Norwegian savings banks face margin squeeze in 2024

ANALYSTS
Geir Kristiansen
+4790784593
geir.kristiansen@nordiccreditrating.com

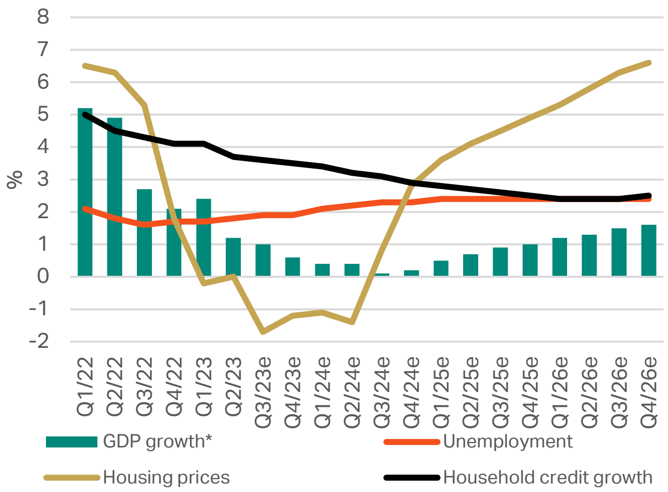
Christian Yssen
+4740019900
christian.yssen@nordiccreditrating.com

Rising interest rates have significantly increased net interest margins among Norwegian savings banks for the past two years. Together with strong lending growth, this has boosted earnings across the sector. However, we believe that core earnings growth in the sector will come to an abrupt halt in 2024 due to increased competition, falling interest rates, and higher loan losses. Among NCR-rated savings banks (see Figure 14), we expect a marginal decline in core profit next year, but anticipate that normalisation of non-core revenues will contribute to an 8% increase in pre-tax profit.

As intended, higher interest rates are contributing to a slowing of the Norwegian economy. We believe that continued high interest rates and a weaker economy will lead to higher loan-loss provisions over the next 12 months, but that levels will vary significantly between individual savings banks. Norway's savings banks are well-capitalised and have strong pre-provision profitability, which makes them resilient to increased credit losses.

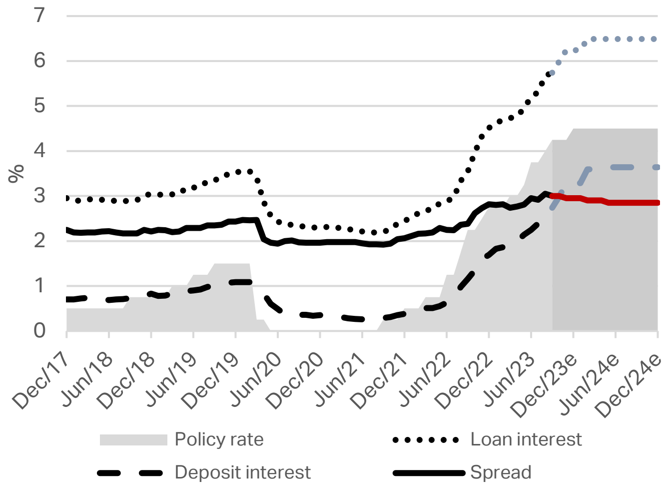
Merger activity in the savings-bank sector has been moderate in recent years. However, a recent announcement that SpareBank 1 SR-Bank and SpareBank 1 Sørøst-Norge intend to merge has led to increased speculation about restructuring across the sector. We expect little change in the level of merger activity in 2024, but acknowledge that savings banks could face pressure to seek partners due to increasing reporting and compliance requirements and pressure on profitability. Broadly, however, we believe that a full-scale consolidation of the wider savings-bank sector would be a lengthy undertaking and is currently unlikely.

Figure 1. Norwegian economic indicators, 2022–2026e



Source: Norges Bank. e-estimate. *Mainland Norway.

