Nordic Credit Rating

SECTOR COMMENT

26 Oct. 2023

High interest rates generate strong first-half earnings for Swedish savings banks

ANALYSTS
Ylva Forsberg
+46768806742
ylva.forsberg@nordiccreditrating.com

Sean Cotten
+46735600337
sean.cotten@nordiccreditrating.com

Swedish savings banks have reported strong results for the first half of 2023 thanks to a rapid increase in market interest rates since April 2022. Actual credit losses have been more moderate than we expected at the start of the year. However, loan-loss provisions remain volatile amid fluctuating economic forecasts and high levels of uncertainty.

While the domestic housing market has stabilised after significant price falls in 2022, mortgage lending growth remains exceptionally low. We believe it is unlikely to pick up any time soon, mainly because increasing transaction volumes will likely reduce prices further. While corporate loan growth outpaced mortgage loan growth in the first half of 2023, it remains muted. We also believe that net interest margins in the sector are near their peak amid slowing interest rate increases, while many savings banks are facing increased competition for deposits as savings growth rates fall.

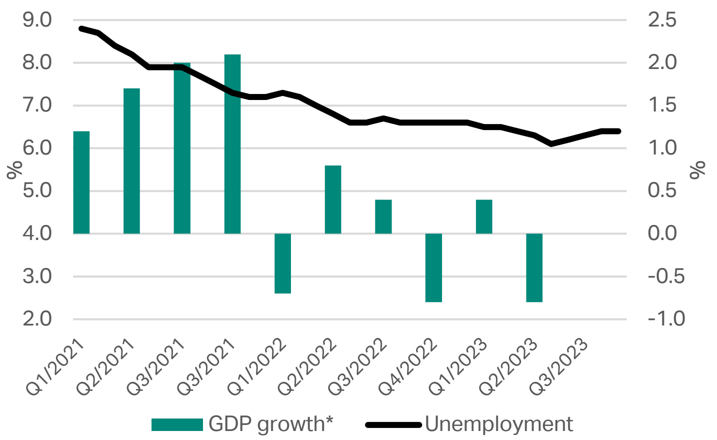
On 26 May 2023, Södra Dalarnas Sparbank and Bergslagens Sparbank announced a first merger in the sector since Sparbanken Skåne was created in 2014. The merged entity, to be known as Sparbanken Bergslagen, is likely to obtain regulatory approval in 2024. Such mergers are unusual in Sweden, but could increase in the years ahead.

In this report, we focus on the first half results of a sample of 13 savings banks, and the outlook for the remainder of the year. We rate four of the banks (see Figure 19).

ECONOMIC FACTORS WEAK IN FIRST HALF

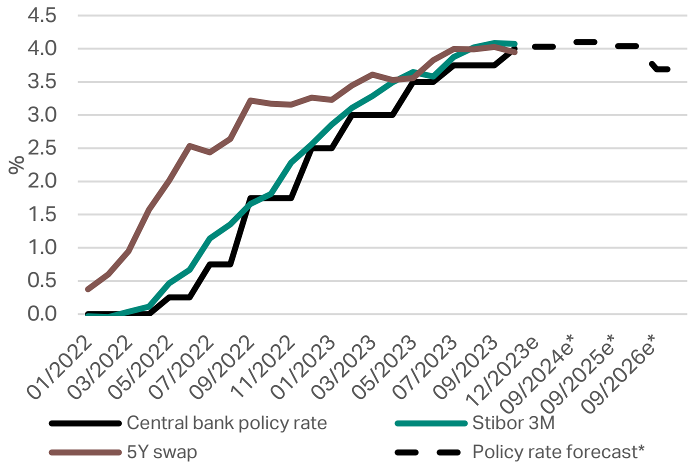
The first six months of 2023 were dominated by expectations of a recession that never came. Although a recession could still emerge when the numbers for the third quarter come in, the economy has proven more resilient than we previously expected, despite persistent inflation and rapid increases in interest rates. Even if a technical recession does not occur, we nonetheless expect the economy to continue to display recessionary characteristics, specifically lower spending by households and corporates, while banks increase their loan-loss provisions and incur actual losses. Positively, Swedish savings banks are well capitalised and have benefited from increasing interest rates. Consequently the sector is well placed to withstand a weaker economy.

Figure 1. Swedish GDP growth* and unemployment, Q1 2021–Q3 2023



Source:Statistics Sweden, Swedish employment Agency. *quarterly reported annual change, seasonally adjusted.

