Nordic Credit Rating

SECTOR COMMENT

24 Mar. 2023

Norwegian mid-size savings banks stand strong in turbulent 2022

ANALYSTS
Christian Yssen
+4740019900
christian.yssen@nordiccreditrating.com

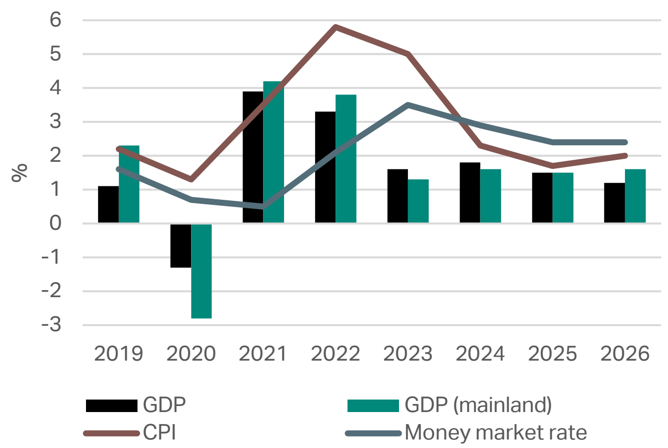
Geir Kristiansen
+4790784593
geir.kristiansen@nordiccreditrating.com

Ylva Forsberg
+46768806742
ylva.forsberg@nordiccreditrating.com

Norwegian mid-size savings banks performed relatively strongly in the fourth quarter of 2022, concluding a successful year overall. Following a prolonged period of very low interest rates, 2022 was characterised by geopolitical instability, rising inflation and measures by central banks to combat inflation. Norway's policy rate and three-month NIBOR have increased by 300bps over the last 18 months, laying the ground for a beneficial operating environment for Norwegian mid-size savings banks. Earnings have been driven by increasing lending rates more quickly than deposit rates to improve the net interest margin. Although the economic outlook deteriorated throughout 2022, our sample of savings banks has not shown any significant signs of increased losses and the Norwegian economy is in a relatively healthy state so far.

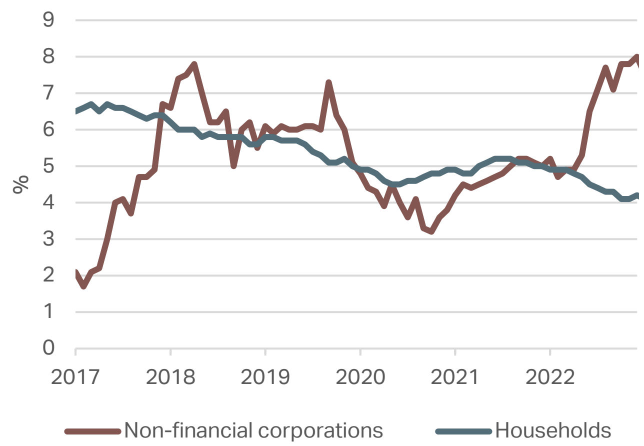
The growth rate in borrowing declined in 2022 for Norwegian households, but increased for non-financial corporations. Despite some signs of brighter economic prospects in 2023, we expect Norway's central bank to maintain a high policy rate due to the ongoing inflationary pressure, which will constrain the lending growth of Norwegian mid-size savings banks in the near term. In addition, the higher interest rates entail greater credit risk. Asset quality and loss performance will therefore be important and may be a distinguishing factor between banks in the near term. However, we believe that strong pre-provision earnings are likely to offset increases in net losses in 2023, while the banks' large capital buffers provide further resilience.

Figure 1. Norwegian GDP, inflation and money market rate, 2019–2026



Source: Statistics Norway.

Figure 2. Annual credit growth in Norway, 2017–2023



Source: Statistics Norway.

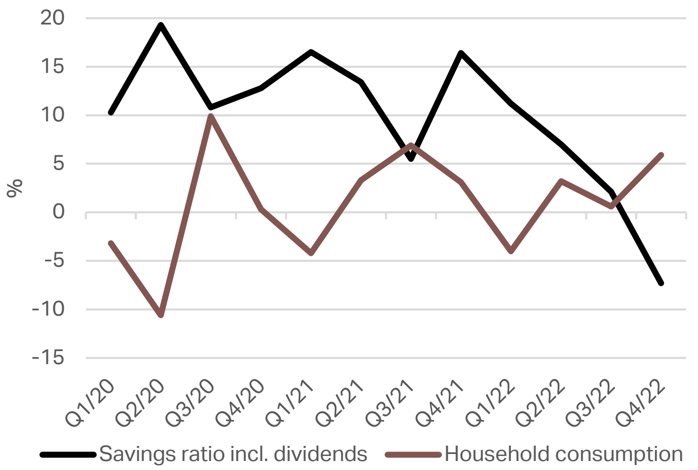
Our sample consists of 18 Norwegian mid-size savings banks with assets under management between NOK 7bn and NOK 17bn. Nordic Credit Rating rates two Norwegian savings banks, Jæren Sparebank and Sparebank 1 Østfold Akershus. The latter is not included in this sample.