Figure 2. Norwegian interest rates and spread, 2022–2024e



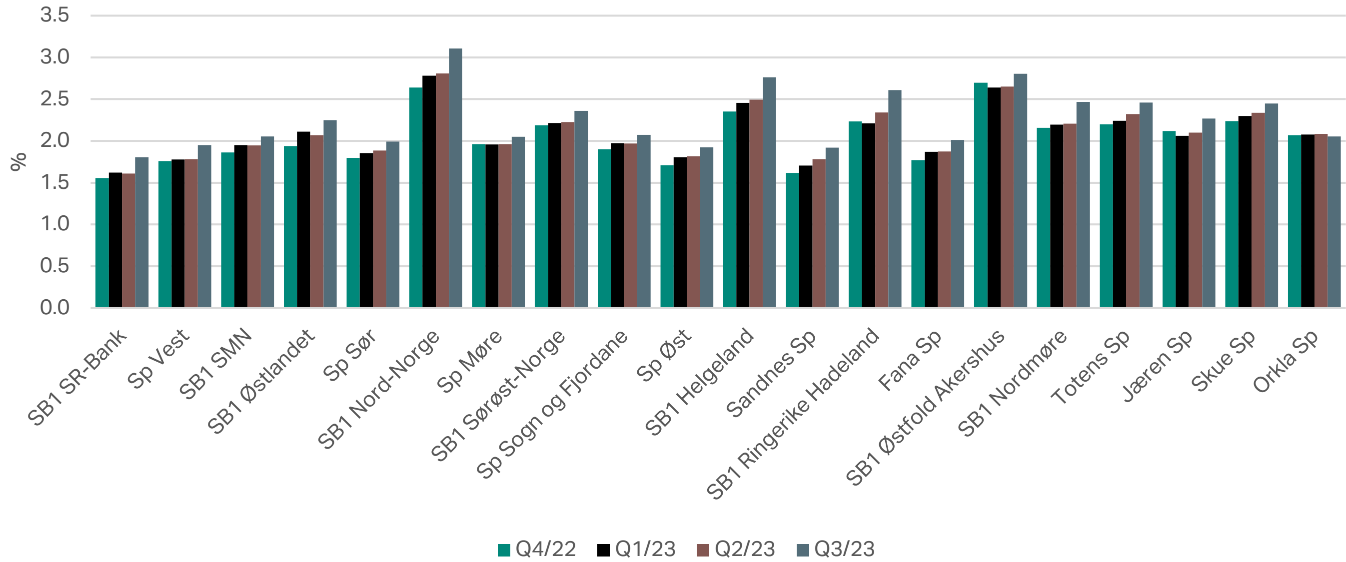
Based on Statistics Norway data and NCR estimates.

LENDING GROWTH LOW AND NET INTEREST MARGINS PEAKING

The Norwegian policy interest rate and NIBOR have increased by about 425bps since September 2021 and banks' net interest margins have been strengthened by lending rates increasing faster than deposit rates. Market expectations had been for an additional interest rate increase of 25bps before year-end, but recently announced expectations of low economic activity from the central bank's Regional Network information unit make this less likely.

