Nordic consumer banks' earnings compensate elevated credit losses

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EDITOR'S NOTE (14 Sep. 2023): Reference to TF Bank being affected by the Norwegian systemic risk buffer on page 3 was removed given that the bank's exposures are below the NOK 5bn threshold. Clarified that the Finnish systemic risk buffer could eventually receive reciprocity treatment from other regulators.

The second quarter of 2023 yielded positive results for most niche consumer banks in the Nordic region, with improved earnings and cost efficiency offsetting elevated loan-loss provisions. We looked at the data for nine regional consumer banks in the three-month period and most reported stable margins and loan-loss provision ratios despite ongoing cost inflation and higher interest expenses for consumers and rising bankruptcy rates across the region. There are signs of weakness ahead, however, as slower deposit growth across Europe is fuelling competition and increasing funding costs for Nordic consumer banks. In addition, a number of banks have indicated that changes in payment patterns and weakening economic conditions are likely to increase the need for future provisioning or hamper their growth strategies in certain segments.

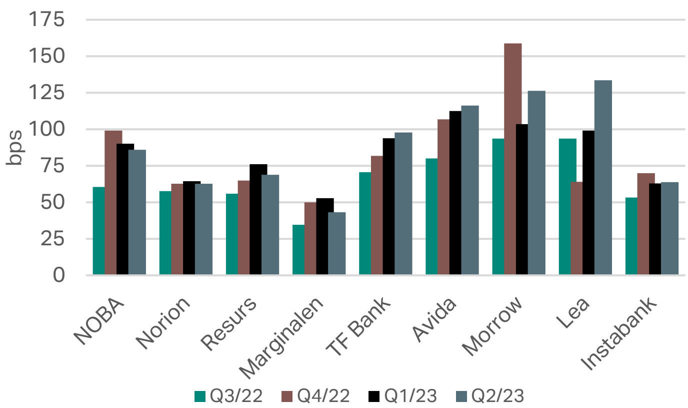
In July, a Swedish government committee submitted its proposal to improve consumer protection in the domestic consumer finance market. They include the establishment of a new national debt registry and specific recommendations for interest rate and total cost limits. We discuss the implications for the sector at the end of this report.

We maintain the view that increasing cost-of-living and regulatory risk is weighing on the consumer lending segment. As banks have noted, higher living costs and interest rates are likely to keep loan-loss provisions at elevated levels through 2024. We also expect margins to come under pressure from increased competition in a stagnant deposit market. The combination is likely to lead to weaker results in the sector over the remainder of 2023.

LOAN-LOSS PROVISIONS REMAIN ELEVATED

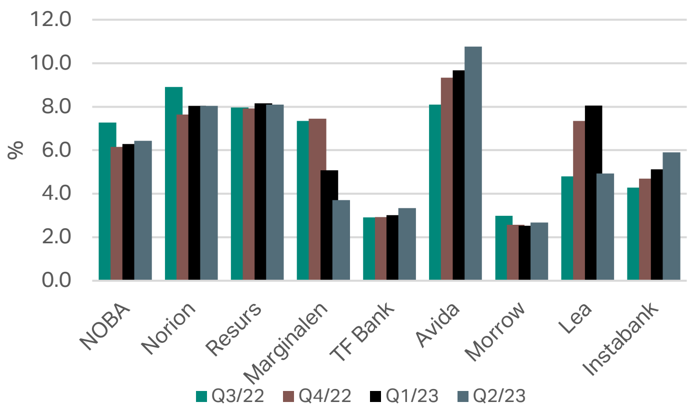
Inflation concerns persist across the Nordic region and further interest rate increases are widely expected. In the second quarter, asset quality metrics remained elevated for a third consecutive quarter although weighted average credit provisions fell slightly to 81bps of average net loans from 82bps and 83bps in the previous two quarters, respectively. Adjusted for loan growth (see Figure 9), loan-loss provisions continued to increase.

Figure 1. Nordic consumer banks' loan-loss provisions to average net loans, Q3 2022–Q2 2023



Source: bank reports.

Figure 2. Nordic consumer banks' net Stage 3 NPLs to net loans, Q3 2022–Q2 2023



Source: bank reports.

NOTE: Collector Bank rebranded to Norion Bank on 5 Sep. 2023.