Figure 2. Swedish market interest rates, Q1 2022–Q3 2026e



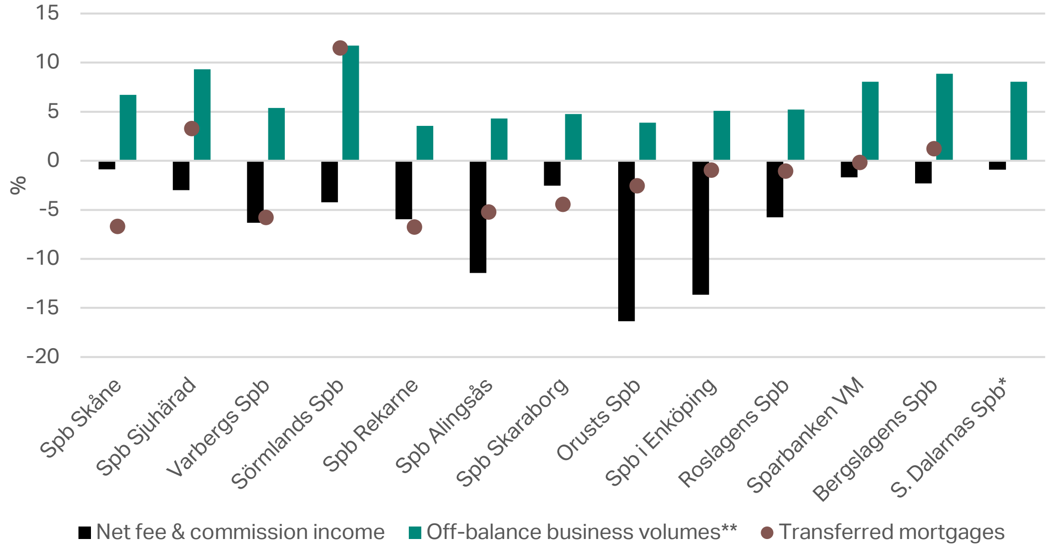
Source: The Riksbank, S&P CapIQ Pro. e-estimate. *central bank.

SLUGGISH MORTGAGE MARKET SLOWS LOAN GROWTH

As of mid-year, mortgage lending accounted for an average 45.2% of Swedish savings banks' on-balance-sheet gross loans (63.4% if mortgage loans transferred to Swedbank Hypotek AB are included).

Average mortgage lending growth across our sample in the first half was 2.1%, while total market growth was closer to 0%, but with significant variation between individual banks. Some of the banks saw on-balance-sheet growth boosted by repatriation of previously transferred mortgages (see Figure 3 and Figure 9), driven by increasingly low margins earned from Swedbank Hypotek. While off-balance-sheet business volumes consist only partly of transferred mortgages, we believe that the resulting decrease in net fee and commission income across the sector was mainly driven by falling margins on transferred mortgages amid increasing off-balance-sheet business volumes.

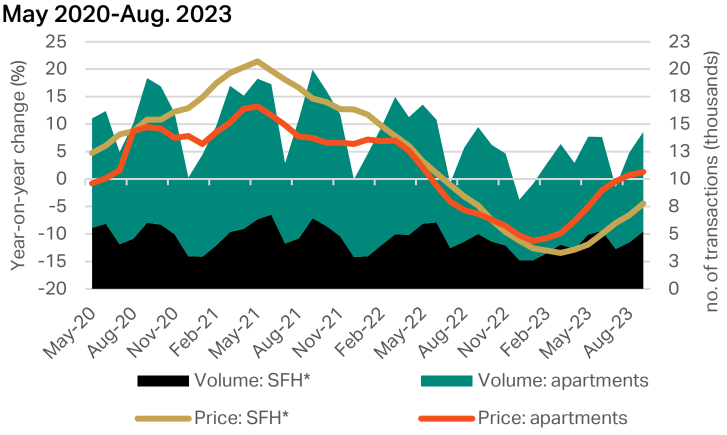
Figure 3. Swedish savings banks growth in commision income vs growth in commission-generating volumes, H1 2023



Source: bank reports. *no data on transferred mortgages as of 30 Jun. 2023. **total business volumes less on-balance loans and deposits.

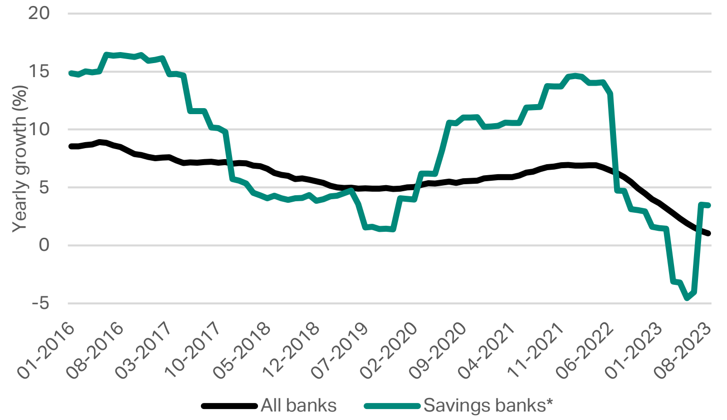
We believe a rapid increase in household mortgage borrowing costs has prompted the Swedish Financial Supervisory Authority to encourage competition in the mortgage market. On October 19, it issued a report highlighting the difficulty of switching mortgage providers. It also proposed increased digitalisation of such transitioning. In addition, the authority has also proposed that the government remove a requirement for mortgage borrowers to pay interest rate compensation to the original lender when switching providers during a fixed-interest rate term.