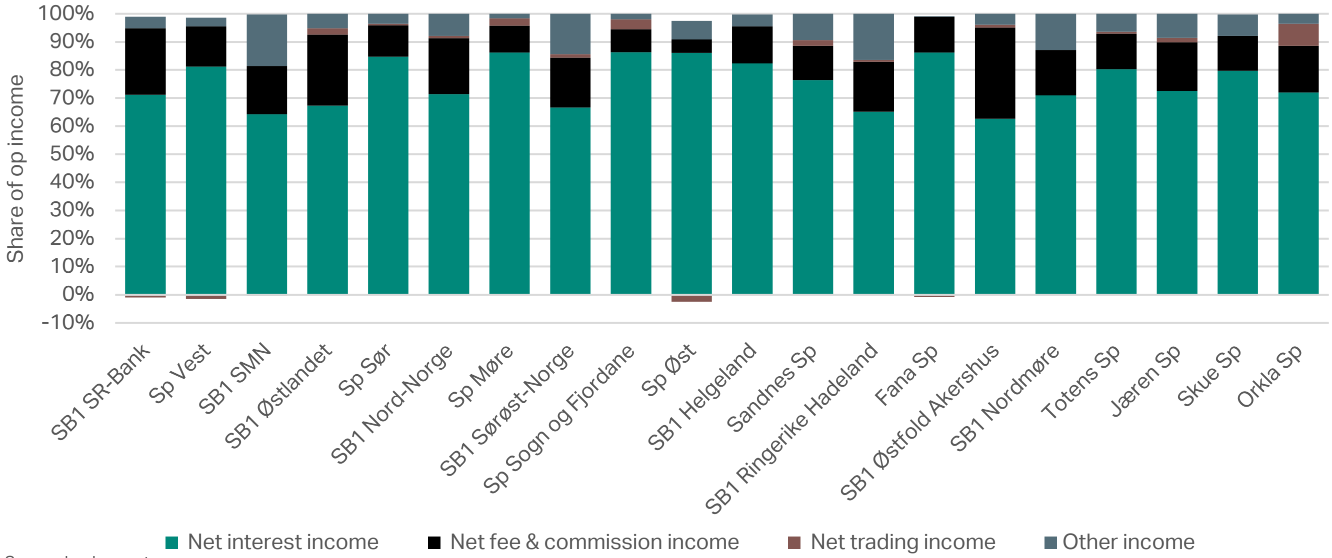
Falling interest rates, which could become a reality during 2024, would have a negative impact on net interest margins (though delayed by lag effects). We also believe that a combination of high capitalisation and low lending and deposit growth will lead to increased competition and margin pressure independent of interest rate movements. As a result, earnings are unlikely to fully compensate for higher loan-loss provisions and continued cost inflation.

Figure 3. Norwegian savings banks' annualised net interest margins, Q4 2022–Q3 2023



Source: bank reports.

Figure 4. Norwegian savings banks' operating revenue by type, Q1-Q3 2023



Source: bank reports.

LOAN LOSSES INCREASING FROM LOW LEVELS

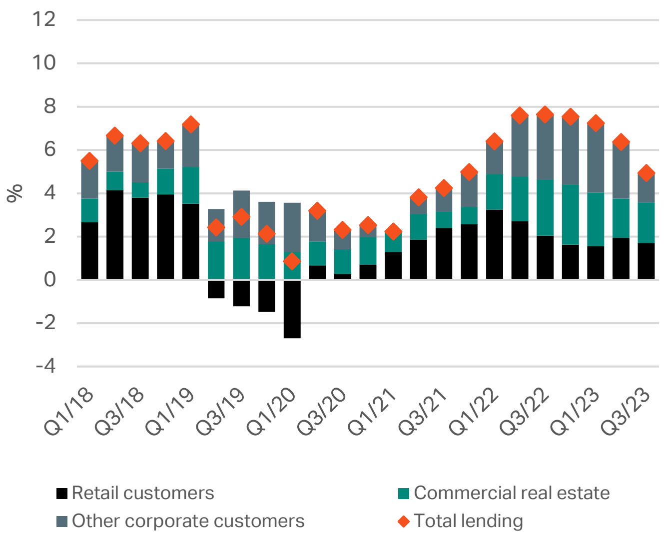
Annual growth rates in the wider Norwegian banking sector fell to 4.9% in the third quarter, ending a period of relatively high loan growth. This was driven primarily by corporate and commercial real estate lending as rising interest rates and a lack of risk appetite led to higher financing costs in the capital markets.

Norwegian banks generally have significant exposure to residential real estate, with retail mortgages accounting for 48% of corporate and retail lending. In addition, the country's banks have significant exposure to commercial real estate (23% of corporate and retail lending). This leads to material exposure to housing price and commercial real estate fluctuations even though price growth over the past decade has strengthened collateral across the wider banking sector.

We are not overly concerned about a significant increase in mortgage loan losses due to low levels of unemployment and Norway's strong social security rights. However, we see a risk that property values could continue to fall in 2024, which could in turn reduce the value of collateral held on savings banks' loan books. Short-term inflation-linked rental contracts are likely to offset some of the yield compression seen in commercial property valuations so far in 2023, while improved rental cash flows reduce the risk that savings banks will have to increase their loan-loss provisions significantly.