NON-PERFORMING LOAN MARKET WEAKENS

Loan-loss provisions increased for each of the five smallest banks in the sample, and averaged 108bps in the second quarter. In particular, loan-loss provisions increased materially for Morrow Bank and Lea Bank. Morrow has said the increase was due to a change in payment behaviour and sees a risk of higher losses going forward. Lea reported a one-off 80bp impact on its annualised loan-loss provisions, from the sale of Norwegian non-performing loans (NPLs) and from acquired Finnish loans.

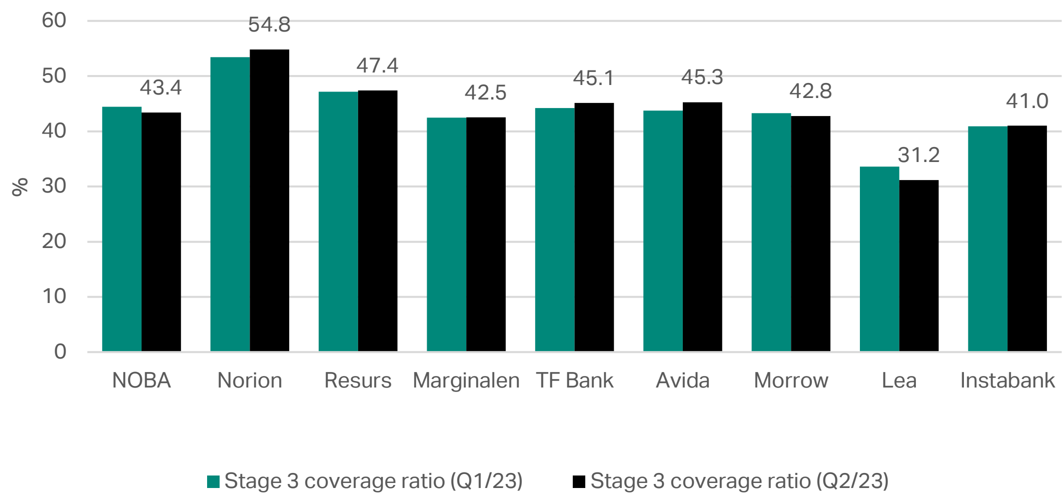
By comparison, the four largest banks in the sample reported lower provisions, at 65bps of average net loans. Notably, asset quality metrics at Norion Bank (previously Collector Bank) remained steady despite increasing concern about the Swedish commercial real estate market. Resurs Bank and Marginalen Bank ended a trend of increasing credit losses in the second quarter, but both flagged an uncertain outlook and heightened credit risk. NOBA Bank reported a high proportion of Stage 1 provisions associated with strong underlying growth.

NPL metrics have remained stable over the past three quarters, with weighted average net Stage 3 loans stable at 6.5%, compared with 6.6% in the two previous quarters. We believe that much of the offloading of NPL portfolios to reduce the capital impact of the EU's NPL backstop regulation is complete. Marginalen has stated that NPLs which are not subject to capital reductions via the backstop remain profitable. As a result, the bank has opted to move NPLs not affected by the backstop to subsidiary Sergel Finans AB while selling NPLs affected by the backstop and halving its NPL ratio in the first half of 2023. We believe other banks with relatively high and stable NPL levels are taking a similar approach.

Turbulent markets, rising interest rates, and negative rating outlooks on market-leading debt purchaser Intrum AB in the second quarter are restricting NPL liquidity across the Nordic region and could negatively affect future pricing and loan-loss provisioning. Despite this, a previously announced sale of Norwegian NPLs by Lea in the second quarter reduced its net reported NPLs to 4.9% from 8.0% during the period. NOBA also reported a sale of SEK 545m in Finnish NPLs in the second quarter.

Using a weighted average, Stage 3 coverage ratios increased marginally to 46.8% in the second quarter from 46.6% in the first. Lea remains an outlier due to a change in its definition of default in the fourth quarter of 2022, which increased its levels of gross Stage 3 loans. Norion's loan-loss provisioning remains the highest among the banks in our sample, reflecting 54.2% Stage 3 provisions for private loans and 58.8% for corporate and real-estate exposures. We expect higher Stage 3 coverage ratios for the sector due to a weaker NPL market and increased economic credit risk in the next few quarters.