Figure 4. Swedish housing price growth and transaction volumes, May 2020-Aug. 2023



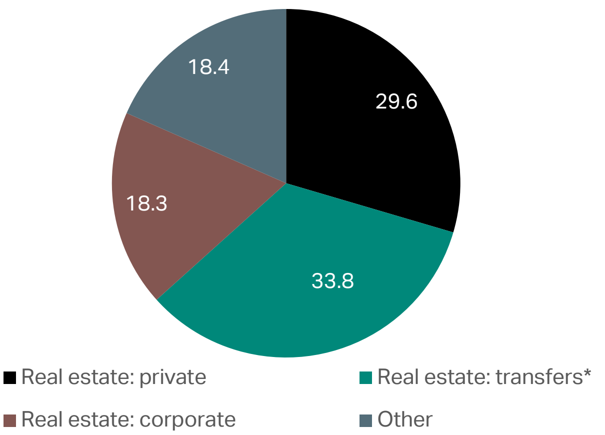
Source: Svensk Mäklarstatistik. *single-family houses.

Figure 5. Swedish mortgage lending growth, Jan. 2016-Aug. 2023



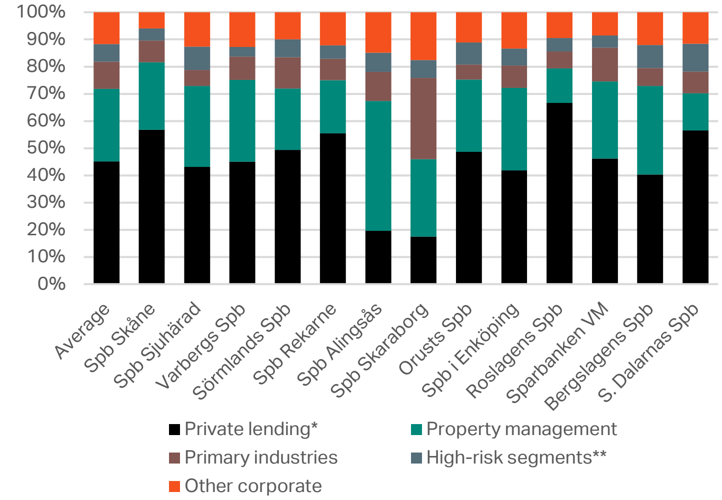
Source: Statistics Sweden. *sample defined by Statistics Sweden.

Figure 6. Swedish savings banks average loan distribution including loans transferred to Swedbank Hypotek (%), 30 Jun. 2023



Source: bank reports.*transferred mortgages.

Figure 7. Swedish savings banks gross loans by segment, 30 Jun. 2023

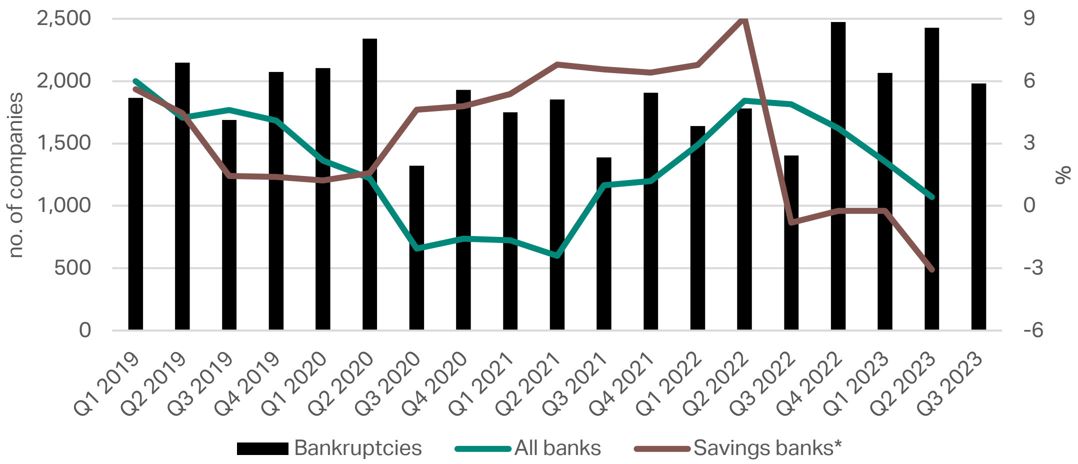


Source: bank reports. *mortgages, other lending to individuals, and loans to housing associations. **construction, retail, and hotel & service.