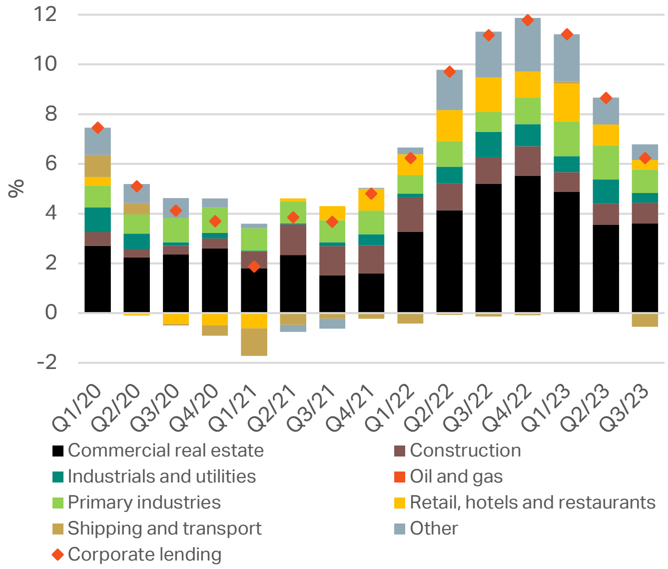
Net non-performing loans across the sample of 20 savings banks that we reviewed for the purposes of this report increased by 22bps to 79bps in the third quarter from end-2022. Stage 2 loans, on which credit risk has increased significantly, have increased by 1.4pp to 9.3% so far this year. We expect the trend to continue into 2024 and believe that loan-loss provisions will rise in the course of the year. We also see a risk that some banks will incur significant individual loan losses.

Figure 5. Norwegian banks weighted annual lending growth, 2018-September 2023



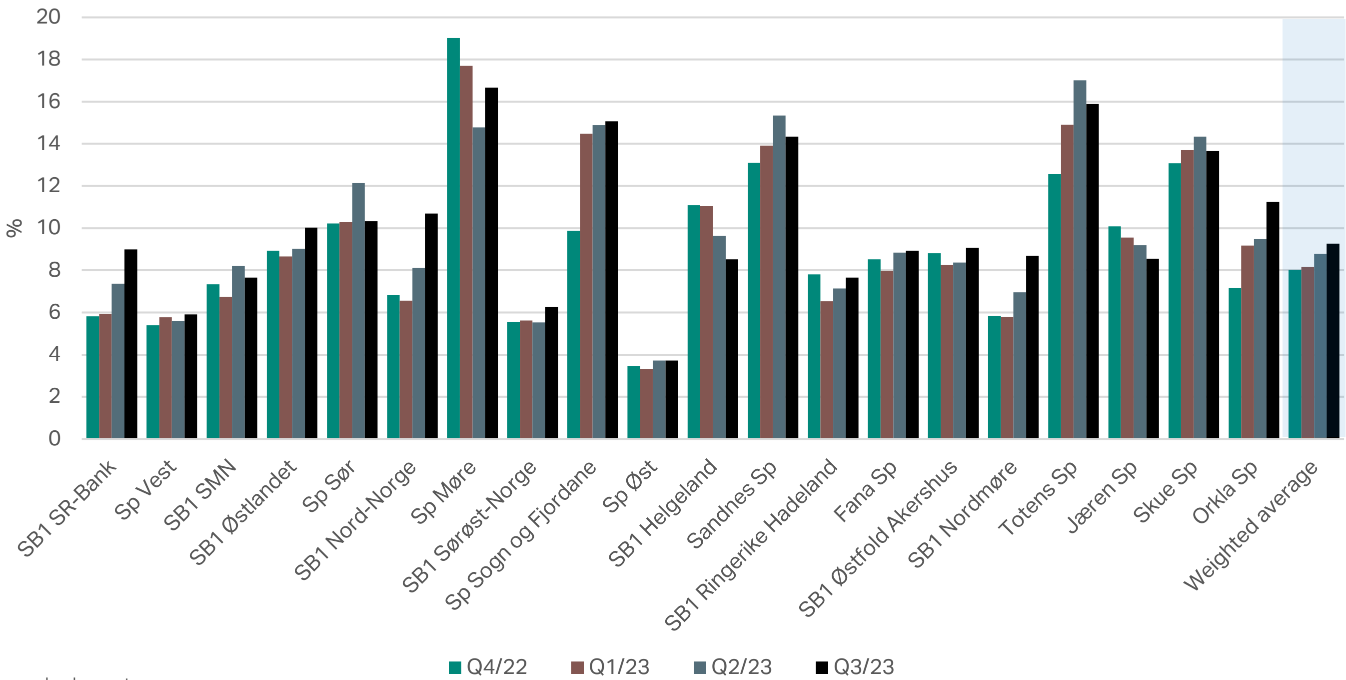
Source: Statistics Norway.