Figure 3. Nordic consumer banks' Stage 3 coverage ratios, Q1 2023–Q2 2023

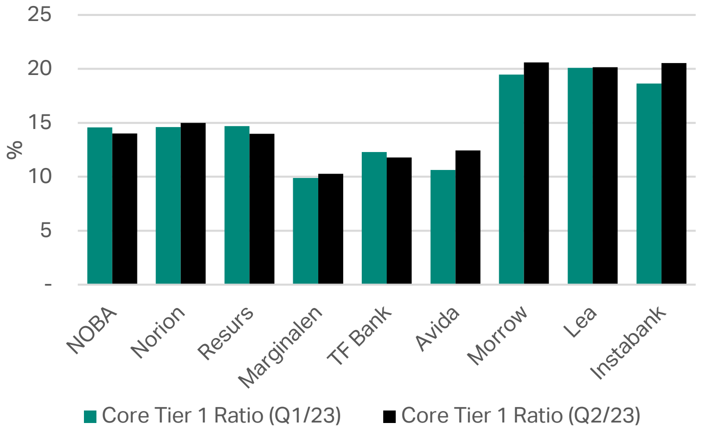


Source: bank reports.

CAPITAL INJECTIONS AND STRONG EARNINGS OFFSET GROWTH

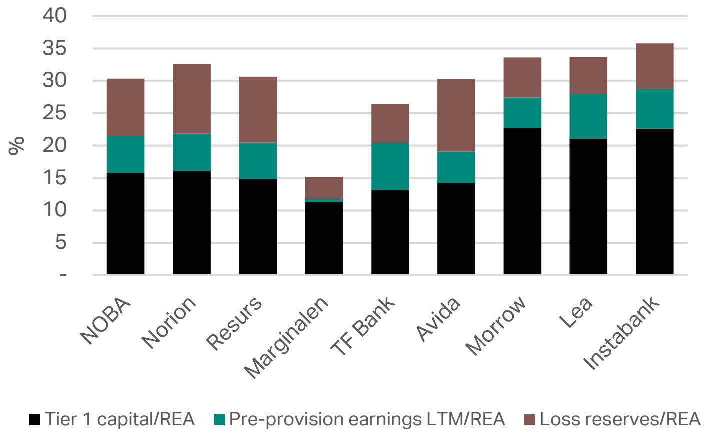
Weighted average common equity Tier 1 (CET1) ratios remained in line with the first quarter at 14.3%. Three banks have actively added new equity to support growth. Avida Finans completed a SEK 201m rights issue in the second quarter, which supported a 180bp improvement in its CET1 ratio. Instabank added NOK 70m in new shares via a private placement in the second quarter, raising its CET1 ratio to 20.5% from 18.6% previously. Morrow completed an equity increase, improving its proforma CET1 ratio to 20.6% from 19.5%. Marginalen raised its CET1 ratio to 10.3% but stands out as having the lowest capital and earnings buffers among the banks in our sample. The Norwegian banks remain significantly ahead of the Swedish banks both in terms of capital and earnings buffers. The generally higher loss reserves among the Swedish banks are a reflection of larger on-balance sheet NPL portfolios (see Figure 2).

Figure 4. Nordic consumer banks' CET1 ratios, Q1 2023–Q2 2023



Source: bank reports.

Figure 5. Nordic consumer banks' loss-absorbing buffers as a proportion of REA, Q2 2023