CORPORATE BANKRUPTCIES ALSO REDUCE LENDING

Apart from mortgage lending, most savings banks' corporate lending is heavily weighted towards the property management and agricultural sectors. High-risk sectors, such as the construction, retail, and hotel and restaurant industries, generally represent a small, but not negligible, part of savings banks' loan books (see Figure 7). Domestic bankruptcies have increased over the past 12 months, but from comparatively low levels at the height of the COVID-19 pandemic. We expect most savings banks to face an increase in bankruptcies among their corporate borrowers into 2024, in particular among high-risk borrowers as property development slows and consumer spending remains low.

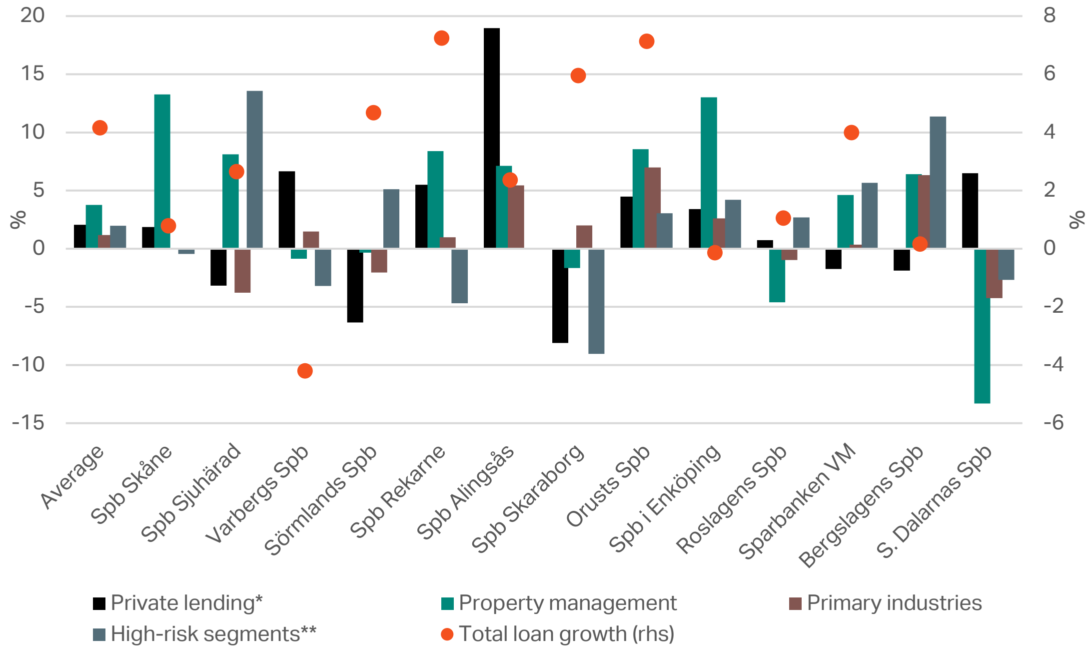
Figure 8. Swedish bankruptcies and banks' loan growth to domestic non-financial companies, Q1 2019–Q3 2023



Source: Statistics Sweden. *sample defined by Statistics Sweden.

Apart from asset quality concerns, strong corporate loan growth has benefited many savings banks in recent years. Aggregate corporate loans among a sample of savings banks defined by Statistics Sweden (see Figure 8) peaked in the second quarter of 2022. (The sample covers more savings banks than our sample but is not comprehensive). While loan growth has been negative over the past 12 months, corporate loan volumes rose in the first half of 2023. However, trends are not uniform (see Figure 9) with several banks seeing significant growth in loans to just a few sectors, and others seeing only modest or even negative growth in most. Because savings banks have a local focus, the respective regional economy has a large impact on investment sentiment among corporate borrowers. In addition, savings banks tend to have conservative risk profiles. Consequently, we expect limited loan growth, as a consequence of lower demand for loans and fewer corporate borrowers meeting their banks' requirements for new or extended loans. We expect modest corporate loan growth to continue into 2024, but with distinct regional variations.

