Nordic Credit Rating

SECTOR COMMENT

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The pressure is rising for Nordic consumer banks

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The fourth quarter of 2023 saw a further increase in credit losses and marginal declines in earnings for niche consumer banks in the Nordic region. Most of the banks in our sample of nine regional consumer banks maintained strong earnings and cost efficiency in the quarter, which continued to offset elevated loan-loss provisions. In addition, the proportion of loans showing increasing signs of weakness (Stage 2 loans) is rising, and banks continue to indicate that payment patterns could be at risk as economic conditions worsen.

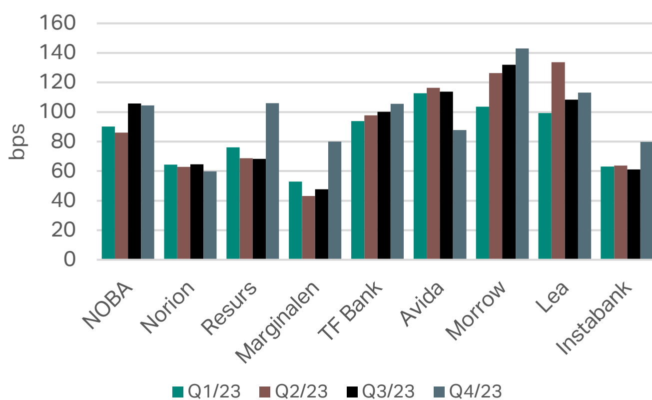
We expect interest rates across the region to remain elevated in early 2024 before the rate paths begin to deviate. Yield curves indicate a steep reduction in market rates in Sweden and the eurozone, and a more gradual decline in Norway. These declines could provide relief to indebted borrowers, though we maintain our view that loan-loss provisions will remain elevated throughout 2024. Furthermore, we anticipate that earnings margins will face pressure due to intensified competition for profitable loan growth and deposit funding. We expect this combination of negative factors to drive weaker performance across the sector in 2024.

Thus far in 2024, NCR's rating on Resurs Bank was put on negative outlook in January to reflect our expectation that the bank's asset quality metrics will deteriorate further and remain worse for longer, compared with previous assessments (see related research (i)). This occurred after the bank announced a significant increase in loss provisions and weakening customer behaviour in December. Also in January, the Swedish government released a proposal to remove the interest rate tax deductibility of consumer loans, which is likely to lead to higher costs for the banks as they adapt. Additionally, on 25 Jan. 2024, the Swedish regulator announced an investigation into Marginalen's risk management and credit risk compliance with applicable regulations.

LOAN-LOSS PROVISIONS AND IMPAIRED LOANS ON THE RISE

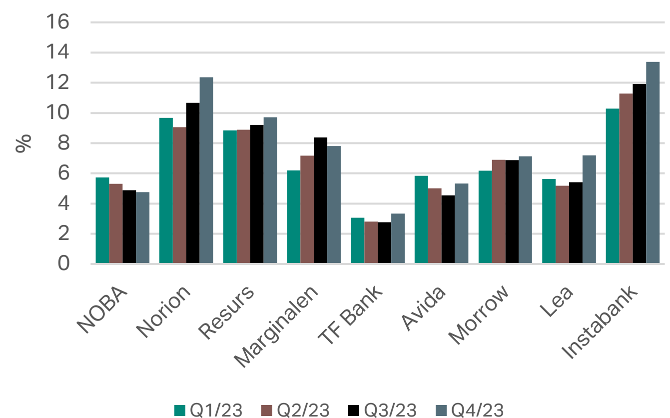
Additional interest rate hikes in all markets in 2023 continue to put stress on the repayment capacity of Nordic households. During the fourth quarter, asset quality indicators jumped, with weighted average credit provisions rising to 96bps of average net loans (excluding the effects of the Resurs securitisation described below) from an average of 84bps in the previous three quarters. Resurs's increase in fourth quarter reserves because of rising delinquencies in December account for around 4bps of the sample's 12 basis point increase.

Figure 1. Nordic consumer banks' loan-loss provisions to average net loans, Q1 2023–Q4 2023



Source: bank reports. Resurs's Q4/23 provisions exclude the one-off impact of securitising non-performing loans.

Figure 2. Nordic consumer banks' net Stage 2 loans to net loans, Q1 2023–Q4 2023



Source: bank reports.