BENEFICIAL OPERATING ENVIRONMENT FOR NORWEGIAN MID-SIZE SAVINGS BANKS

The operating environment for Norwegian mid-size savings banks was beneficial throughout 2022 and we expect it to remain positive for 2023, despite signs of a slowing economy. Households are facing tougher economic conditions, but the vast majority of households' finances are sufficiently robust to withstand price increases through adjustments in consumption and savings. Amid the inflationary environment of 2022, the savings ratio of Norwegian households decreased to negative 7.3% in the fourth quarter of 2022, compared with an average of positive 13% in 2021. Household consumption growth averaged 1.4% in 2022, suggesting that households have begun to eat into their savings. In our view, this tapping of savings will constrain banks' deposit growth. On the other hand, a higher interest rate environment has improved banks' ability to compete for customers by offering higher savings rates and incentives for households in order to reverse the trend.

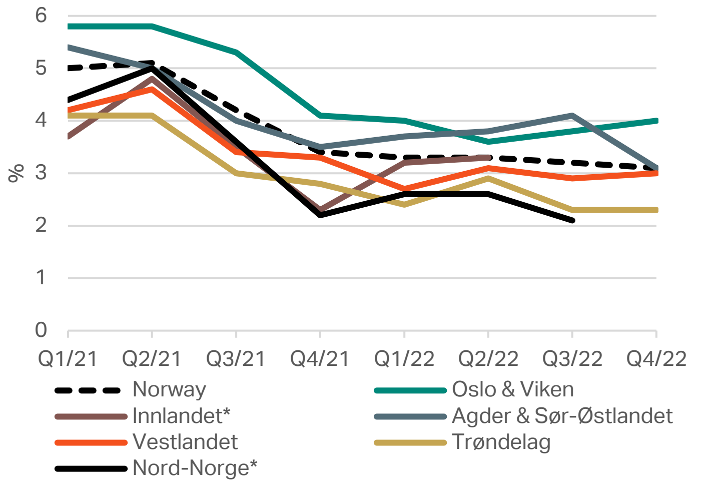
The unemployment rate in Norway remains at very low levels and dipped below 3% during 2022, a level last seen in 2008. As of the fourth quarter of 2022, Norway's unemployment rate was 3.1%, which reflects good financial health among banks' customers. However, we expect the unemployment rate to increase to 4% in 2023. Norwegian savings banks sample are generally located in regions with low unemployment and are resilient to geopolitical risk factors. However, the significant rise in interest rates has led to higher risk in the commercial real-estate segment in general, and real-estate development in particular.

Figure 3. Norwegian savings ratio and household consumption, Q1 2020–Q4 2022



Source: Statistics Norway.

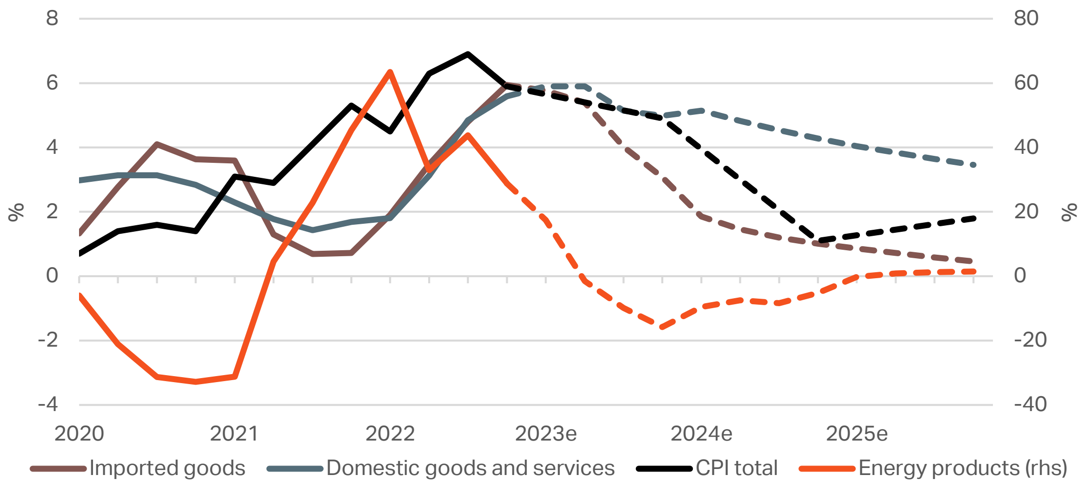
Figure 4. Norwegian unemployment by region, Q1 2021–Q4 2022



Source: Statistics Norway. *Confidential data in Q3/22 and Q4/22.