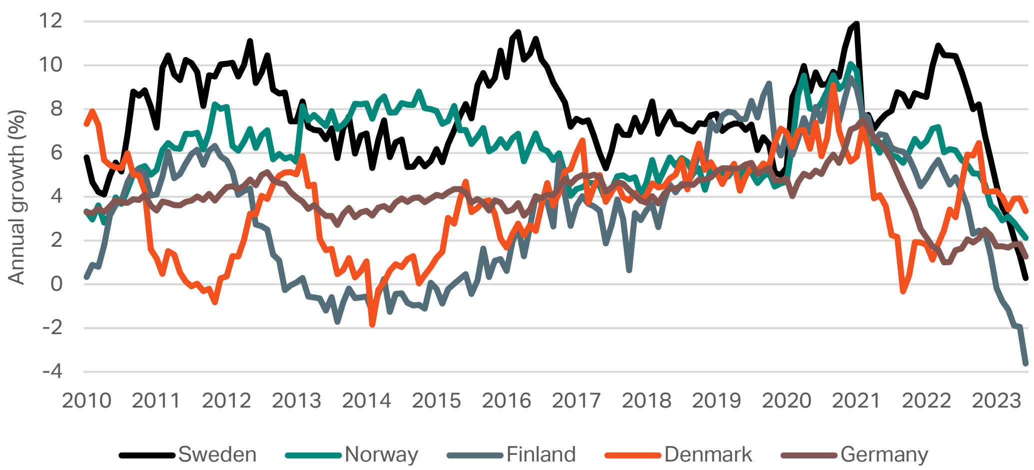


Source: bank reports. REA–risk exposure amount.

Regulatory adjustments continue to affect capital requirements across the sector. The European systemic risk board has accepted a lower threshold for the Norwegian systemic risk buffer (NOK 5bn from NOK 32bn previously), which will apply to all the Norwegian banks in the sample from end-2023. In May, the Swedish regulator announced it would apply the Norwegian systemic risk buffer of 4.5% to Norwegian exposures as of end-2023. The increase has the largest impact on NOBA, which has over 20% of loans located in Norway. Finally, the Finnish regulator has announced its own systemic risk buffer of 1% from April 2024, which could eventually also be subject to regulatory reciprocity for the Finnish exposures of the banks in our sample.

HOUSEHOLD DEPOSIT GROWTH STAGNANT

Figure 6. Annual household deposit growth in the Nordic countries and Germany, 2010-July 2023



Source: Statistics Sweden, Statistics Norway, Statistics Denmark, ECB.

Despite a relative lack of capital market financing, the banks in our sample have been able to support loan growth with Nordic and German deposits in recent years. However, savings rates have fallen across Europe and resulted in lower household deposit growth in all relevant markets. Rising interest rates have also increased competition from larger Nordic banks which have materially increased their deposit rates and begun to pay interest on current accounts.

The risk associated with on-demand, price-sensitive deposits has been elevated by recent bank runs in the US and Swiss banking sectors, in our view, despite generally high levels of government guarantees for the banks in our sample. NCR-rated Nordic consumer banks have around 95% of their deposits guaranteed, reducing such risk, but we note that elevated reputational risk could have severe effects on liquidity in a digital banking environment.

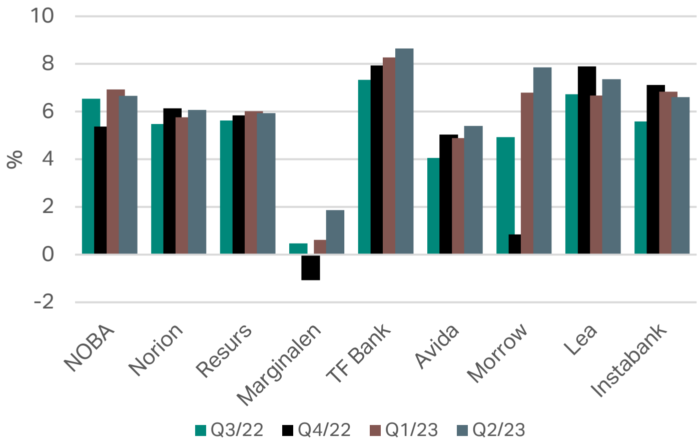
In such conditions, it is important for banks to maintain liquid buffers against potential outflow of deposits. During the second quarter, the average ratio of liquid assets to customer deposits fell to 19.4% among the banks in our sample, down from 23.7% a year earlier and 20.3% in the first quarter. Notably Morrow's liquidity buffer fell to 14.3% from 22.5% in the first quarter and the bank reported a NOK 950m reduction in customer deposits despite a NOK 282m increase in net loans. This was offset in part by equity injections and new Tier 2 capital. Avida has seen a SEK 1.6bn reduction in customer deposits since the beginning of 2023 (compared with a SEK 300m reduction in net loans), which it says was related to the maturity of deposits denominated in euro. Avida also offset the increased funding gap by issuing equity during the second quarter. Conversely, Norion and TF Bank each increased their customer deposit coverage of net loans by over SEK 1bn during the second quarter and increased liquid assets as a proportion of customer deposits.