Marginalen, Instabank and Avida saw material one-off impacts on credit losses in the quarter. Marginalen made a SEK 38m reserve for a planned calibration of its IFRS 9 credit loss model, while

Instabank's own IFRS 9 model update led to an increase in losses in Finnish consumer loans. In contrast, Avida's sale of non-performing consumer loans resulted in a decrease in provision levels.

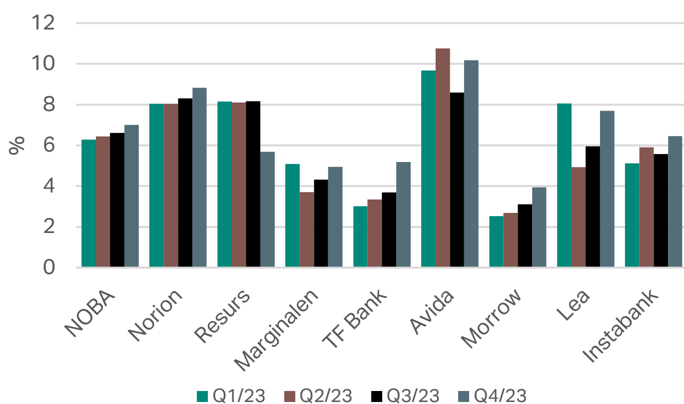
The level of net loans at Stage 2, i.e. showing signs of weakness but not yet non-performing, weakened to 7.3% in the fourth quarter of 2023 from 6.9% in the third, driven by the continued increase in Stage 2 corporate and real-estate loans at Norion and an increasing trend in impaired loans for Instabank. When loans move from Stage 1 (performing normally) to Stage 2, on average our sample banks' increase loan-loss provisions to 11.2% of gross Stage 2 loans from 1.4% for Stage 1 loans to reflect the increasing risk. A bigger increase in loan-loss provisions for the sample banks occurs when Stage 2 loans deteriorate further to Stage 3, increasing the average provision rate to 45.8% of gross Stage 3 loans, which drives credit losses. However, Stage 2 loans are a good indicator of possible larger losses in the quarters ahead, given that they have given indications of weakness.

RISE IN NON-PERFORMING LOANS AS SECONDARY MARKET REMAINS WEAK

We expect that the weakness of debt purchasing companies will affect banks' ability to offload non-performing loans (NPLs) throughout 2024. As a sign of the weakened NPL market, in December Resurs securitised 39% of its net NPLs in partnership with credit management company Lowell, resulting in a SEK 198m one-off increase in loss provisions (see related research (ii)). Marginalen also indicated in its fourth-quarter report that it is considering a securitisation of some of its loan book. We understand that some banks' forward flow contracts are expiring rather than being renegotiated due to a lack of attractive pricing. Given few offloading opportunities, banks are seeking alternatives to reduce the capital impact of retaining NPLs on their own balance sheet.

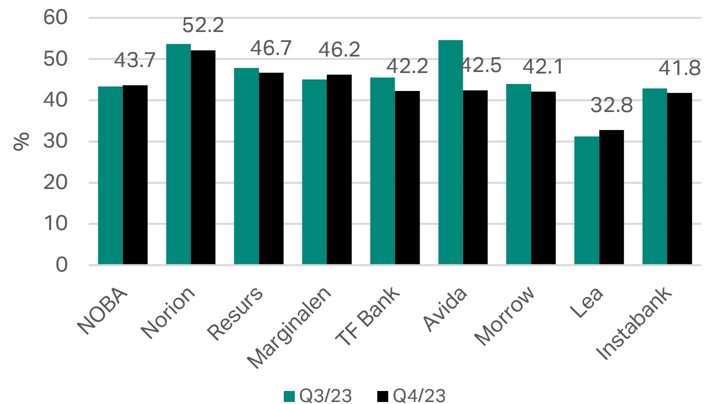
NPL metrics rose slightly in the fourth quarter compared with the previous three quarters, with weighted average net Stage 3 loans at 6.9%, an increase of about 20bps over third-quarter levels. Excluding Resurs, banks in the sample showed a material 60bps quarter-on-quarter increase in net NPLs. Avida's share of Stage 3 loans increased due to a reduction in the loan book from sales of NPL portfolios in Sweden and Finland and net amortisation of consumer loans as the bank reduces its focus on the segment. Lea also saw a large increase in net NPLs during the fourth quarter due primarily to consumer loans in Finland and Sweden.

