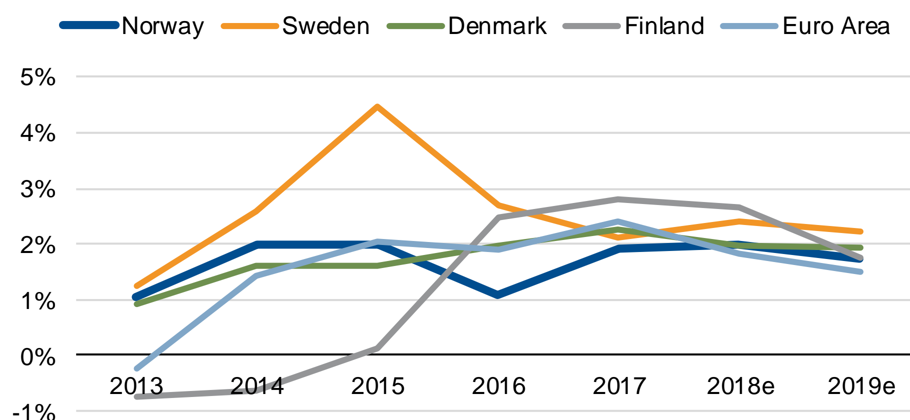
Scope Ratings

Norway's banks: profitable and efficient

The Norwegian banking system exhibits solid profitability underpinned by good cost efficiency and low credit costs. The country has a relatively large number of banks for a population of just 5.3 million. The banks co-operate to better serve their customers and manage costs, while alliances are important in the areas of product offerings, technology and access to market funding. In addition to a supportive macro environment, the system continues to benefit from close supervision and regulation.

A positive economic outlook for Norway and a backdrop of positive interest rates provide a constructive environment for the country's banks, although notably the banks had been resilient even when oil prices fell in 2014-15, adversely affecting the economy. Norway's GDP growth in 2019 is expected to be 1.8%, while the benchmark interest rate is flagged to rise again this year, following a quarter point increase to 0.75% in September 2018.

Figure 1: GDP growth (%)



Notes: Scope estimates for Norway and Euro Area; IMF for others.
Source: IMF, Scope Ratings

As highlighted in the central bank's October 2018 financial stability report, high household debt, high house prices and high commercial property prices continue to be vulnerabilities. Bank lending in Norway is relatively concentrated, with mortgages accounting for nearly 50% of overall loan books and commercial real estate accounting for 45% of corporate lending exposures.

However, sound regulatory and prudential frameworks are in place. Norwegian banks remain subject to relatively stringent solvency and liquidity requirements, with supervisory authorities being mindful of lessons learned from earlier banking crises. There is also an increasing focus on cyber risk as Norway is at the forefront of digital financial services, particularly in payment services.

At the macro-prudential level, residential mortgage loan guidelines were first introduced in 2010 and subsequently became regulations in 2015. These include a 5% interest-rate stress test, limits on loan-to-value ratios, and a 5x debt-to-income ratio. Regulations concerning consumer loans and credit cards are also being introduced. Most aim to protect consumers, but some are also meant to increase the resilience of financial institutions.

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Related Research

The Status of MREL in the Nordic Region
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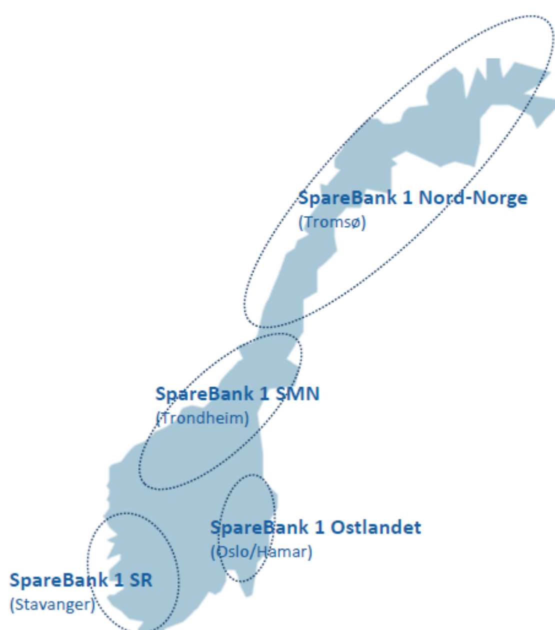
A relatively large number of banks

For a country with a population of 5.3 million, Norway has a surprisingly large number of banks, at over 130. Around 100 are savings banks (whose number has reduced from around 600 in 1960). Commercial banks tend to be national players, while savings banks tend to be regional or local.