Figure 9. Swedish savings banks loan growth by segment, H1 2023

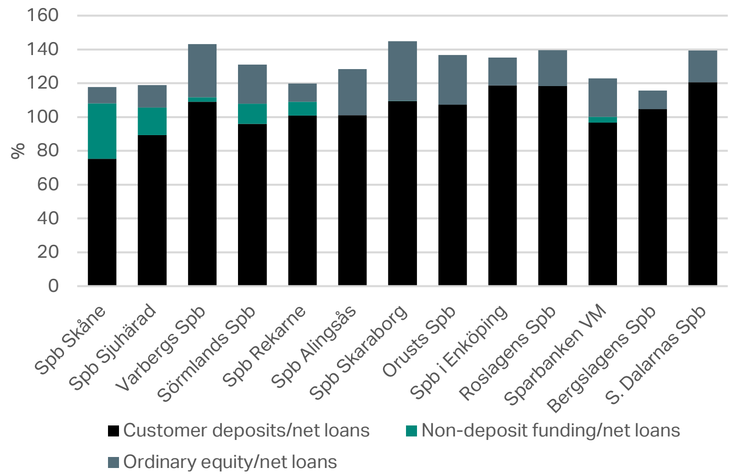


Source: bank reports. *mortgages, other lending to individuals, and loans to tenant associations. **construction, retail, and hotel & service.

DEPOSITS UNDER SIGNIFICANT PRESSURE IN FIRST HALF

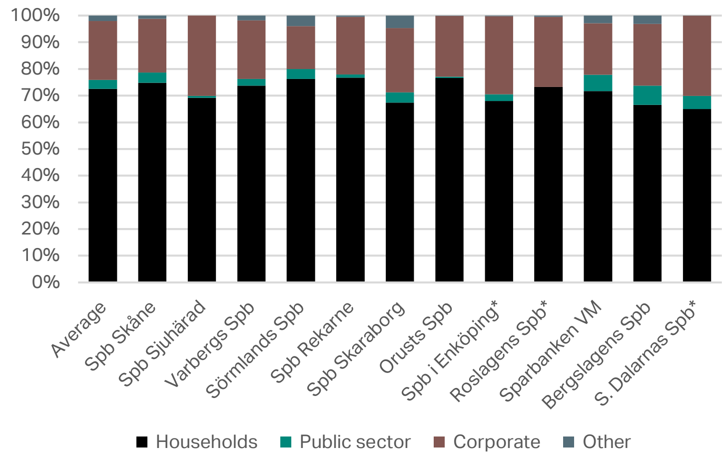
All of the banks in our sample are financed primarily through customer deposits, with the largest proportion coming from households. Public sector deposits generally come from local municipalities, which can be subject to volatile inflows and outflows, as has been the case in 2023.

Figure 10. Swedish savings banks funding, 30 Jun. 2023



Source: bank reports.

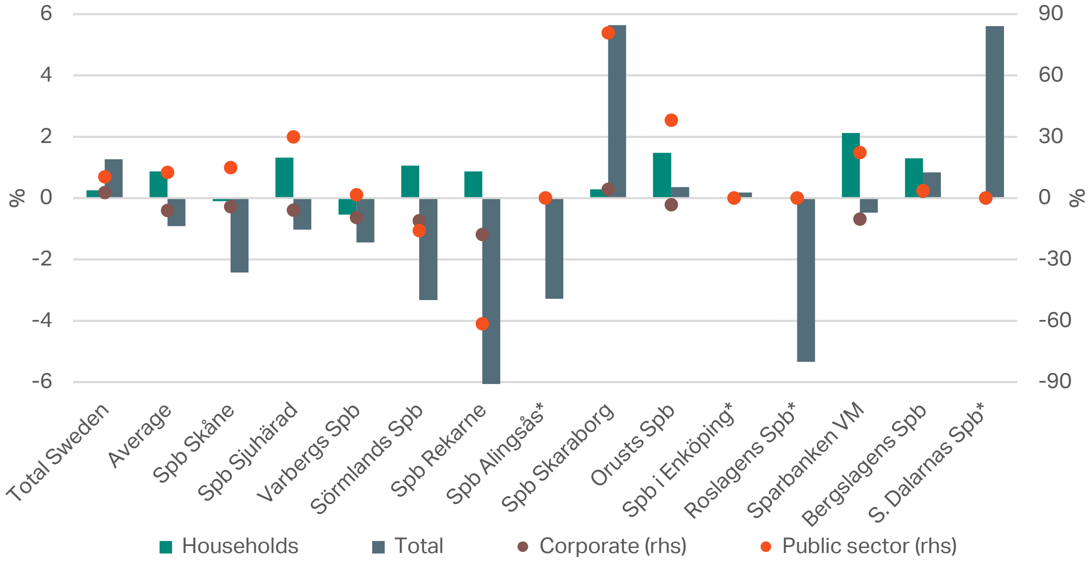
Figure 11. Swedish savings banks deposits by segment, 30 Jun. 2023



Source: bank reports. *as of 31 Dec. 2022.