In addition, risk premiums for capital market financing remain elevated and unattractive, adding to the pressure on customer deposits in the sector. Market spreads are still elevated following the bank runs in the second quarter and banks have only used market financing for capital instruments and asset backed securities. For example, NOBA has raised secured financing backed by equity release mortgages and consumer finance loans since April, while repurchasing senior unsecured bonds worth about SEK 700m (both in Swedish krona and Norwegian krone).

MARGIN PRESSURE FROM HIGHER DEPOSIT RATES LIKELY

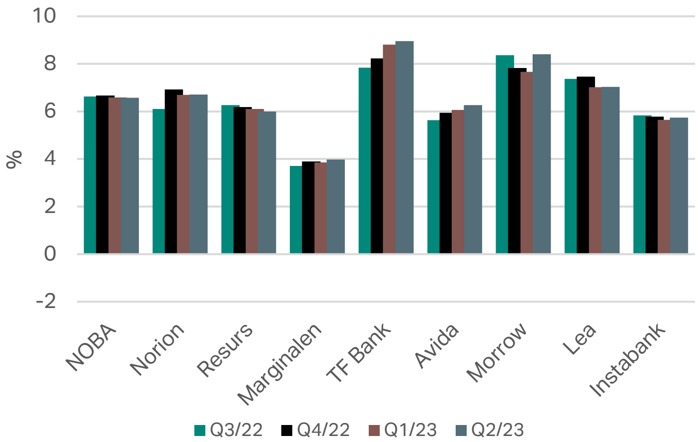
We expect lower supply and increasing competition to lead consumer banks to raise their interest rates on customer deposits and to erode their net interest margins. We also expect funding costs to increase as large commercial and savings banks actively compete to attract customer deposits amid lower systemic deposit growth and higher capital market spreads. Through the second quarter, the weighted average net interest margin remained stable at 6.5% in line with levels since the fourth quarter of 2022.

Figure 7. Nordic consumer banks' annualised pre-provision income to average REA, Q3 2022–Q2 2023



Source: bank reports.

Figure 8. Nordic consumer banks' annualised net interest margins, Q3 2022–Q2 2023



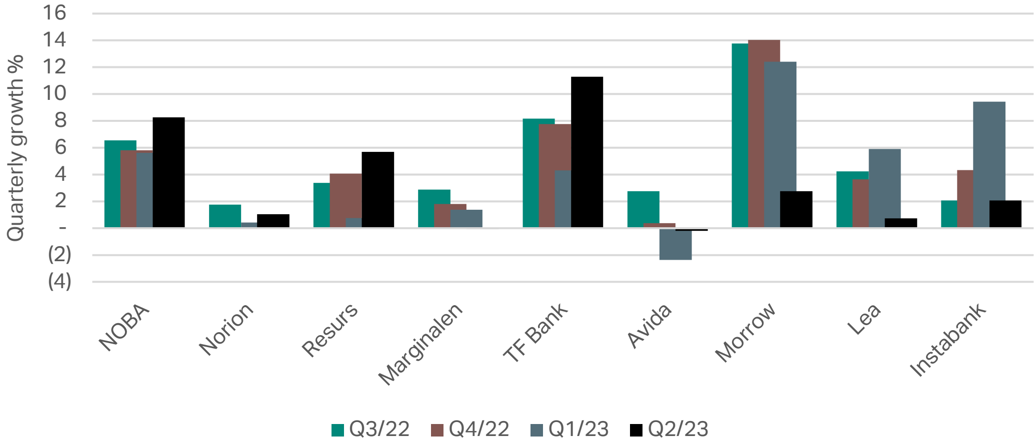
Source: bank reports.

Despite the pressure on margins, they remain higher than a year previously and risk-adjusted earnings continued to show strong improvements in the second quarter. Higher volumes and greater cost efficiency also supported pre-provision profitability. In total, the banks in our sample reported weighted average annualised pre-provision income-to-REA of 6.3%, up from 5.0% in the second quarter of 2022. Cost-income ratios also improved across the sector to 38% from 41.3% a quarter earlier. Morrow saw the largest improvement in earnings and efficiency thanks to a material cost reduction programme and pursuit of significant growth. Elsewhere, Marginalen reported positive valuation changes in its portfolios of purchased NPLs.