The largest bank is DNB with a market share of around 30%. Since 1985, foreign banks have been allowed to engage in banking activities in Norway. Nordea, based in Finland, is the second largest with a market share of around 10%. The market shares of other individual banks are much smaller. Most savings banks, however, are part of the SpareBank 1 Alliance (established in 1996) or the Eika Alliance (established in 1997). The Sparebank 1 Alliance consists of 14 regional banks, while the Eika Alliance consists of 67 smaller, more local banks. The extensive branch networks of the alliances provide broad geographic coverage throughout the country. Meanwhile, DNB, the market leader, has fewer than 60 branches.

Figure 2: SpareBank 1 Alliance – geographic reach of larger members with about 170 branches



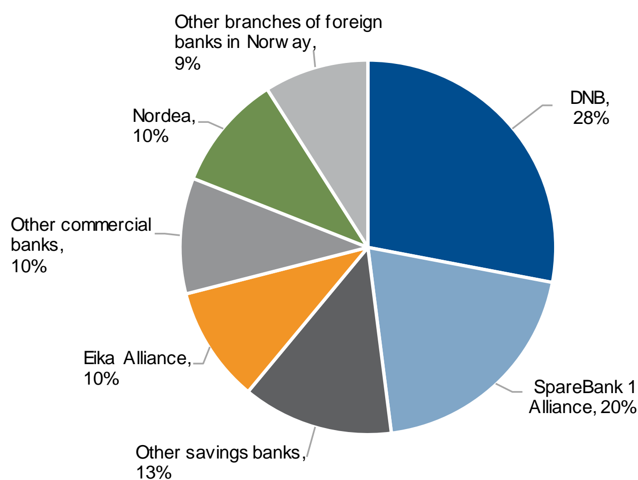
Source: SpareBank 1 Alliance

Figure 3: Eika Alliance – geographic reach with over 200 branches

Source: Eika Alliance

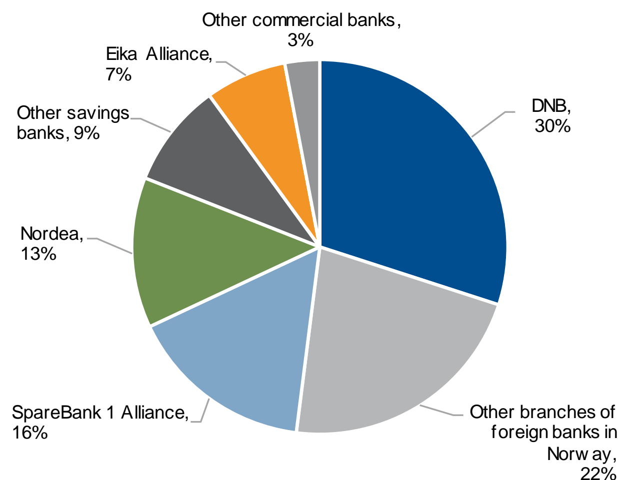
The individual banks of the alliances often hold leading positions in their respective home markets. Meanwhile, the alliances as groups hold material market positions nationally (Figures 4 and 5). In line with their business models, the savings banks maintain larger market shares in the retail market than in the corporate market. Foreign banks tend to have stronger positions in the corporate market.

Figure 4: Market shares – retail market



Note: Data as of 30 June 2018.
Source: Norges Bank, Scope Ratings

Figure 5: Market shares – corporate market



Note: Data as of 30 June 2018.
Source: Norges Bank, Scope Ratings

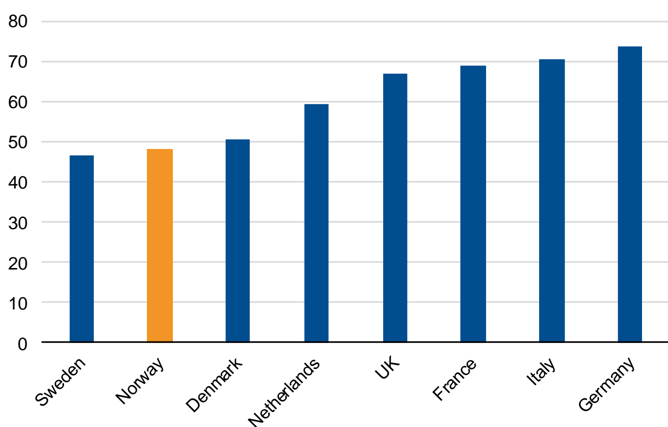
Alliances enable smaller players to compete effectively

Alliance members operate as independent banks, with most maintaining their own branding. There is no liability sharing or common support mechanism. However, as alliance members, they benefit from being able to offer a wider range of products and services as well as from economies of scale. The alliances have established joint product companies for non-banking activities such as credit cards, asset management and insurance. In addition, important efficiencies are achieved in the areas of technology, credit systems and funding via the alliances' dedicated covered bond issuing entities.