The Norwegian economy has remained relatively stable compared with other countries amid the geopolitical uncertainty that began in 2022. This is largely due to its natural resources of oil, gas and hydro power. Norway has not yet entered recession and we believe a technical recession is unlikely in 2023. The global outlook has improved, due to a less severe energy crisis than feared, strong consumer spending in the US and better economic prospects in China. Nevertheless, the consumer price index (CPI) in Norway in 2022 was 5.8% in 2022 compared with the previous year and the central bank is expected to increase the policy rate further to slow the economy. The policy rate was raised by 25bps on 23 Mar. 2023 to 3% and we believe a similar rate hike in May is the most likely scenario. The central bank's policy rate decisions will depend on the economy's performance, but inflationary pressure, low unemployment and a strong housing market will likely mean further policy rate hikes.

Figure 5. Norwegian CPI and inflation of domestic, imported and energy products, March 2020–December 2025

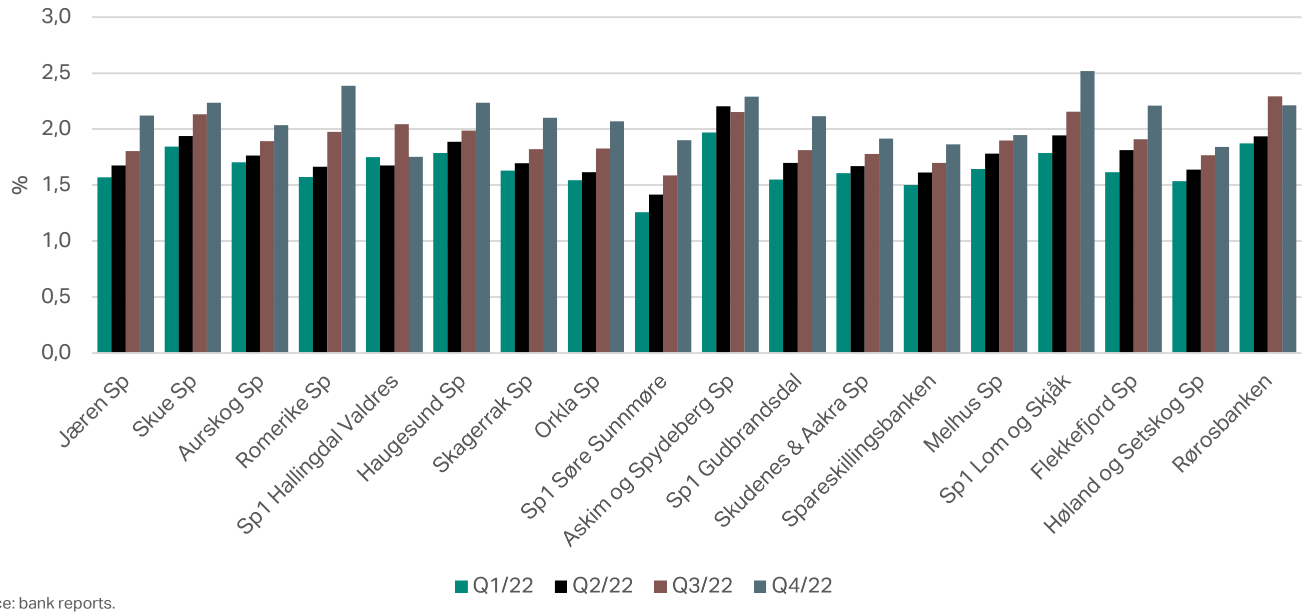


Source: Norges Bank, Statistics Norway. e–estimate.

STRONG EARNINGS DRIVEN BY NET INTEREST

Norwegian mid-size savings banks improved net interest margins amid yet another quarter of strong growth. Repricing rounds in the fourth quarter enabled the savings banks to further improve earnings by increasing lending rates in line with policy rate hikes while raising deposit rates at a slower pace. This drove significant improvement in net interest margins on lending. Our sample of Norwegian mid-size savings banks reported an increase in the net interest margin each quarter in 2022, at an average annualised figure of 2.1% in the final quarter. Although we expect most of the fourth quarter's repricing to be utilised, a portion of the repricing effects reflected in fourth-quarter reports is yet to be felt and should have a positive impact on earnings in the first quarter of 2023. Furthermore, additional policy rate hikes should support earnings, though to a lesser degree than in 2022, counteracting a potential increase in losses and loss provisions.