Figure 6. Norwegian savings banks weighted annual corporate lending growth, 2020-September 2023



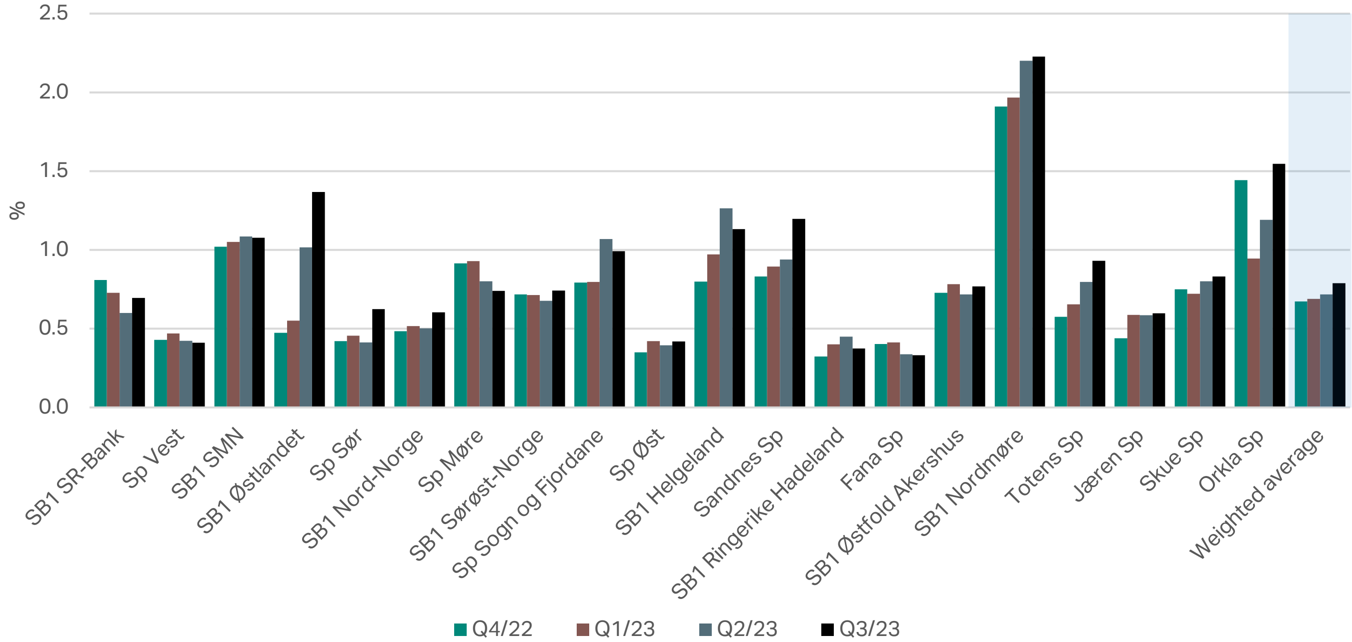
Source: Statistics Norway.

Figure 7. Norwegian savings banks' net Stage 2 loans to net loans, Q4 2022–Q3 2023



Source: bank reports.