Solid profitability underpinned by good efficiency and low credit costs

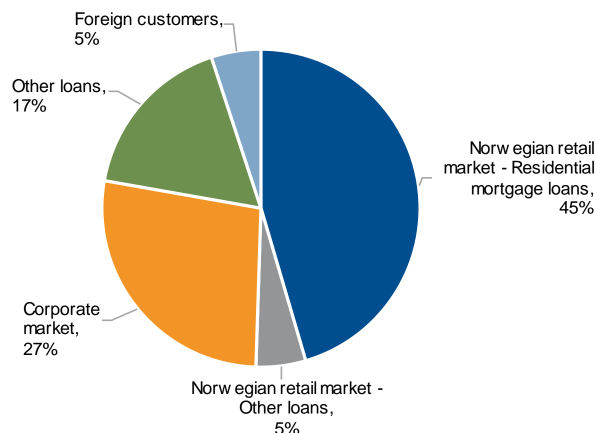
The Norwegian banking system is solidly profitable. Looking at a sample of nearly 100 banks, the average return on average equity is 9.3% with the median being 8.5%. Returns are supported by high levels of efficiency, with Norwegian banks exhibiting some of the lowest cost-income ratios.

Figure 7: Costs % Income



Note: Data as of YE 2017.
Source: SNL, Scope Ratings

Figure 8: Distribution of lending

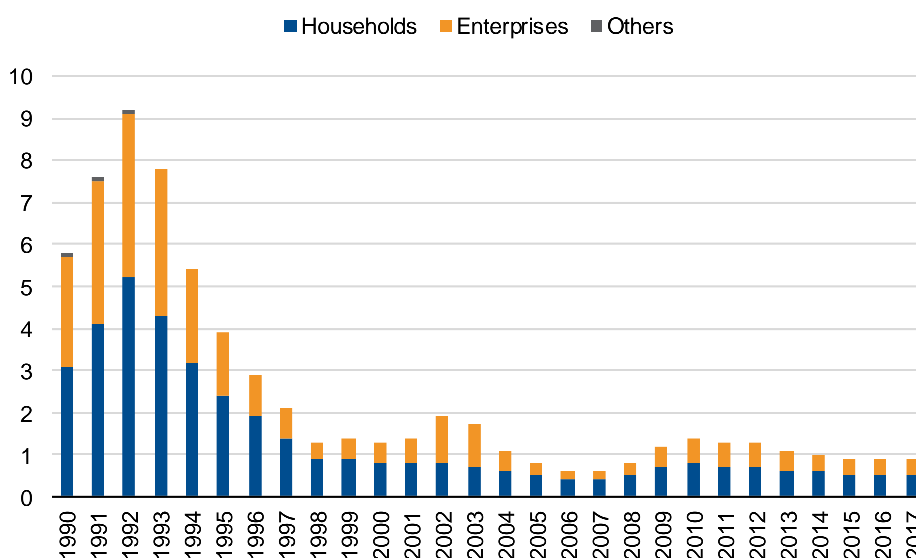


Note: All banks and mortgage companies in Norway. Data as of 30 June 2018.
Source: Norges Bank, Scope Ratings

Asset quality is not an issue, with problem loans accounting for on average 0.9% of loans (median of 0.5%). Banks with the highest problem loans tend to be those focused on consumer finance such as Bank Norwegian and Monobank, where problem loans can account for up to 8% of loans.

Over time, the industry sectors with the highest loan-loss rates have been construction, shipping and pipeline transport, retail trade and auto repair. More recently, the crude oil and natural gas extraction and ship and boat building sectors have also experienced high loss rates. Local savings banks tend to focus on retail lending and are thus less exposed to sectors which experience higher losses.

Figure 6: Loan defaults % Lending to private sector



Source: Norges Bank

Both larger and smaller banks in the system display reassuring financial profiles. For example, DNB’s return on equity was 11.7% and its cost-income ratio was 44% in 2018. Meanwhile, each of the Eika banks is profitable. As of 2Q 2018, the Eika banks as a group generated a return on equity above 12% and had a cost-income ratio of 43%.