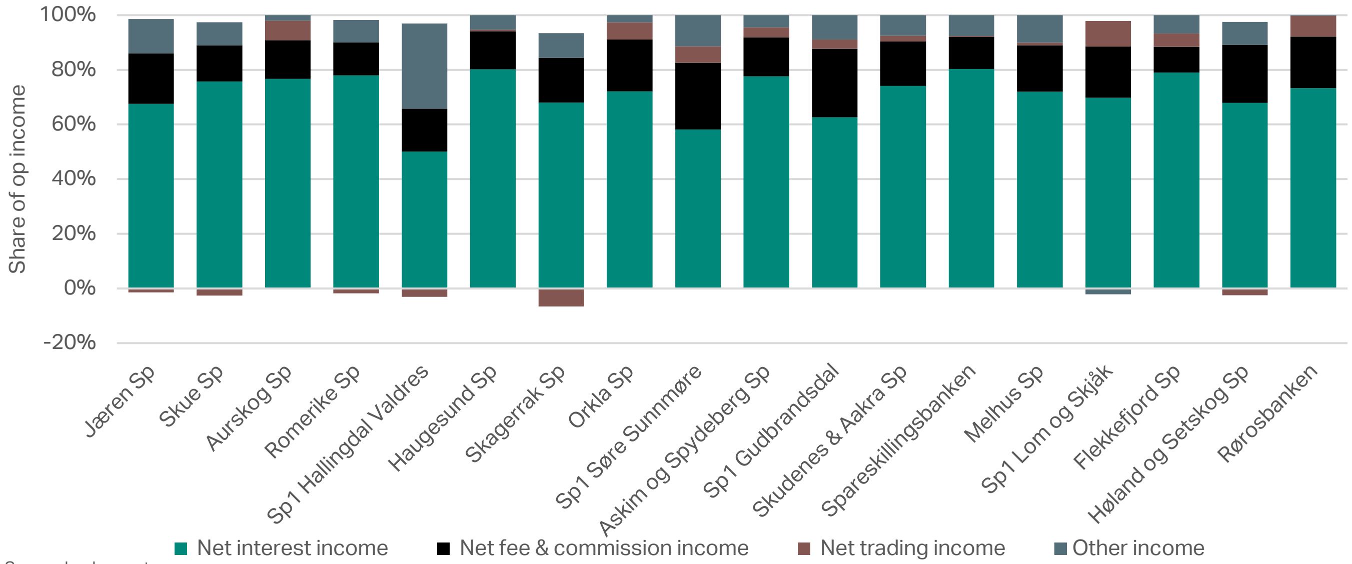
Figure 6. Norwegian mid-size savings banks' annualised quarterly net interest margin, Q1 2022–Q4 2022



Source: bank reports.

Fee and commission income levels remained virtually flat across our sample in the fourth quarter of 2022. Fees from savings products, insurance products and payment services remained solid, but were offset by lower commission income and changes in the value of financial assets. For our sample, commission income is mainly associated with substantial transfers of mortgage loans to partially owned covered-bond companies, for which margins have decreased in line with rising three-month NIBOR. The banks in our sample are highly exposed to and dependent on commission income, as approximately 30% of all retail lending on average is transferred to external covered-bond companies. There is also reduced activity in the housing market, in which many Norwegian banks' subsidiaries operate. This lower activity resulted in reduced real-estate brokerage fees for some banks.

Figure 7. Norwegian mid-size savings banks' operating revenues by type, Q1 2022–Q4 2022