Many banks report increased competition for deposits, especially from household depositors. However, average deposit growth remains positive across the sample. Competition arises by increasing cost differences between market funding and deposits, as well as the fact that deposit growth is no longer significantly outpacing loan growth (on average deposit growth outpaced loan growth by 0.5pp-4pp. annually between 2018 and 2021). Generally, we consider savings banks' position in their respective local communities to promote customer loyalty, which could prove beneficial in terms of lessening competitive pressure on deposit and lending margins. In addition, we expect the banks in our sample to be able to pace their own loan growth, and transfers to Swedbank Hypotek, to maintain strong loan-to-deposit ratios. However, in our view, household and corporate savings rates are likely to decrease further, possibly into negative territory, which would increase pressure on margins.

Figure 12. Swedish savings banks deposit growth byr segment, H1 2023

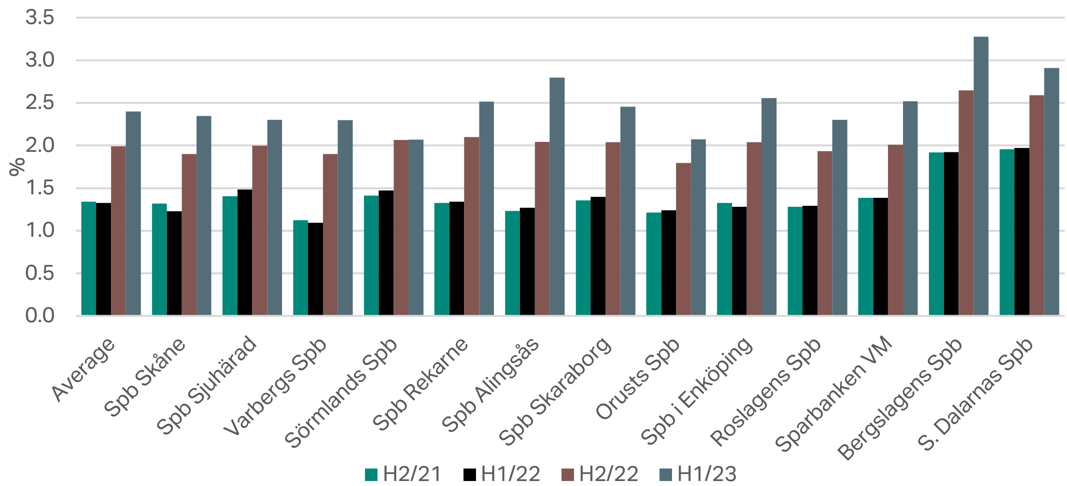


Source: bank reports. *deposit segment data not available as of 30 Jun. 2023.

HIGH INTEREST MARGINS CONTINUE TO ELEVATE EARNINGS

The first half saw a continued rise in net interest margins for all banks in our sample. Sörmlands Sparbank has a relatively large proportion of fixed-interest loans, and consequently saw a slower rise in margins in the period. We generally expect net interest margins to remain close to their current levels, but for many banks the peak has passed or is imminent.

Figure 13. Swedish savings banks net interest margins, H2 2021–H1 2023 (annualised)

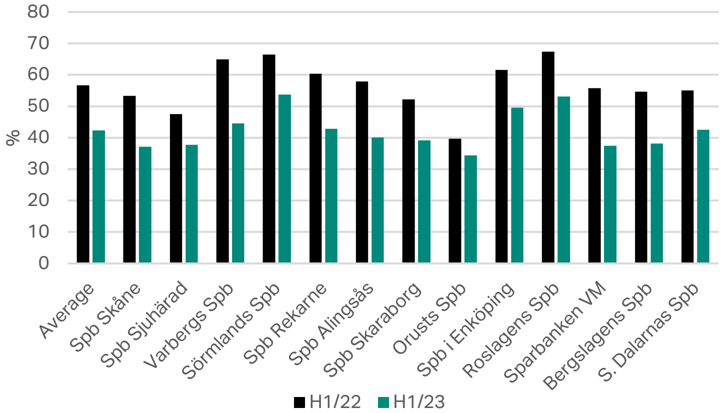


Source: bank reports.

The banks in our sample have continued to show significant improvements in earnings, despite competitive pressure, slow loan growth, and concerns about increasing non-performing loans. In addition to core earnings (net interest income and net fee and commission income), most banks' first half earnings were boosted by dividends from Swedbank Hypotek parent Swedbank AB. Cost efficiency metrics are benefiting from the strong earnings even though costs have increased.