Embracing technology in a co-operative manner

Norway is at the forefront of digital adoption, with over 90% of the population using the internet and online banking services.[1] Importantly, banks in the country are co-operating to address the evolving banking landscape. The CEO of DNB has said that banks need to disrupt themselves or others will do so for them.

In May 2015, DNB launched the Vipps mobile P2P payment app. Subsequently, other functionalities such as P2B, paying invoices, e-commerce and in-store have been added. In 2017, Vipps was spun-off, with DNB retaining the largest stake and the remainder being held by over 100 Norwegian banks, facilitating the adoption of a single platform in the country. Vipps is now used by 75% of those aged 10 and over in Norway.

In July 2018, Vipps merged with BankAxept, the national payment system, and BankID, a digital identification system, creating the largest electronic payment and identification verification operator in the Nordic region. BankID is used by 90% of the those aged 15 and over in Norway, while BankAxept is used by 90% of merchants in the country. With its broad reach, the share of fee-based transactions has increased to 30%. Vipps is also

[1] International Telecommunications Union, Statista

now expanding abroad, agreeing on a standard, international QR code with China's Alipay.

Other ongoing co-operation projects are a regional payment infrastructure and a common Nordic Know Your Customer (KYC) infrastructure. DNB is part of a group of major Nordic banks establishing a pan-Nordic payment infrastructure supplemented with common products. The idea is to create, within the region, the world's first area for domestic and cross-border payments in multiple currencies (NOK, SEK, DKK and EUR).

A joint venture between DNB, Danske, Nordea, Svenska Handelsbanken and SEB also aims to develop an efficient, common, secure and cost-effective Nordic KYC infrastructure, initially for large and mid-size Nordic corporates. Currently, bank customers struggle with time-consuming KYC information requirements, often including numerous banks and formats. While owned and controlled by the founding banks, the JV would offer its services to third parties.

No great impetus for consolidation although there is scope to do so

Due to the overall health of the sector, there does not appear to be a great drive for consolidation, although it is happening with smaller savings banks. In 2018, there were mergers involving seven of the Eika banks. These mergers appear sensible as the resulting three banks each still have total assets below NOK 10bn.

While being part of an alliance can help a smaller bank to compete, there are advantages to being larger. Reasons cited for the above mergers include increasing competitiveness in local markets, improving attractiveness as an employer and enhancing the ability to contribute to the development of local communities.

The governance structure of savings banks means that customers, employees and potentially local government representatives have an important say in strategic decisions. The representation of any external equity investors is normally limited to 40%.

Robust solvency driven by relatively stringent regulatory requirements

The last banking crisis in Norway occurred between 1988 and 1993, with banks accounting for nearly 60% of bank lending to the non-financial domestic sector experiencing difficulties.[2] Regulatory and supervisory authorities in Norway continue to bear in mind lessons from the crisis, noting that financial crisis prevention cannot be limited to supervising individual banks but must also consider the interplay between macroeconomic factors and financial markets.

The regulatory environment for Norwegian banks remains relatively stringent, both at micro and macroprudential levels. Since July 2013, all Norwegian banks have been subject to a systemic risk buffer (initially set at 2% and subsequently increased to 3%). In addition, a countercyclical buffer has been in place since 2015 (rising to 2.5% by the end of 2019). As well, the Basel I floor for calculating risk-weighted assets was maintained until this year.

Further, systemically-important institutions must hold an additional 2% buffer. Currently, only DNB and Kommunalbanken have been classified as systemic. However, in October 2018, the Norwegian FSA proposed a change to the criteria such that a bank with at least a 10% share of the corporate market in a region would also be considered systemic. If adopted, this would increase the number of systemic financial institutions to eight from two. Based on 4Q 2017 figures, the following banks would also be considered systemic:

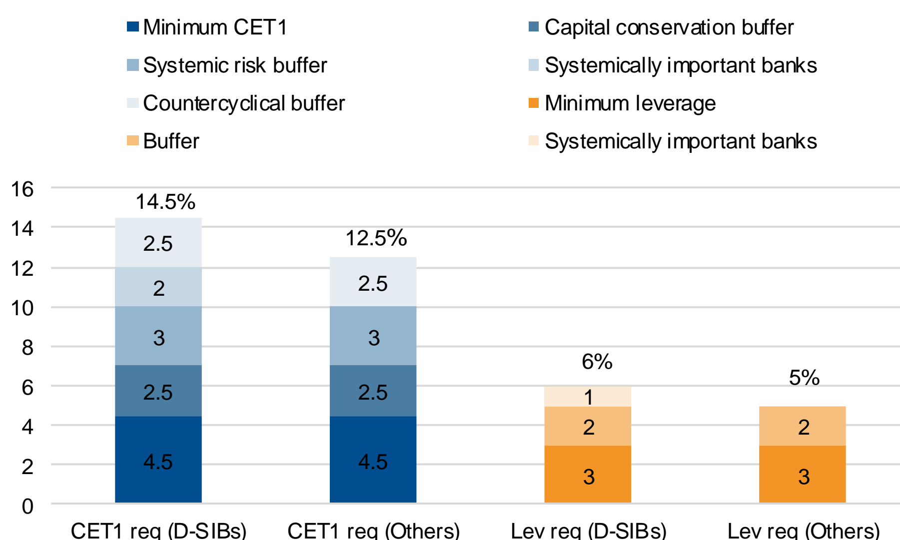
[2] Norges Bank, The Norwegian Banking Crisis, Occasional Papers, No. 33, 2004.

SpareBank 1 Nord-Norge, SpareBank 1 SMN, Sparebanken Sor, SpareBank 1 Ostlandet, SpareBank 1 SR-Bank, and Sparebanken Vest. The Norwegian FSA has further acknowledged that linkages between members of alliances can increase a bank's systemic importance.

For the same sample of 100 banks mentioned above, the average CET1 ratio is 18.1%, with the median being 17.6%.

In addition, all Norwegian banks have been subject to a minimum Tier 1 leverage ratio requirement of 5% since June 2017. For systemic institutions, the minimum requirement is 6%.

Figure 9: CET1 capital and Tier 1 leverage requirements (%)



Note: D-SIBs are currently DNB and Kommunalbanken.
Source: Scope Ratings

CRR and CRD IV

While CRR/CRD IV is pending incorporation into the EEA agreement (expected in 2019), Norway has been for some time introducing measures in line with the EU's capital requirements framework and earlier than most other countries. Transposition of the remaining requirements will harmonise Norwegian and European rules such that Norwegian banks' capital ratios are expected to appear higher without a real improvement in solvency. This stems from the removal of the Basel I floor for banks using internal-ratings-based models as well as the introduction of lower capital requirements for lending to small and medium-sized enterprises (the SME supporting factor). Consequently, the Norwegian FSA has stated that available means should be used to prevent the adoption of CRR/CRD IV leading to a decline in the capitalisation of the banking sector.

BRRD and MREL

From 1 January 2019, the Bank Recovery and Resolution Directive (BRRD) has been in place in Norway. MREL requirements are expected to be generally in line with the EC's proposal of November 2016, with MREL consisting of a loss-absorption amount and a recapitalisation amount. However, the Norwegian FSA considers that there is basis for most Norwegian banks to be subject to an MREL requirement greater than the loss-absorption amount, as financial institutions which are important to a region or customer group may also be subject to resolution. As well, the distress of small and medium-sized financial institutions may have negative contagion effects and reduce market confidence.

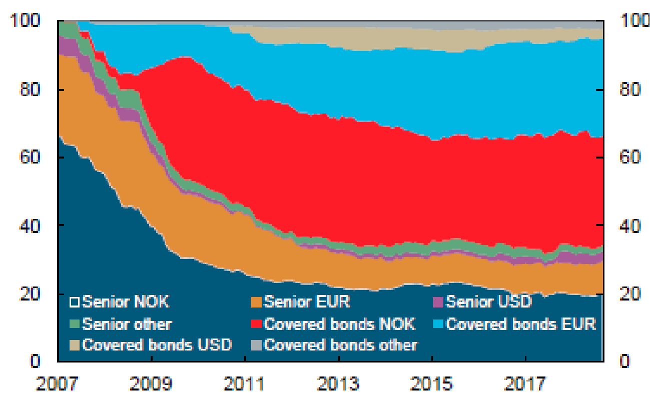
From 31 December 2022, all liabilities used to meet MREL need to be subordinated, i.e. rank below ordinary senior bonds and ordinary unsecured debt instruments. At this time, the EU directive 2017/2399 harmonising the insolvency ranking of unsecured debt instruments has not been implemented in Norway. During the transition period, existing outstanding senior debt will generally be eligible for meeting MREL requirements. Financial institutions with MREL requirements must disclose this information, including the maturity profile and priority order of capital and debt used to fulfill the requirement.