Figure 8. Norwegian savings banks' net Stage 3 loans to net loans, Q4 2022–Q3 2023



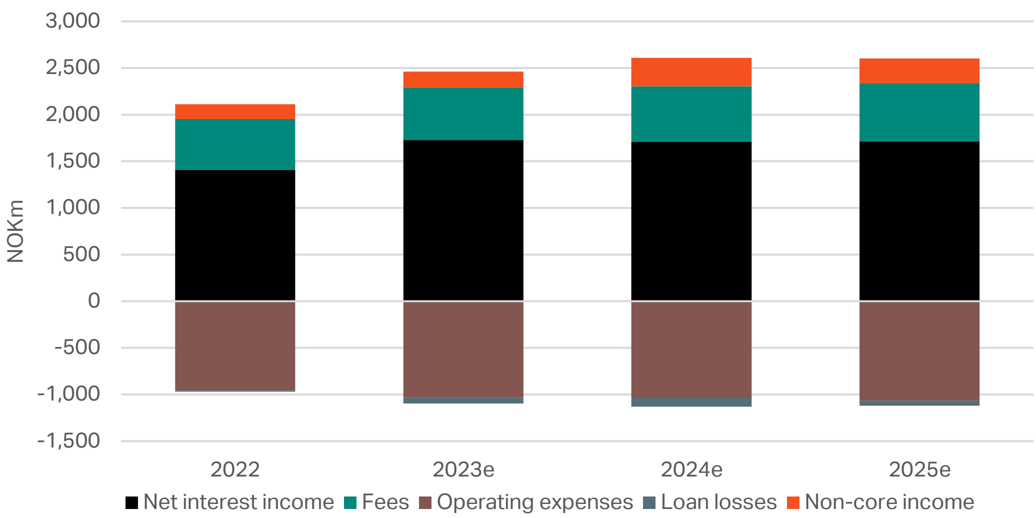
Source: bank reports.

OUTLOOK FOR NCR-RATED SAVINGS BANKS

Among NCR-rated Norwegian savings banks (see Figure 9), we expect higher fee and commission income and relatively stable operating expenses to counteract pressure on margins. Savings banks generate commission income mostly from transfers of mortgage loans to partly owned covered-bond companies. In this area, margins have trailed rises in three-month NIBOR due to a lag in the re-pricing of loans. Savings banks are also exposed to cost inflation, and higher wages in particular, but tend to have a strong focus on costs. Banks in the Eika Alliance, one of two savings-bank groups that dominate the sector, are currently benefiting from lower costs thanks to a new IT platform. We expect average loan losses to net loans of 0.15% in 2024, compared with 0.10% in 2023.

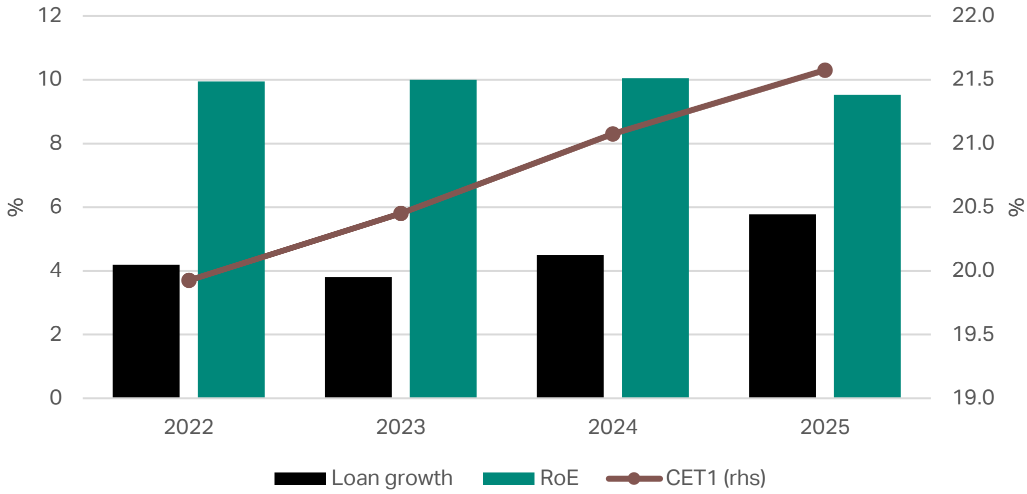
Broadly, we expect 2% lower core profit across the sector in 2024. An important driver for pre-tax profit is non-core revenue, which includes contributions from securities investment and jointly-owned companies, particularly insurance companies. We expect non-core revenues to normalise in 2024 after a weak performance in 2023, mainly due to a decrease in climate-related insurance claims, and anticipate an average 8% rise in pre-tax profit. We also expect that moderate lending growth will contribute to increasing CET1-ratios going forward.

