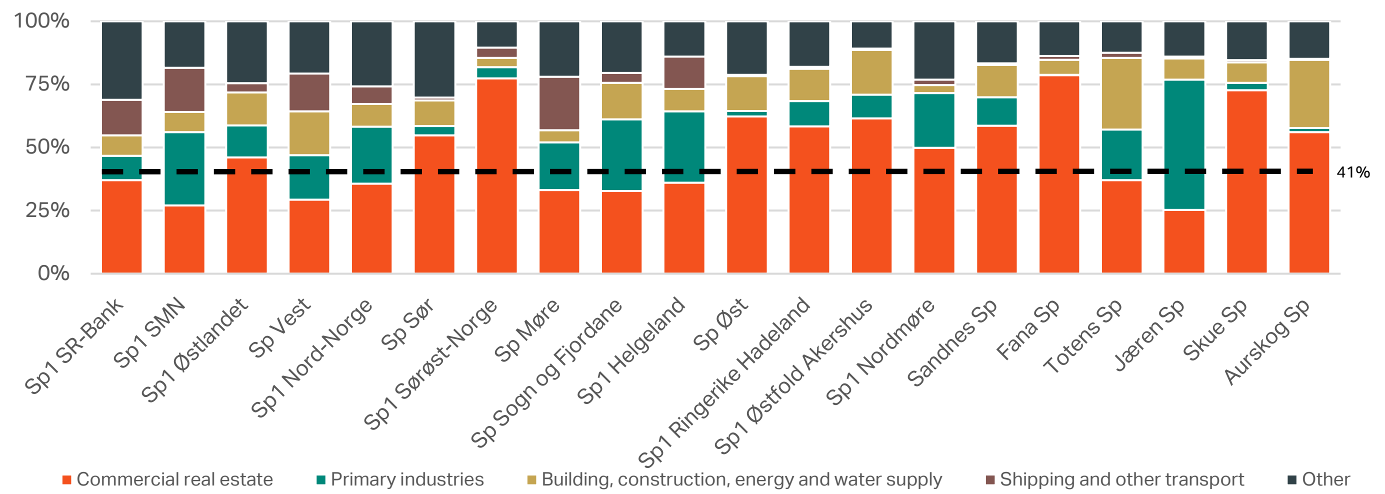
COMMERCIAL REAL ESTATE RISK RISING BUT MANAGEABLE

Norwegian savings banks have high levels of exposure to local and regional real estate markets. This concentration has a generally negative impact on our overall credit assessments and ratings. A long period of relatively low interest rates has resulted in appreciation of real estate assets and driven strong transaction markets over the past decade, peaking in 2021 at nearly NOK 170bn, according to real estate advisor Malling & Co. Higher valuations have also increased borrowing secured by real estate collateral as properties have changed hands.

Higher market rates, geopolitical concerns and increasing risk aversion began to negatively affect transaction volumes and property yields in mid-2022, slowing volumes by an estimated 40% after a relatively strong first half, according to Malling & Co. In 2023, we expect transactions to remain muted as buyers and sellers await further clarity on interest rates and yields.

We expect property values to decline through 2024 as yields rise. Property types such as residential, where the potential for rent increases is moderate, could see a larger decline than commercial properties as residential yields rise from very low levels. However, following a 250bp increase in market rates since the central bank began raising the policy rate in September 2021, we believe yields will inevitably increase across all property types.