Ability to access market funding, especially covered bonds

In Norway, deposits account for about 40% total bank funding, while bonds and short-term paper account for another 30% plus.[3] The latter is comprised primarily of long-term bonds, over half of which are covered bonds. Although covered bonds have proven to be a stable funding source, market funding in general is more vulnerable to changes in investor sentiment.

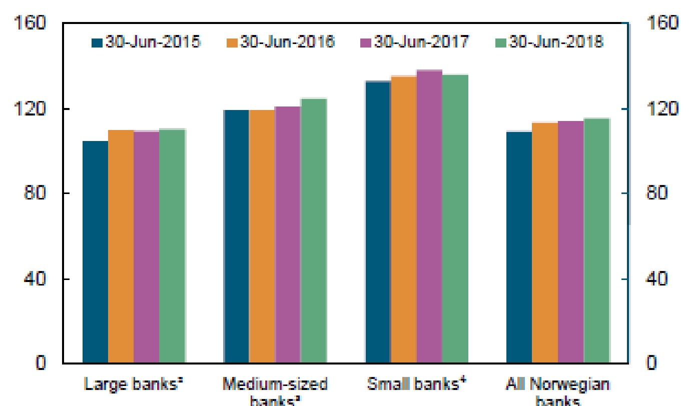
While the Norwegian covered bond market was established only in June 2007, Norway had become the sixth largest issuer and the seventh largest by total outstanding size in 2017. Norwegian banks and mortgage companies, however, are also the largest investors in the Norwegian covered bond market, holding over 50% of the total. This may pose systemic risks as the large holdings of covered bonds amplify the connectedness of Norwegian financial institutions.

Figure 10: Outstanding wholesale funding (%)



Notes: Norwegian banks and covered bond mortgage companies. Data from Jan 2017 – Sep 2018.
Source: Norges Bank

Figure 11: Net Stable Funding Ratio (%)



Notes: Large banks = DNB, SpareBank 1 SR-Bank, Sparebanken Vest, SpareBank 1 SMN, Sparebanken Sor, SpareBAnk 1 Ostlandet and SpareBank 1 Nord-Norge. Medium-sized banks = total assets > NOK 10bn. Small banks = total assets < NOK 10bn.
Source: Norwegian FSA

Of note, both larger and smaller banks are active market participants and regularly issue covered bonds, unsecured senior bonds and capital securities (Tier 2 and AT1).

Short-term wholesale funding in foreign currencies accounts for around 14% of Norwegian banks' funding. Mitigating the rollover risk are central bank deposits and other highly liquid investments. The share of short-term foreign currency funding not matched by central bank deposits is about 4%, down from around 8% in 2016.

[3] Norges Bank, Financial Stability Report, October 2018. Figures in this section relating to investors in the Norwegian covered bond market and short-term funding are from the same source.

LCR and NSFR

Liquidity Coverage Ratio (LCR) requirements were introduced in Norway ahead of the EU schedule, which were phased-in to 2018. In Norway, systemic institutions were required to meet the 100% LCR requirement from 31 December 2015. For other banks, the LCR had to be at least 80% as of 31 December 2016 and 100% as of 31 December 2017.

In addition, as of 30 September 2017, an LCR requirement was introduced for significant currencies. If liabilities denominated in a currency amount to more than 5% of a bank's total liabilities, the currency is considered significant. Banks with EUR or USD as a significant currency, must maintain an LCR in NOK of at least 50%.

While the Net Stable Funding Ratio (NSFR) has not been finalised or implemented in the EU and Norway, Norwegian banks report their NSFR and meet the Basel Committee's proposals (Figure 11).

Appendix – Scope's outstanding public ratings

	Issuer Rating	Outlook	Senior unsecured *	Covered bonds	Tier 2	Additional Tier 1
DNB Bank ASA	AA-	Stable	A+		A-	BBB+
Landkreditt Bank AS	A-	Stable	BBB+			
Landkreditt Boligkreditt AS	A-	Stable		AAA		
Sandnes Sparebank	BBB+	Positive	BBB			
SSB Boligkreditt AS	BBB+	Positive		AAA		
Totens Sparebank	A-	Stable	BBB+			
Totens Sparebank Boligkreditt AS	A-	Stable		AAA		

Note:
In line with our bank rating methodology (May 2018) and when the Norwegian FSA clarifies which debt is MREL-eligible, we expect to rate senior unsecured MREL-eligible debt one notch below the Issuer Rating and senior unsecured non-MREL-eligible debt at the same level as the Issuer Rating.

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