FOREX EFFECTS DRIVE LOAN GROWTH, BUT BANKS INCREASINGLY CAUTIOUS

Weighted average net loan growth increased to 5.2% in the second quarter from 3.4% in the first, supported by a significant depreciation of the Swedish krona (4.5%) and Norwegian krone (3.0%) against the euro. This had a sharply positive effect on loan growth in the sector, especially in Denmark, Finland, Germany, Latvia, Lithuania, and Estonia. Morrow bucked the general trend with abruptly slower growth during the quarter despite a target of NOK 12bn in gross loans by end-2023 (NOK 10.5bn at 30 Jun. 2023). This was mostly due to weaker credit conditions and changing repayment patterns. Avida also reported increased caution in consumer lending, while other banks said their underwriting remained prudent in view of continued adverse conditions. NOBA, Resurs and TF Bank reported growth of over 5% in the second quarter, but growth at many other banks in the sector slowed dramatically.

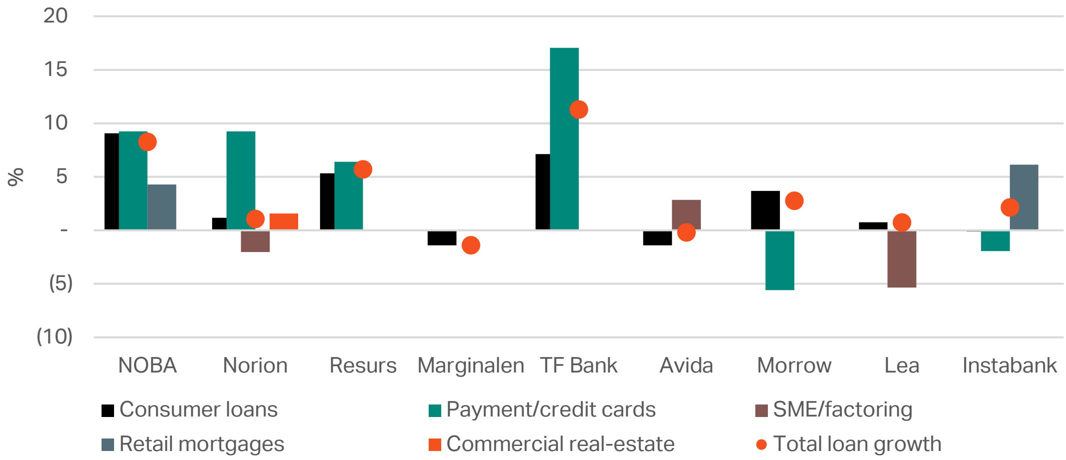
Figure 9. Nordic consumer banks' net loan growth, Q3 2022–Q2 2023



Source: bank reports.

Growth drivers in the sector varied by customer segment. On aggregate, consumer loans grew by 5.3%, payment and credit cards volumes by 9.0%, and retail mortgages by 4.5%. Among individual banks, TF Bank's credit card volumes rose by 17%, mostly in Germany. NOBA expanded lending in all of its key customer segments, though it announced a pause in new lending and card issuance in Spain due to poor performances. Morrow closed its point-of-sales business in April and slowed the growth of consumer loans materially. Most of Instabank's recent growth has been driven by non-standard Norwegian mortgage products since they were launched three years ago, and such loans now account for 40% of the bank's total loan book. Instabank has also announced that it is rolling out SME lending.

Figure 10. Nordic consumer banks' net loan growth by segment, Q2 2023



Source: bank reports.