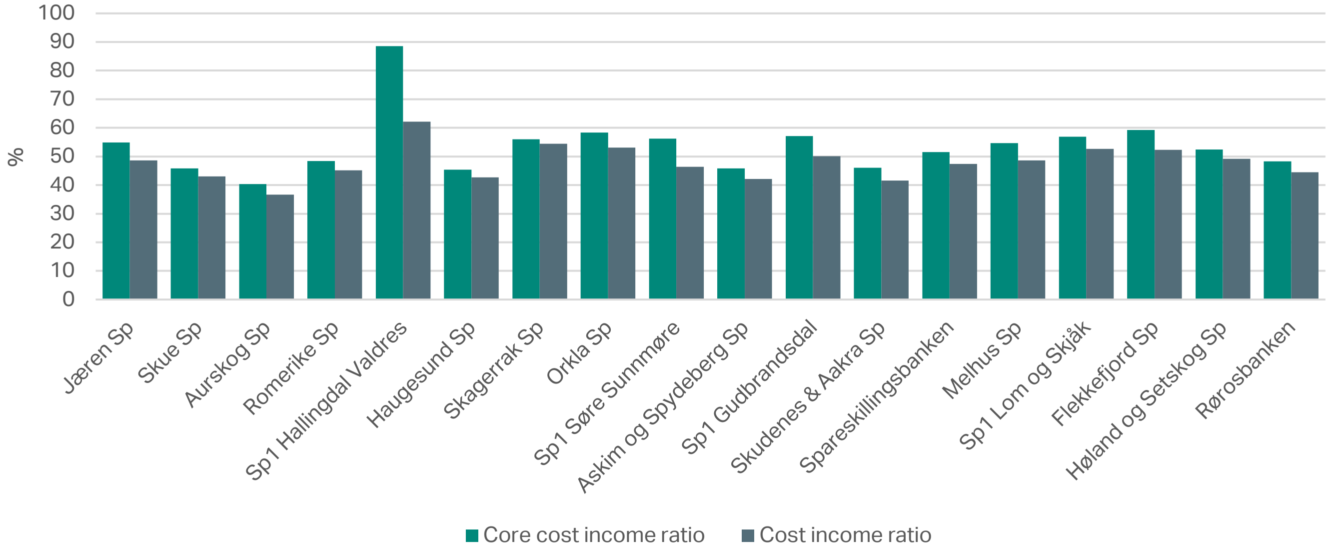


Source: bank reports.

Our sample of Norwegian mid-size savings banks reported an average cost-to-income ratio of 48.8% in 2022. Sparebank 1 Hallingdal Valdres stands out with a ratio of 62.2%. According to its report, underlying banking operations are healthy but conditions outside ordinary banking operations have had a negative impact on profitability. The deterioration in its cost-to-income ratio was due to a significant decline in earnings for the Sparebank 1 alliance and a decrease in the value of financial assets.

Half of our sample of savings banks are affiliated with the Eika Gruppen alliance of savings banks and reported higher costs related to the implementation of a new core service IT system by the alliance. These expenditures had a negative impact on fourth-quarter performance, but are expected to have a positive effect in the longer term. In terms of interest and net fees only, banks in our sample reported average core cost efficiency of 53.7% in 2022.

Figure 8. Norwegian mid-size savings banks' core cost-to-income ratios, 2022



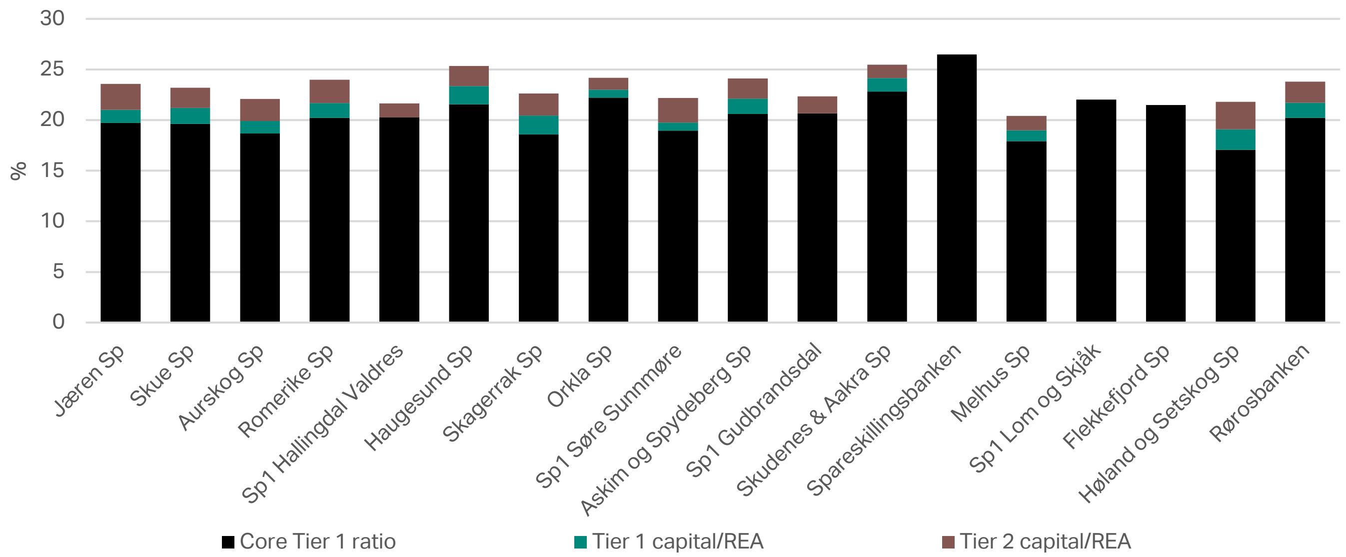
Source: bank reports.

