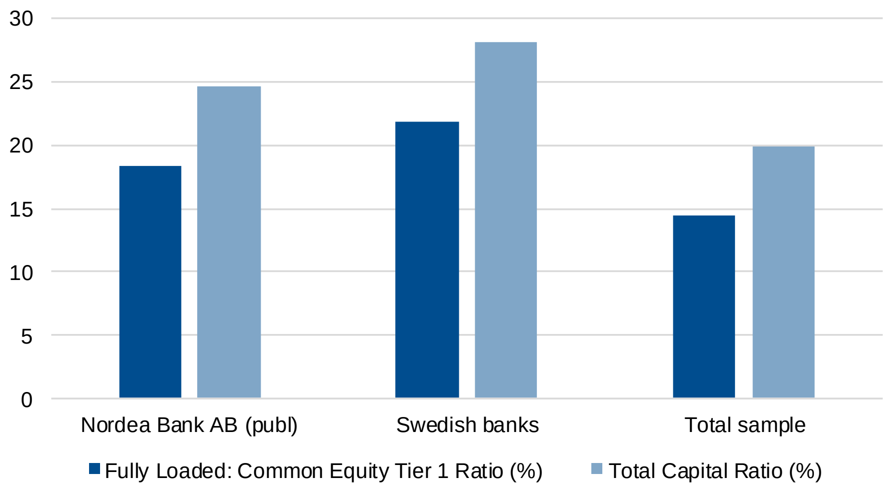
Nordea's New Structure and Domicile Plans: A Manageable Challenge

In this brief report Scope comments on the implications of Nordea's proposed change of headquarters domicile from Sweden to Finland, from the point of view of its consequent prudential supervision by the ECB. We also note the challenges presented by the bank's new cross-border branches for individual countries, and for the ECB as a potential provider of liquidity beyond the euro area (EA).

Nordea Bank AB (Issuer Rating AA- with Stable Outlook) announced on 6th September that, pending shareholders' approval, it will move from Sweden to Finland, targeted to take place in 2H17. The Group will set up a new Finnish subsidiary and merge Nordea Bank AB into it. Nordea has therefore chosen to be brought under the supervision of the ECB rather that Sweden's Finansinpektionen. It will, as noted by the bank's Board, put Nordea on a regulatory level playing field with other large EU banks. With total assets of EUR 643bn at 1H17, Nordea is the Nordic region's only Global Systemically Important Bank (G-SIB). With the extra need for total to loss-absorbing capacity (TLAC) this entails, such a regulatory level playing field is perhaps more important for Nordea than for its Nordic peers.

Scope does not view regulatory arbitrage in the form of lower capital requirements as a motive for the change. The bank will not revise its capital or dividend policies, and it is too early to judge how real capital requirements will be affected. Swedish banks have some of the highest headline capital ratios internationally (See Figure 1), but on average lower levels of risk asset intensity (Figure 2). Their leverage ratios are not far from European norms (Figure 3). Nordea's risk asset mix is somewhat different to that of other Swedish banks, in that its franchise is more diversified, weighted towards unsecured lending to (largely Nordic) corporate customers and trading assets, and less towards domestic mortgages.

Figure 1. Fully-loaded common equity Tier 1 and total capital ratios for Nordea, top 4 Swedish banks and top 50 European banks at YE16



Source: SNL, Scope Ratings

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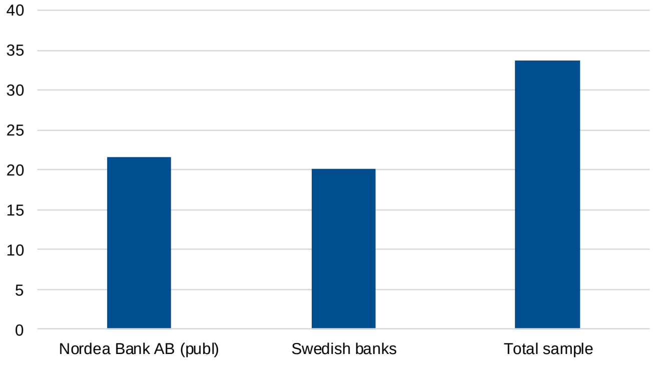
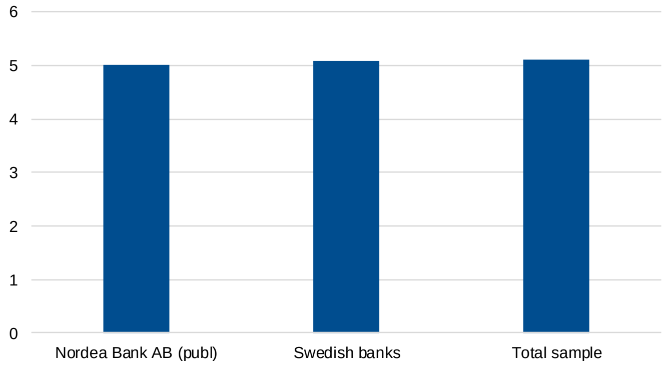
Figure 2: Risk-weighted assets/total assets for Nordea, top 4 Swedish Banks and top 50 European banks as of YE16



Source: SNL, Scope Ratings

Figure 3: Leverage ratio for Nordea, top 4 Swedish Banks and top 50 European banks as of YE16



Source: SNL, Scope Ratings

Nordea does, however, have cost-related considerations driving its plans to re-domicile. The bank expects to save about EUR 1.1 bn because of the move, largely related to regulatory costs, including proposed resolution fees.

We note that Nordea's proposed move will also put the ECB in an unprecedented position with respect to its primary responsibility for supervising a bank with systemic importance not only in its home market within the EA, but within the three Nordic countries outside the EA and the Banking Union (see Figure 4).