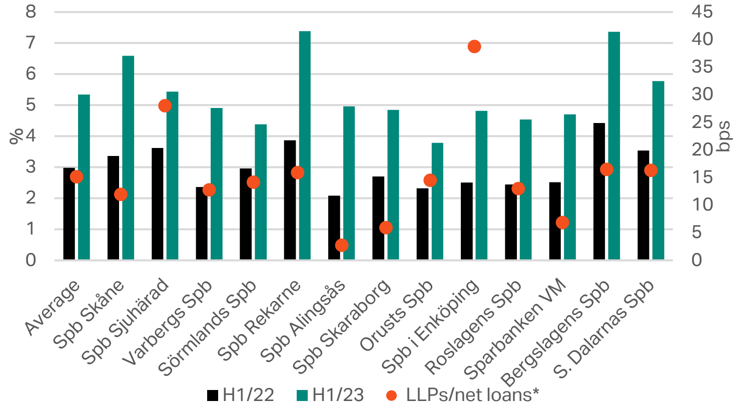
Having suspended dividends through the initial stages of the COVID-19 pandemic, Swedbank has resumed distributing payments at 50% of net profits (albeit below its long-term policy rate of 75%). We believe the decision not to pay 75% is due to continuing uncertainty about the outcome of legal action by the U.S. Department of Justice. We consider it likely that Swedbank will temporarily reduce the level of its dividend payments or cancel them altogether following a verdict. Consequently we focus on savings banks' core earnings. Sweden's savings banks have a long history of cooperation with Swedbank, including significant levels of cross ownership. In addition, Swedbank acts as a clearing bank for the savings banks and provides them with economies of scale and cost efficiency benefits via cooperation on IT infrastructure, risk modelling, and financial reporting. For details of the relationship see Relevant research v. and vi.

Figure 14. Swedish savings banks core cost-to-income ratios, H1 2022 and H1 2023



Source: bank reports.

Figure 15. Swedish savings banks core risk-adjusted earnings, H1 2022 and H1 2023 (annualised)

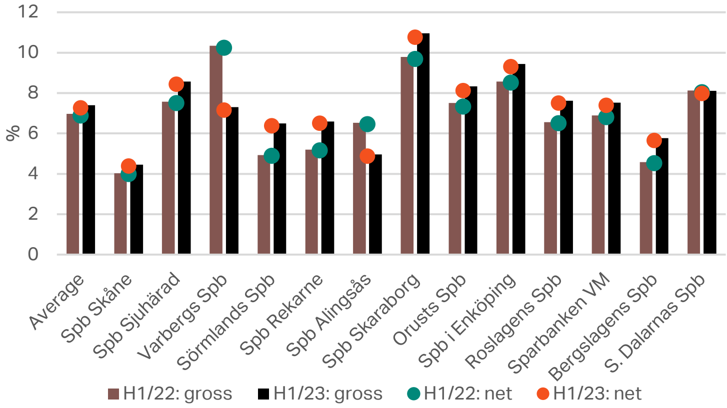


Source: bank reports. Core pre-provision income over risk exposure amount. *loan loss provisions, last 12 months.

NON-PERFORMING LOANS LIKELY TO INCREASE

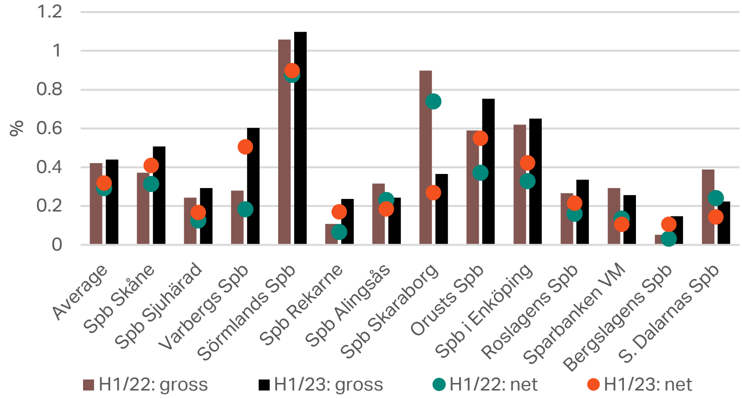
Loan-loss provisions in the sector in the year to 30 Jun. 2023 were volatile (see Figure 15). Rapid shifts in economic indicators and forecasts, combined with manual adjustments when models are thought to capture future portfolio risk inaccurately, have led to a rise in provisions since the height of the COVID-19 pandemic. Due to the forward-leaning nature of provisions modelled on IFRS 9, many banks oscillate between large provisions and reversals.

Figure 16. Swedish savings banks gross and net Stage 2 loans, H1 2022 and H1 2023



Source: bank reports. Gross Stage 2 loans as share of total gross loans. Net Stage 2 loans as share of total net loans.