Figure 3. Nordic consumer banks' net Stage 3 NPLs to net loans, Q1 2023–Q4 2023



Source: bank reports.

Figure 4. Nordic consumer banks' Stage 3 coverage ratios, Q3 2023–Q4 2023



Source: bank reports.

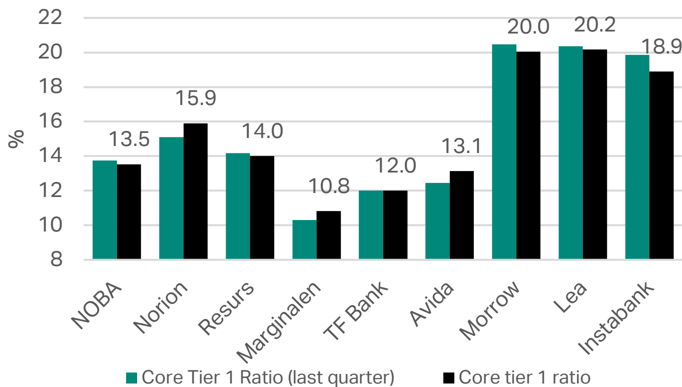
We would typically expect weaker NPL markets to be reflected by higher provisioning for Stage 3 NPLs. However, using a weighted average, Stage 3 coverage ratios fell unexpectedly to 45.8% in the fourth quarter from 47.4% in the third. Avida's coverage ratio fell from a temporary high in the third quarter, which accounts for nearly half the decline. Norion's loan-loss provisioning remains the highest in the sample, with 55.4% Stage 3 provisions for consumer loans and 40.6% for corporate and real-estate exposures. Lea stands out due to an earlier designation of non-performing loans (see related research (vi)).

CAPITAL RATIOS STAGNANT DESPITE STRONG EARNINGS

Weighted average common equity Tier 1 (CET1) ratios remained in line with previous quarters at 14.3%. The most significant changes in the fourth quarter were for Norion, whose CET1 ratio improved

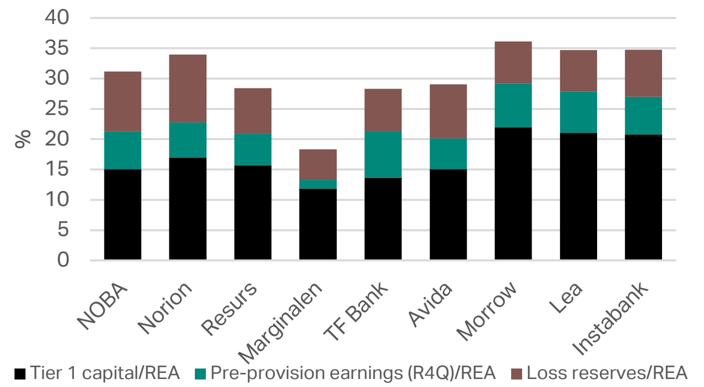
by 80bps following the implementation of the alternative standardised approach for operational risk, and for Instabank, which saw its ratio fall by 97bps during the quarter due to strong loan growth. In contrast, the decline in lending for Avida and Marginalen improved capital ratios during the quarter. Resurs Holding issued a SEK 300m additional Tier 1 instrument in December, adding to its SEK300m instrument with a call date in December 2024.

Figure 5. Nordic consumer banks' CET1 ratios, Q3 2023–Q4 2023



Source: bank reports. Marginalen's capital ratios are shown as the consolidated ratios reported by its parent company, ESCO Marginalen AB.

Figure 6. Nordic consumer banks' loss-absorbing buffers as a proportion of REA, Q4 2023



Source: bank reports. Marginalen's capital ratios are shown as the consolidated ratios reported by its parent company, ESCO Marginalen AB.

The Norwegian systemic risk buffer threshold was lowered to NOK 5bn on 31 Dec. 2023, raising the capital requirements for the Norwegian exposures of Morrow, Lea and Instabank by 1.5pp. The change also impacts NOBA, which has more than NOK 5bn in lending in Norway. Resurs has said it will maintain its Norwegian loan book under the threshold to avoid the increased capital requirements. Finland's 1% systemic risk buffer will be in place from April 2024, and could eventually be subject to regulatory reciprocity for the Finnish exposures of the banks in our sample.