WELL-CAPITALISED BANKS WITH RESILIENCE TO WEAKER ASSET QUALITY

Under IFRS 9, banks are required to set aside loan loss provisions based on macroeconomic indicators. Consequently, loan loss provisions for banks will increase as the economy slows. Some banks are concerned that their model-based loss provisions do not take sufficient account of the current economic uncertainty, with worse macro prospects than those currently underpinning their models. Some banks have reported additional stage 2 provisions in light of this deficiency. In addition to higher macroeconomic provisions, which might not translate into actual losses, we also believe actual losses and non-performing loans will increase. However, mid-size Norwegian savings banks are well capitalised and have improved earnings in recent years, providing strong buffers against any increase in credit losses and non-performing loans.

A decrease in lending growth, combined with strong earnings, has boosted capital ratios for the banks in our sample. Core Tier 1 ratios are strong across the sample of banks, which reported an average of 20.5% in the fourth quarter. This is an increase on the 19.7% reported for the same period last year.

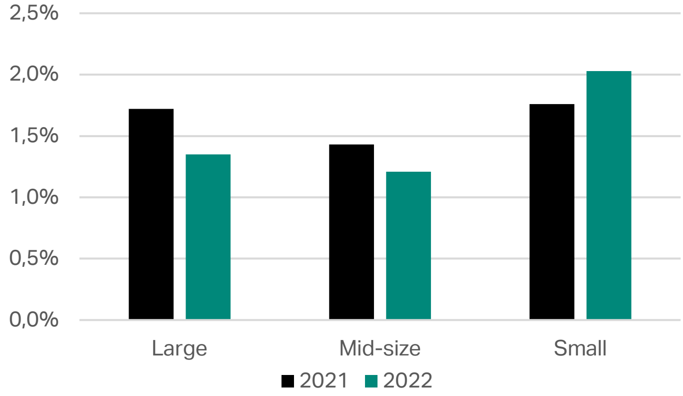
Figure 9. Norwegian mid-size savings banks' capital ratios, 2022



Source: bank reports.

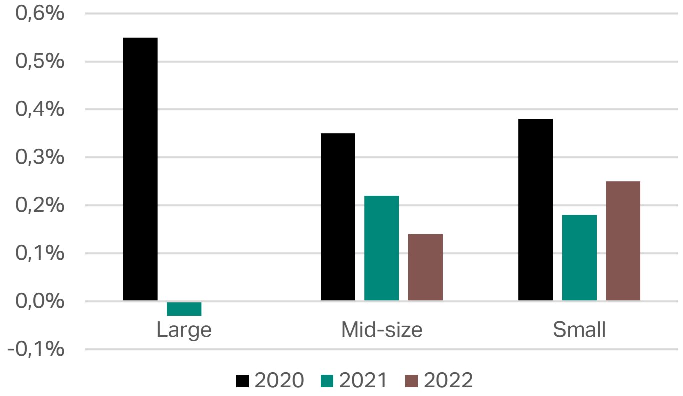
We expect non-performing loans and net losses to increase over the next few quarters as further interest rate increases and a slowdown in the economy are likely to affect the banks' customers. However, Norwegian banks reported strong non-performing loan performance in 2022. Norway's financial supervisory authority stated that mid-size savings banks reported 1.2% of their loans were non-performing in 2022. This is down from 1.4% in 2021 and is better than the performance of both large and small banks. However, large banks have outperformed in terms of net losses on lending in the past two years, with losses at approximately zero. Norwegian mid-size banks reported improved net loss performance and better figures than small savings banks in 2022, with net losses at 14bps. In our view, asset quality and loss performance will be key drivers for profitability if interest rates increase further and lending growth declines.

Figure 10. Norwegian savings banks' non-performing loans by bank size, 2021–2022



Source: Norwegian financial supervisory authority.