Figure 17. Swedish savings banks gross and net Stage 3 loans, H1 2022 and H1 2023

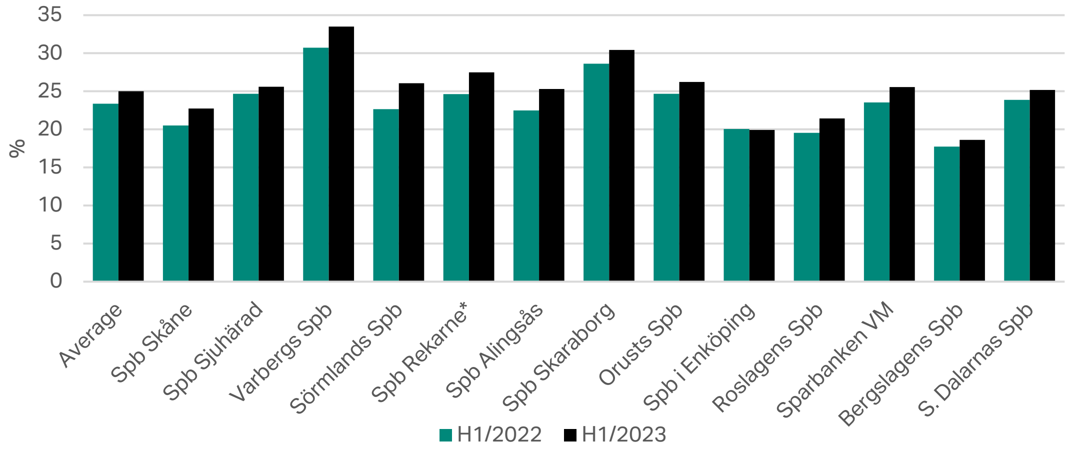


Source: bank reports. Gross Stage 3 loans as share of total gross loans. Net Stage 3 loans as share of total net loans.

Given Swedish savings banks' lending mix (see Figure 7) and high level of secured lending, we believe the risk of significant loan losses is relatively low. However, we expect a rise in non-performing loans to the property management sector and high-risk sectors as cash flow problems limit some borrowers' ability to service their debt. In 2022, the EU introduced new directives for classifying non-performing loans (the New Definition of Default). Our impression is that interpretation has varied among Swedish savings banks, especially as to whether amortisation breaks on mortgage loans should cause a loan to be classified as non-performing in the first instance, or only after recurring periods of relaxation. We believe that higher ratios of non-performing (Stage 3) loans are likely, as the new criteria entail a more binary assessment of loans that are not fully serviced by the customer, compared with previous standards.

So far in 2023, the savings banks in our sample have reported an increase in Stage 2 loans, on both a gross and net basis, while the proportion of Stage 3 loans has remained relatively flat. We believe this is indicative of a wider weakening in credit quality and that more non-performing loans will follow.

Figure 18. Swedish savings banks common equity tier 1 ratios, H1 2022 and H1 2023



Source: bank reports. *including SEK 120m in tier 2 capital.

However, even with an increase in loan-loss provisions and non-performing loans, we expect Swedish savings banks to remain strong, largely due to their exceptional capital positions. Improved earnings and slowing loan growth have boosted capital positions from already high levels, given modest dividend payouts across the sector. While we believe that little room exists for earnings to improve further, we consider that improvements to date outweigh any increase in loan-loss provisions. Modest loan growth and continued strong earnings suggest that capital ratios are likely to improve, in our view. We are wary that this could tempt some banks into expanding their areas of operation, or accepting higher risk in new lending, due to a lack of attractive corporate clients, but do not consider the risk significant.

NCR-RATED SWEDISH SAVINGS BANKS

Figure 19. NCR ratings on Swedish savings banks, (26 Oct. 2023)

	Sparbanken Rekarne AB (publ)	Sparbanken Västra Mälardalen	Sörmlands Sparbank AB (publ)	Varbergs Sparbank AB (publ)
Long-term issuer rating	A-	BBB+	BBB+	A-
Outlook	Stable	Stable	Stable	Positive
Subfactors:				
Operating environment (20%)	bbb	bbb-	bbb	bbb+
Risk appetite (50%)	a-	a	a	a
Market position (15%)	bbb	bb+	bbb	bbb+
Performance indicators (15%)	a	a-	bbb	a-
Ownership adjustment	0	0	0	0

See NCR's company rating reports for details.

RELEVANT RESEARCH

(i) The Swedish mortgage market (Q4, 2022), 31 Jan. 2023.
(ii) Swedish savings banks well positioned for economic downturn in 2023, 19 Dec. 2022.
(iii) Mid-sized Norwegian savings banks navigate economic challenges, publ. 28 Aug. 2023
(iv) Swedish savings banks end turbulent first half of 2022 in good shape, publ. 12 Sep. 2022
(v) Swedish savings banks get dividend boost after solid 2020, 21 Jun. 2021.
(vi) Q&A: Swedbank judgement and share price impacts on Swedish savings banks, 23 Mar. 2020.

DISCLAIMER

NORDIC CREDIT RATING AS

nordiccreditrating.com