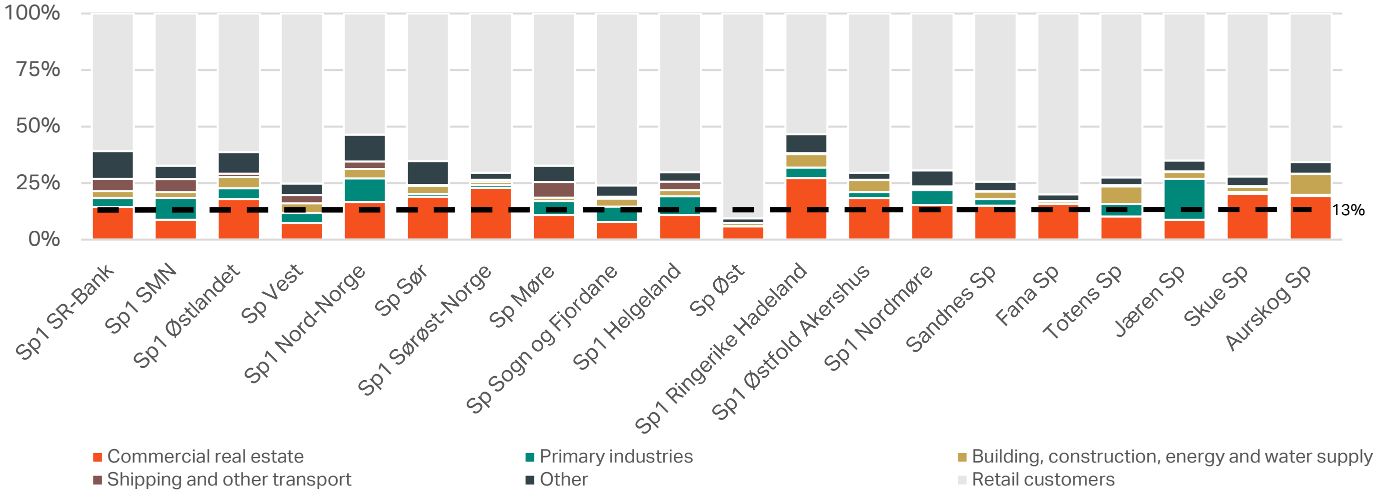
Figure 11. Norwegian savings banks' corporate exposure by sector, 30 Sep. 2022



Source: bank reports.

The share of commercial real estate lending varies widely among Norway's largest savings banks, from around 75% of corporate lending at SpareBank 1 Sørøst-Norge and Fana Sparebank to closer to 25% at Jæren Sparebank, SpareBank 1 SMN, and Sparebanken Vest. On average, the leading 20 savings banks account for 41% of corporate lending extended to real estate companies, which is somewhat lower than the national average of 46% reported in the central bank's latest financial stability report. The average Norwegian savings bank extends two-thirds of its lending to the private market, mostly in the form of mortgages, reducing the average proportion of commercial real estate lending to 13% across the sector.

Figure 12. Norwegian savings banks' total exposure by sector, 30 Sep. 2022



Source: bank reports.

A large proportion of commercial real estate lending finances offices or mixed properties with office, retail and residential elements. In its 2022 report (Nr.6, 2022), the central bank estimated that 44% of the market value of commercial real estate collateral resides in offices. For savings banks included in this report, this figure was closer to 30-35%, with 20-25% associated with retail properties and another 20-25% with industrial and logistics facilities. While we view risk in the commercial real estate segment as increasing, the short-term benefit of inflation-linked rental contracts is likely to offset yield compression in commercial property valuations throughout 2023 and reduce the risk of increased loan loss provisions by banks. However, if economic conditions worsen, real estate exposures could come under pressure as a result of increased vacancies.

In addition, banks provide loans to multi-family rental properties and housing associations, which we view as lower risk assets, but with the potential for higher price fluctuations (due to lower initial yields) than commercial properties.

NCR-RATED SAVINGS BANKS

Figure 13. NCR ratings on Norwegian savings banks

	SpareBank 1 Østfold Akershus	Jæren Sparebank	Kredittforeningen for Sparebanker
Long-term issuer rating	A	A-	A-
Outlook	Stable	Stable	Stable
Subfactors:			
Operating environment (20%)	a	a-	a-
Risk appetite (50%)	a	a	a
Competitive position (15%)	bbb+	bbb-	bb-
Performance indicators (15%)	a+	a-	bbb+

See NCR company reports for details. n/a–not applicable.

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