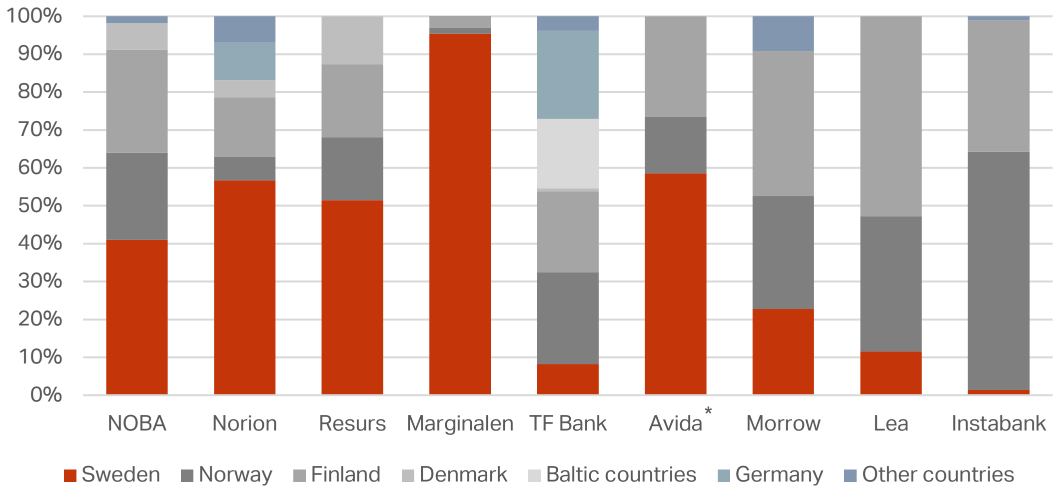
Norion ended a long-term trend of declining consumer lending, but grew only modestly in the quarter, with real-estate loan growth offset by a reduction in its SME and consumer loan book due to economic concerns. Avida reduced lending to consumers in favour of SME loans. Lea continued to unwind its SME lending business, reallocating capital to growth in consumer lending. Resurs said it had reached an "important milestone" in second-lien mortgage lending in Norway but nonetheless generated most loan growth in Sweden and Finland.

SWEDISH PROPOSALS UNLIKELY TO IMPOSE MATERIAL RESTRICTIONS ON SECTOR

In July, a Swedish government committee on over-indebtedness published a report on high-risk consumer loans and specific proposals to improve consumer protection. The suggestions seek to lower the interest rate ceiling to 20pp over the reference rate from the current 40pp. They also call for a national debt registry.

In our view, all banks in our sample would benefit from the creation of a national debt registry, including those currently using private-sector credit reference agency UC, as it would give them a more comprehensive picture of a prospective borrower's debt profile. Conversely, a drop in the interest rate ceiling would be unlikely to materially impact the banks in the sample, as interest rates of up to 40% on consumer loans are more commonly charged by small credit providers. In addition, the proposed interest rate cap would exclude credit cards. The government committee estimates the proposed cap would decrease loan volumes by SEK 1bn annually. The proposals could also have a minor impact on NPL pricing, as they suggest that collectors of such loans focus on reducing principal amounts rather than interest payments. In our view, the banks in our sample are most likely to be negatively affected by a proposed limit on the total cost of debt (1x principal) and a ban on extending loan maturities for a fee.

Figure 11. Net loans by country (highlighting Sweden), Q2 2023



Source: bank reports. *as of end 2022.

All of the banks in our sample have some exposure to Sweden. Marginalen has more than 90% exposure, while that of Instabank is relatively minor. It is unclear which, if any, of the proposals will become law, or what the ultimate effect will be. But in our view, the main impact will be on small credit providers rather than the niche banks in our sample. In addition to the government, the Swedish Financial Supervisory Authority is also focusing on consumer lending, having been assigned supervision of small credit providers earlier this year. Irresponsible and excessive lending remain key topics of media and political debate as many households continue to face tough economic conditions.

NCR-RATED CONSUMER BANKS

The following table summarises NCR's ratings on Nordic consumer banks as of 11 Sep. 2023.

Figure 12. NCR ratings on Nordic consumer banks

	Resurs Bank	Norion Bank	NOBA Bank Group
Long-term issuer rating	BBB	BBB-	BBB
Outlook	Stable	Stable	Stable
Subfactors:			
Operating environment (20%)	bbb-	bbb-	bbb-
Risk appetite (50%)	bbb	bbb-	bbb
Market position (15%)	bb+	bb	bbb-
Performance indicators (15%)	bbb+	bbb+	bbb+
Ownership adjustment	0	0	0

See NCR's company rating reports for details.

RELEVANT RESEARCH

(i) Nordic consumer banks' loss provisions remain elevated, 28 Jun. 2023
(ii) Nordic consumer banks increase loss provisions amid rising cost of living, 31 Mar. 2023.
(iii) Nordic consumer banks improve margins to offset higher loss provisions, 11 Nov. 2022.

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