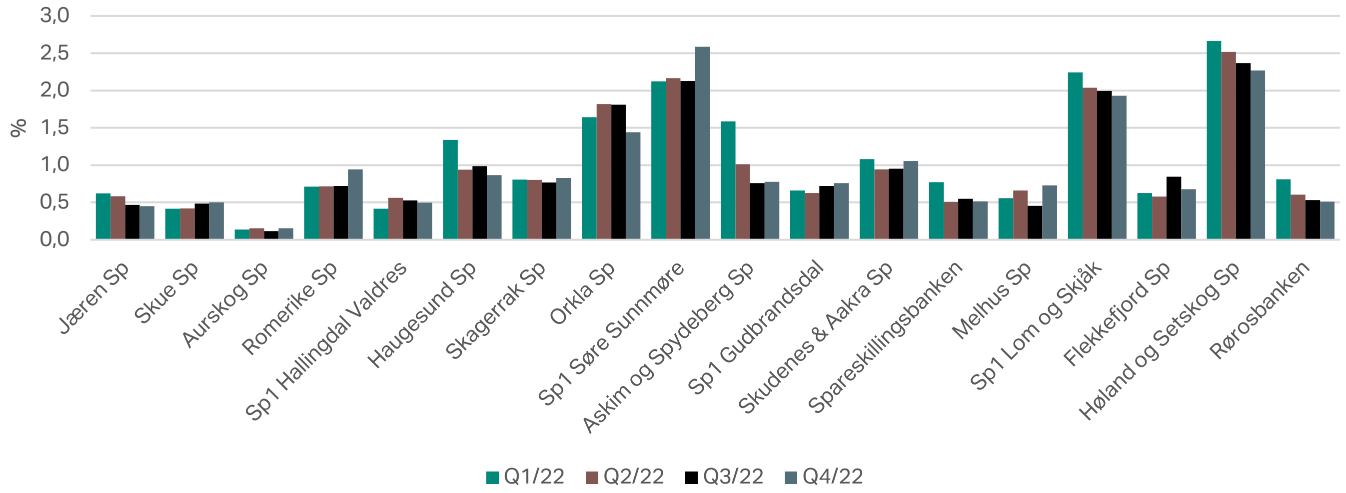
Figure 11. Norwegian savings banks' net losses by bank size, 2021–2022



Source: Norwegian financial supervisory authority.

Levels of net non-performing loans vary substantially in our sample. The average for the fourth quarter was 0.97%, with Aurskog Sparebank achieving the best performance of 0.15%.

Figure 12. Norwegian mid-size savings banks' net stage 3 loans to net loans, Q1 2022–Q4 2022

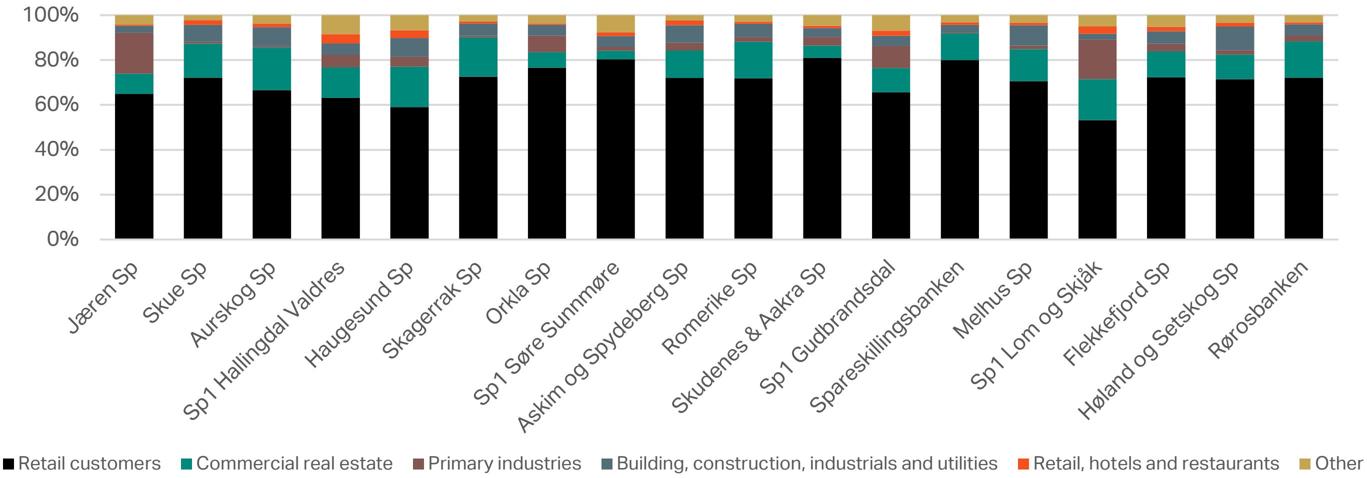


Source: bank reports.