Figure 9. Aggregate estimates for NCR-rated Norwegian savings banks, 2022-2025e



Based on NCR and company data.

Figure 10. Average key ratios for NCR-rated Norwegian savings banks, 2022-2025e



Based on NCR and company data.

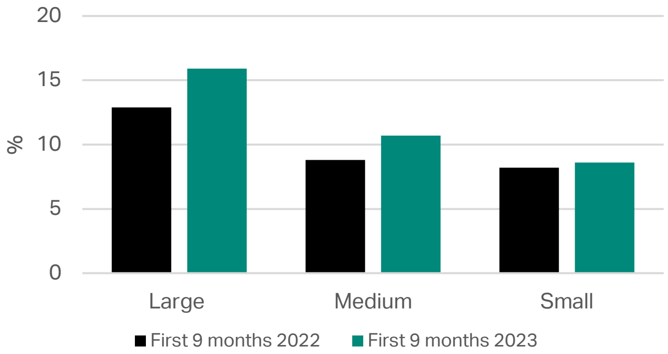
MERGERS AND ACQUISITIONS COULD PICK UP, BUT FULL-SCALE TSUNAMI UNLIKELY

Over the past 30 years, the savings-bank sector has seen an average of two mergers a year, following a wave of restructuring in the 1980s. While the establishment of the SpareBank 1 Alliance in 1996 and the Eika Alliance in 1997 have bolstered the structure of the wider sector, we note that most mergers have been within the respective alliances.

An announcement in October that SpareBank 1 SR-Bank and SpareBank 1 Sørøst-Norge intend to merge to form SpareBank 1 Sør Norge (with a combined NOK 451bn in assets under management) has led to increased speculation about restructuring elsewhere in the sector. This was followed by another announcement in November, when Haugesund Sparebank and Tysnes Sparebank said they, too, intended to merge, forming an entity that would have combined assets of NOK 18bn. Last week, Sandnes Sparebank and Hjelmeland Sparebank also announced that they intend to establish a savings bank under the name Rogaland Sparebank, with NOK 38bn in assets under management. Mergers announced in 2022 and completed in 2023 include Hemne Sparebank and Åfjord Sparebank (as Trøndelag Sparebank, with NOK 8.4bn in assets) and SpareBank 1 SMN and SpareBank 1 Søre Sunnmøre (with NOK 238bn in assets).

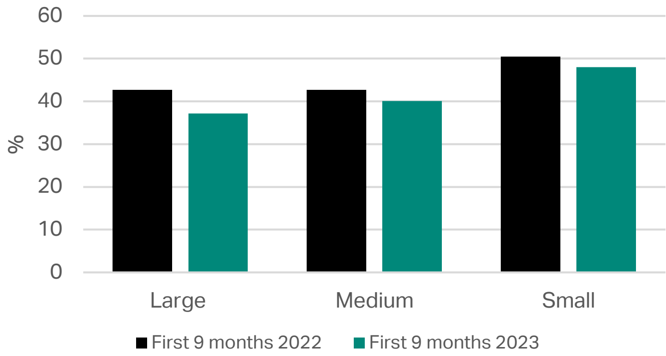
Large savings banks have higher returns on equity than medium sized and small savings banks (see Figure 11). In our view, three main reasons account for this difference: Large banks usually adopt the internal ratings-based approach to credit risk and have lower capital requirements than smaller banks; they also tend to have lower funding costs; and they benefit from greater economies of scale. However, we believe a new wave of takeovers in the sector is unlikely for several reasons. The EU's CRD IV initiative, which we expect to take effect in Norway from 2026, is likely to reduce the differences in capital requirements between banks using the internal ratings-based approach and smaller banks using the standard approach. In addition, small savings banks can generate higher net interest margins than larger banks, an advantage which can be reduced by a merger with a larger bank. Finally, the savings-bank alliances that dominate the sector, effectively reduce the difference between large and small banks in terms of funding, development and operating costs. In addition, we note that Norwegian savings banks are protected against hostile takeovers as owners of their equity capital certificates cannot control more than 40% of votes in their respective governing bodies.