Figure 3. Nordea's presence in Nordic countries (2Q17 unless otherwise stated)

	Denmark	Finland	Norway	Sweden
Mortgage Loans	17.1%	29.7%	10.6%	15.1%
Consumer Loans	17.8%	30.2%	6.7%	5.8%
Corporate Loans	20.5%	26.1%	11.3%	12.2%
Household Deposits	21.5%	28.4%	7.1%	14.0%
Corporate Deposits	24.4%	31.1%	11.5%	15.0%
Total Assets in Country (EUR bn) YE16	217	92	87	168
Total operating income (EUR bn) 2016	2.8	1.9	1.6	2.5
Market Position by Local Assets	3	1	2	4

Source: Company data, Scope Ratings

It is normal for a EA bank to have subsidiaries – with local capital requirements – operating outside the EA. However, Nordea's recently revised Nordic structure puts it in a class of its own, as it operates primarily through branches. On 2 January 2017 the Swedish parent bank absorbed all assets and liabilities of its subsidiary banks in Norway, Finland and Demark. Nordea retains locally capitalised mortgage banking subsidiaries, and some other non-bank subsidiaries in the other countries, but otherwise at one stroke most of its Nordic retail banking businesses are now booked on the balance sheet of a single bank, capitalized and supervised in a single country – a reality that will not change when the ECB becomes the supervisor. Adding to the bank's reasons to move out of Sweden, Nordea's newly enlarged Swedish balance sheet has had had a direct impact on the potential resolution fees payable to the Swedish Government, as these are calculated based on a percentage of debt less guaranteed deposits.

There are no other examples of a retail bank with a true cross-border branch structure operating on this scale. Luminor Bank, Nordea's Estonia-based joint venture with DNB in the Baltic region (implemented as of 2 October 2017), will adopt a similar structure, and

Svenska Handelsbanken has built up a cross-border branch network in the UK, the Netherlands and the other Nordic countries, but neither is as large as Nordea's non-domestic operations.

On the face of it, the uniqueness of Nordea's position may appear surprising. given that the vision of cross-border banking is deeply enshrined in the concepts underlying the EU's various directives affecting the banking sector. Nordea has taken advantage of the provisions of CRD IV that give a home member state the right to authorise a bank domiciled there to operate in the whole of the EU/EEA area (the Single Market), either through setting up a branch (without separate authorisation) or the direct provision of services cross-border, along with appropriate product 'passporting' arrangements. However, the European Commission's 2015 Green Paper on retail financial services[1] noted that the reality of a minimal level of cross-border activity in the EU appears to reflect cultural and national preferences, and perhaps also a wider distrust in cross-border providers of financial services following the financial crisis.

Nordea's new structure increases the size of the banking sector in the home country, and also increases its regulatory authorities' potential responsibility to act in a crisis. The Riksbank estimated (as of April 2016) that the local balance sheet of Nordea Bank AB would jump from SEK 1.8tn to SEK 4.8tn on absorbing the other Nordic banks. YE16 data confirms this estimate. Sweden's already large banking sector has grown by an amount equivalent to c. 73% of GDP (see Figure 5). In moving, Nordea will become, by far, Finland's largest banking group. Also based on YE16 data, we estimate that the size of Finland's banking sector will rise to over 300% of GDP if Nordea relocates there, from a current 50%. The European average is about 200%.

Figure 5. Banking Sector Assets/GDP before and after Nordea restructuring and potential move to Finland

	Banking Sector Assets/GDP YE16	Banking Sector Assets/GDP 2 Jan 2017	Banking Sector Assets/GDP after Nordea move to Finland
Sweden	316%	389%	316%
Finland	86%	50%	305%

Note: data includes only banking assets, not financial sector assets as a whole
Source: Company data, Eurostat, ECB, Scope Ratings

It is important to note that to deal with the current situation the Group's regulators signed a Memorandum of Understanding on 19th December 2016, to co-ordinate supervision and the exchange of information, and to allow foreign supervisors to continue to participate and play an important role in the supervisory college for Nordea. Host country authorities naturally consider it essential to have access to information concerning Nordea's solvency and liquidity. We expect this arrangement to remain in place when it is the ECB which heads the supervisory college.

Aside from resolution and bail-in tools, less dramatic steps to support EU banks in recent years have included the ECB's provision of suitably collateralised liquidity support. This occurs via its regular refinancing operations and longer-term LTRO and TLTRO operations. Nordea is more dependent on wholesale funding than many international peers, and has extensive assets and liabilities in non-euro currencies. Thus, it would be something of a singular challenge for the ECB to provide liquidity for its operations, though not one Scope considers unmanageable. Eligible collateral for the ECB, except in exceptional circumstances, has usually been euro-denominated. In Nordea's case, much

[1] EC Green Paper on retail financial services, 10.12.2015

of its available collateral would be in SEK, DKK and NOK, but we would expect it to be predominantly of high quality.

To illustrate the scope of the responsibility, the Riksbank (which currently stands as lender of last resort to Nordea) pointed out that the Nordea Group's total liabilities in foreign currency correspond to over 900 per cent of the Riksbank's foreign currency reserve[2] . With respect to acquiring foreign currency funding, we note that the ECB has the ability to tap into the foreign currency reserves of National Central Banks within the Eurosystem (which manage these on the ECB's behalf), but this would not apply to Sweden, Norway or Denmark. The Nordic host countries outside Finland are losing responsibility for supervising Nordea, but given the bank's continued systemic importance a degree of moral hazard remains a political reality, and the likelihood is that they would choose to be involved in any plan involving future liquidity support for Nordea.

[2] Consultation response on Nordea's applications for permission to implement merger plans, Riksbank, 12 April 2016

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