PROPOSAL TO REMOVE INTEREST RATE DEDUCTIBILITY ON CONSUMER LOANS

In January 2024, the Swedish government issued a proposal to remove the tax deductibility of interest on unsecured loans from the current 30% deduction. In our view, the proposal is part of a broad political effort to reduce indebtedness among consumers following a series of consumer loan regulation proposals released by a government committee in July 2023 (see related research (iv)).

The January proposal is likely to have the largest impact on big-ticket consumer loans. We believe the established consumer lenders exclude the current tax deduction from their loan approval calculations, implying low impact on approval rates. We also assume that most individuals do not give material consideration to the tax deduction of consumer loans in their borrowing decisions. Nonetheless, we believe demand will likely decrease over time as the higher cost burden becomes apparent. For example, for an individual with only consumer loans, the removal of the 30% reduction increases net interest costs by 43% and reduces individuals' cash flows, typically by reducing tax refunds each spring. In addition, while likely not directly included in the banks' loan calculations, the deduction has served as a buffer against losses, and we consequently also expect supply to decrease as lenders become more restrictive.

According to the proposal, deductibility on all new and existing loans not secured by a residential property, car or boat will be reduced over two years. Thus, the deduction will be lowered to 15% for the 2025 tax year and 0% for 2026 taxes. We expect to see an increase in payment failures and non-performing loans from the first half of 2026, when individuals would have received refunds for tax deductions for the 2025 tax year.

Many of those with consumer loans tend to have a weaker economic profile. Although the change in net cost from the removal of deductibility is minor in cash value, it could significantly impact those on tight budgets. For existing borrowers, the ability to repay a loan early or tie the loan to eligible collateral (houses, boats, and cars) and avoid the higher net interest might also be limited. For those with unsecured loans tied to their homes, this may be an incentive to consolidate these loans into mortgages, if possible. However, for some, this could trigger amortisation requirements, or require a

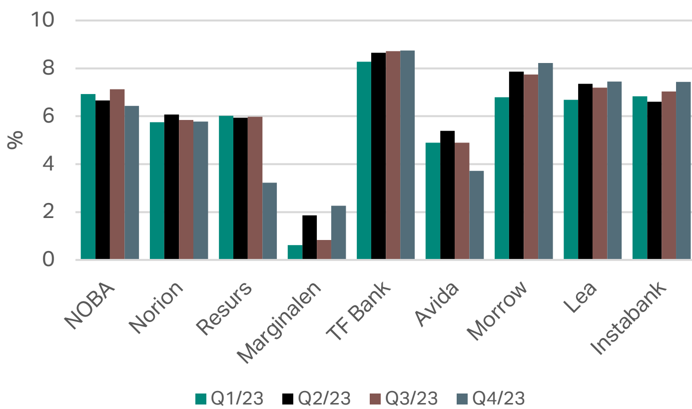
costly increase in existing mortgage deeds, reducing the benefit of consolidation. We expect banks to actively adapt their product offerings in 2024, perhaps complementing unsecured loans with secured auto and boat loans, all in all leading to an increased cost burden.

MARGIN PRESSURE FROM RISING FUNDING COSTS CONTINUES

Competition for deposits continues to increase banks' funding costs and pressure net interest margins. However, the weighted average net interest margin in our sample remained resilient, rising slightly to 6.6%. The increase for the sample is largely attributable to the aggregate shift in product mix, due to the continued increase in high-margin credit card lending at NOBA.

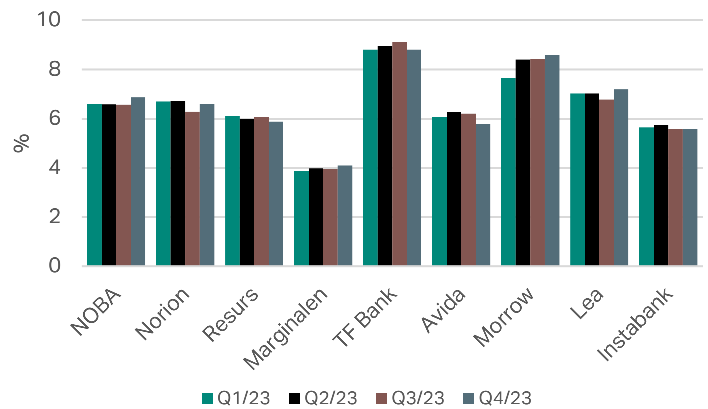
Risk-adjusted earnings fell to 5.9% during the fourth quarter, from 6.2% in the third. However, excluding Resurs, which had a total of SEK -207m in one-off impacts, risk-adjusted earnings were stable. Even excluding Resurs' one-off charges, cost-income ratios weakened for the sample, with the average ratio increasing to 43% from below 40% for the previous two quarters. Aside from Resurs, additional personnel, consultancy and legal expenses for Avida resulted in a material increase in cost-to-income ratios among the banks.