HIGH EXPOSURE TO REAL ESTATE

There is an increased concentration risk of real estate among our sample. Norwegian mid-size savings banks have high levels of exposure to local and regional real-estate markets. This has a generally negative impact on our overall credit assessments and ratings. Retail real estate accounts for 70% of gross lending by Norwegian mid-size savings banks. Including transferred loans to covered-bond companies, retail real estate accounts for 77%. Overall housing price development was positive in 2022, due to an increase in the first half of the year, although transaction volumes were down for the full year. However, Statistics Norway predicts housing prices will decline by 9% from their peak in the second quarter of 2022 to the end of 2024. A tighter economy with higher living costs and rising interest rates is at the root of the decline, and we expect future policy rate decisions to have a significant impact on housing price development. However, we expect that a softening of lending regulations from 1 Jan. 2023, as well as a reduced housing supply due to lower new construction activity, will support housing prices in 2023.

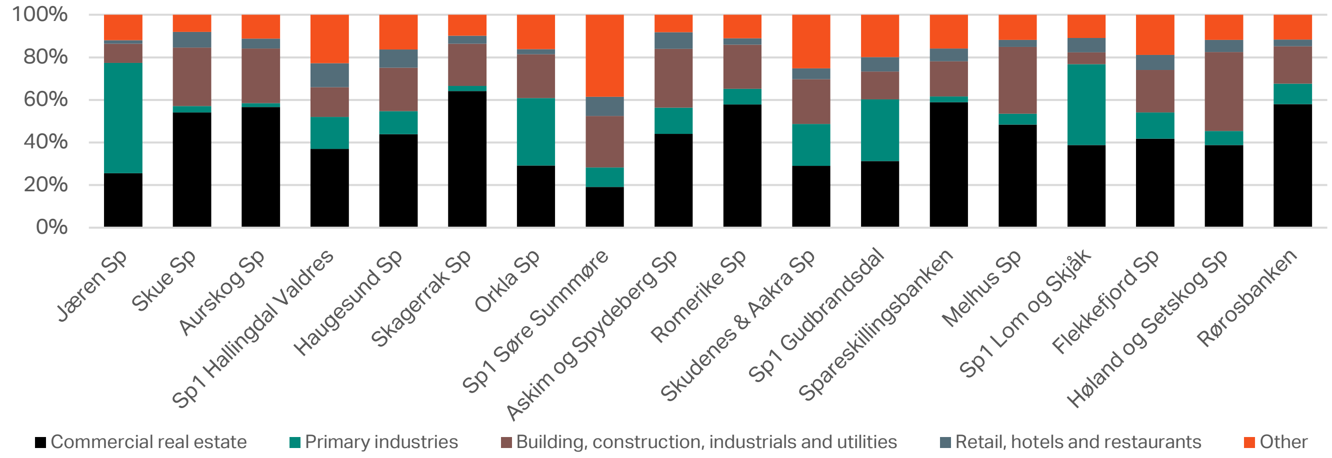
Figure 13. Norwegian mid-size savings banks' total exposure by sector, 31 Dec. 2022



Source: company reports. Commercial exposure for Melhus is not provided.

Exposure across our sample to commercial real estate varies widely, with lending to this sector averaging 43% of corporate lending. We see increased risk for the segment as a result of expectations of falling property values in 2023, which may in turn reduce collateral on the savings banks' loan books. Macro indicator-based provision models, as used in IFRS 9, do not necessarily take sufficient account of the risk of future problems in the commercial real-estate sector. Consequently, some banks have made additional provisions to account for this risk, while others may have to make larger loan loss provisions as property values decline or if increased vacancies impact debt servicing abilities. Although we believe risk in the commercial real-estate segment is 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.

Figure 14. Norwegian mid-size savings banks' corporate exposure by sector, 31 Dec. 2022



Source: bank reports.

The building and construction sector accounts for a significant portion of corporate lending for our sample, and this sector experienced reduced activity in 2022. A higher required rate of return has led to more building projects being put on hold, as well as an increase in redundancies in companies within the sector. Some Norwegian mid-size savings banks reported ongoing high activity in the fourth quarter of 2022, but are also noticing that customers are somewhat more concerned about how price increases will affect their own finances or business operations. We expect increasing loss provisions in this segment, but see activity remaining at moderate levels and expect a decline in lending growth for building and construction in 2023.

NCR-RATED NORWEGIAN SAVINGS BANKS

Figure 15. 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.

DISCLAIMER

NORDIC CREDIT RATING AS

nordiccreditrating.com