Figure 11. Norwegian savings banks return on equity by bank size



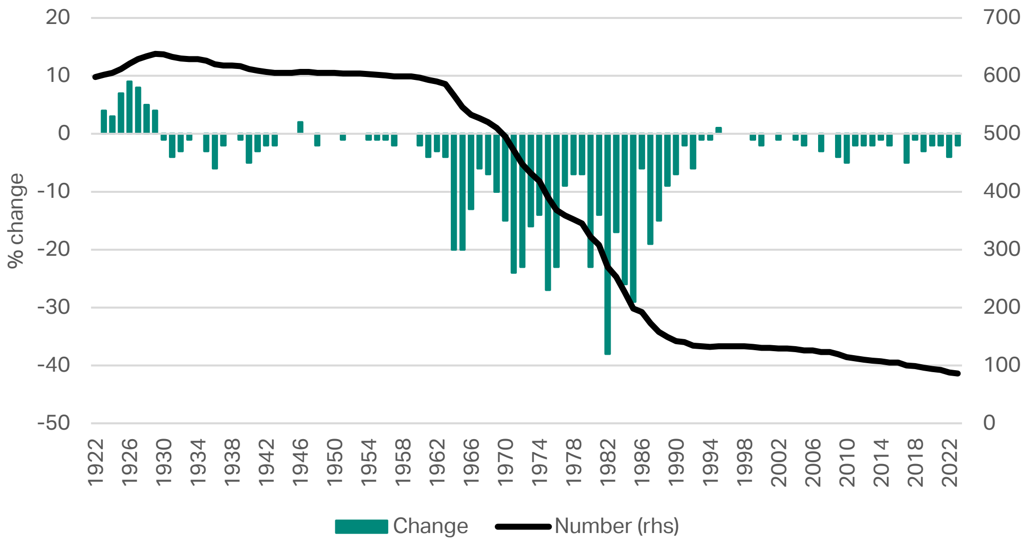
Source: Finanstilsynet.

Figure 12. Norwegian savings banks cost/income by bank size



Source: Finanstilsynet.

Figure 13. Norwegian savings banks' consolidation, 1922-2023



Source: Sparebankforeningen.

We do not expect a boom in merger activity in 2024, although industry consolidation could increase over the next few years due to increasing reporting and compliance requirements and increased pressure to achieve profitability. However, we believe a sector-wide restructuring would prove a lengthy process. Small banks are more likely to seek to merge with one another to create larger and more sustainable entities, even though greater synergies tend to be achieved when large banks take over smaller banks. Over the longer term, we could see more mergers between regional savings banks, similar to the Sør Norge merger, or even between the five major regional banks, which would boost their ability to compete with major Nordic banks for large corporate clients.

NCR-RATED NORWEGIAN SAVINGS BANKS

NCR's ratings on Norwegian savings banks and Kredittforeningen for Sparebanker as of 11 Dec. 2023.

Figure 14. NCR ratings on Norwegian savings banks

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

See NCR company reports.

RELEVANT RESEARCH

(i) Norwegian mid-size savings banks maintain growth in a competitive market, 20 Nov. 2023.
(ii) High interest rates generate strong first-half earnings for Swedish savings banks, 26 Oct. 2023.
(iii) Nordic consumer banks' earnings compensate elevated credit losses, 11 Sep. 2023.
(iv) Mid-sized Norwegian savings banks navigate economic challenges, 28 Aug. 2023.
(v) Norwegian mid-size savings banks stand strong in turbulent 2022, 24 Mar. 2023.
(vi) Norwegian savings banks carry positive momentum into 2023, 24 Jan. 2023.

DISCLAIMER

NORDIC CREDIT RATING AS

nordiccreditrating.com