Figure 7. Nordic consumer banks' annualised pre-provision income to average REA, Q1 2023–Q4 2023



Source: bank reports.

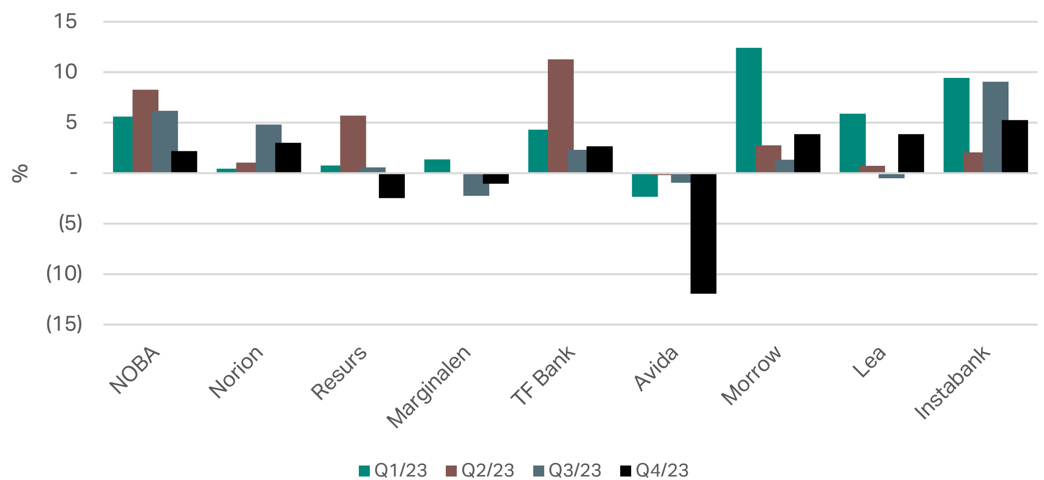
Figure 8. Nordic consumer banks' annualised net interest margins, Q1 2023–Q4 2023



Source: bank reports.

LENDING GROWTH SLOWS MATERIALLY

Figure 9. Nordic consumer banks' net loan growth, Q1 2023–Q4 2023



Source: bank reports.

Weighted average net loan growth dropped materially to 1.0% from 3.5% in the third quarter. Avida's significant reduction in consumer loans stands out in the peer group, resulting in a 12% reduction in net loans during the quarter. Excluding Avida, the sample still only grew a modest 1.6% during the quarter and growth for the majority of banks was muted. The Swedish krona's appreciation during the

quarter reversed some of the recent euro-denominated growth trend and contributed to slowing loan growth for the Swedish banks. In addition, we believe the weak market for offloading NPLs is affecting banks' ability to allocate capital for new lending and affecting growth ambitions. Only Morrow, Lea, and Instabank reported growth of over 3.5% in the fourth quarter, while Resurs, Marginalen and Avida reported a decline in net loans.

NCR-RATED CONSUMER BANKS

The following table summarises NCR's ratings on Nordic consumer banks as of 12 Mar. 2024.

Figure 10. NCR ratings on Nordic consumer banks

	Resurs Bank	Norion Bank	NOBA Bank Group
Long-term issuer rating	BBB	BBB-	BBB
Outlook	Negative	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) Resurs Bank AB outlook revised to negative; 'BBB' long-term issuer rating affirmed, 22 Jan. 2024.
(ii) NCR comments: Resurs Bank offsets impact of non-performing loan backstop, 1 Dec. 2023.
(iii) Nordic consumer banks increase credit losses, 29 Nov. 2023.
(iv) Nordic consumer banks' earnings compensate elevated credit losses, 11 Sep. 2023.
(v) Nordic consumer banks' loss provisions remain elevated, 28 Jun. 2023.
(vi) Nordic consumer banks increase loss provisions amid rising cost of living, 31 Mar. 2023.
(vii) Nordic consumer banks improve margins to offset higher loss provisions, 11 Nov. 2022.

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