Norwegian banks well placed to deal with twin challenge of Covid-19 and falling oil prices

Norwegian banks look well placed to deal with the twin challenge of falling oil prices and a Covid-19 related contraction of GDP, thanks to their solid earnings capabilities and sound solvency positions. The Norwegian Ministry of Finance estimates that mainland GDP will contract by around 2% in 2020. Meanwhile, the government has implemented fiscal measures to offset the loss of income and improve liquidity for households and businesses by approximately NOK 310bn.

Earnings are a first line of defence against higher loan losses

With their solid profitability and sound solvency positions – in part due to relatively stringent regulatory requirements – Norwegian banks have capacity to absorb higher loan losses and compare well to European peers in this regard. On average, Norwegian banks' 2019 pre-provision income could absorb loan losses up to 1.8% of loans (including loans transferred to covered bond companies) before eating into reserves (Figure 1).

Figure 1: Earnings are a first line of defense against higher loan losses

(NOK m)	Preprovision income	Loan losses	Loans	Loans incl CBs	PPI % Loans	PPI % All loans
All Norwegian banks	71,469	7,225	3,706,300	4,002,100	1.9%	1.8%
Large banks	46,421	2,804	2,485,200	2,610,800	1.9%	1.8%
Medium sized banks	20,133	3,674	933,300	1,019,500	2.2%	2.0%
Small banks	5,098	747	287,800	371,800	1.8%	1.4%

Notes: Data as of YE 2019. Large banks refer to DNB and 6 large regional savings banks. Medium sized banks refer to other banks with more than NOK 10bn in assets (31 banks). Small banks refer to banks with less than NOK 10bn in assets (84 banks).
Source: FSA 2019 performance report, Scope Ratings.

Recent recommendations from the Norwegian FSA with respect to the distribution of profits should further bolster bank's capital positions. While acknowledging that most Norwegian banks at the end of 2019 met capital requirements by a wide margin, the FSA on 16 March requested boards to review their proposed profit distributions considering the changed economic outlook. Subsequently, some banks announced reduced distributions.

On 24 March, the FSA further recommended that the Ministry of Finance pass legislation to restrict distributions entirely. Although this was not adopted, we expect banks to remain prudent. Originally proposed dividend distributions and share buybacks had totaled more than NOK 20bn (roughly EUR 1.7bn).

Loan loss coverage varies by bank, but many banks' pre-provision income has averaged between 1.5%-2.0% of loans over the past three years. To that one can add the substantial capacity of the banks to absorb losses with capital buffers, providing a further 2%-7% against loan losses before affecting minimum solvency requirements (Figure 2).

Analyst
Pauline Lambert
p.lambert@scoperatings.com

Associate analyst
Andre Hansen
a.hansen@scoperatings.com

Team leader
Dierk Brandenburg
d.brandenburg@scoperatings.com

Media
Keith Mullin
k.mullin@scopegroup.com

Related Research

Covid-19 economic crisis: banks emerge as part of policy solution
March 2020

Covid-19: Matrix for assessment of economic vulnerability and healthcare capacity
March 2020

Scope Ratings GmbH
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

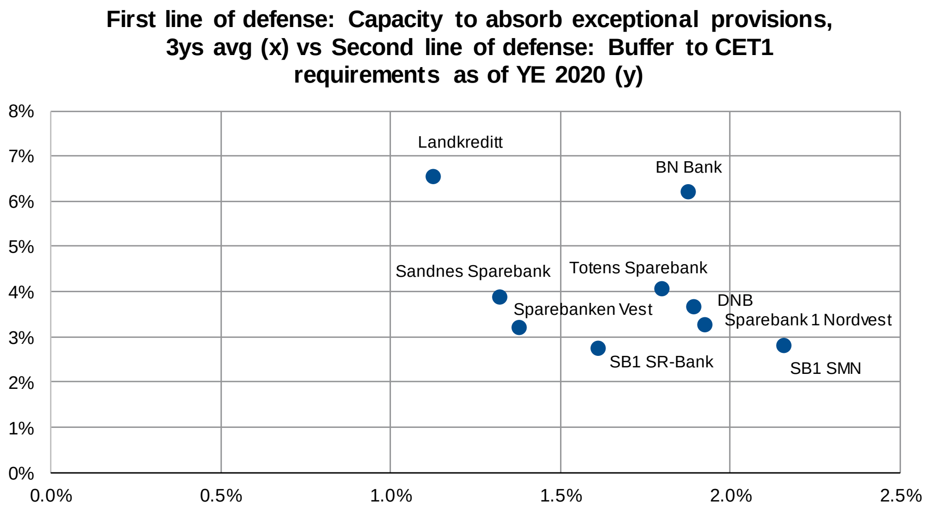
Headquarters
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Figure 2: Capacity of selected Norwegian banks to absorb higher loss provisions from pre-provision income and excess capital

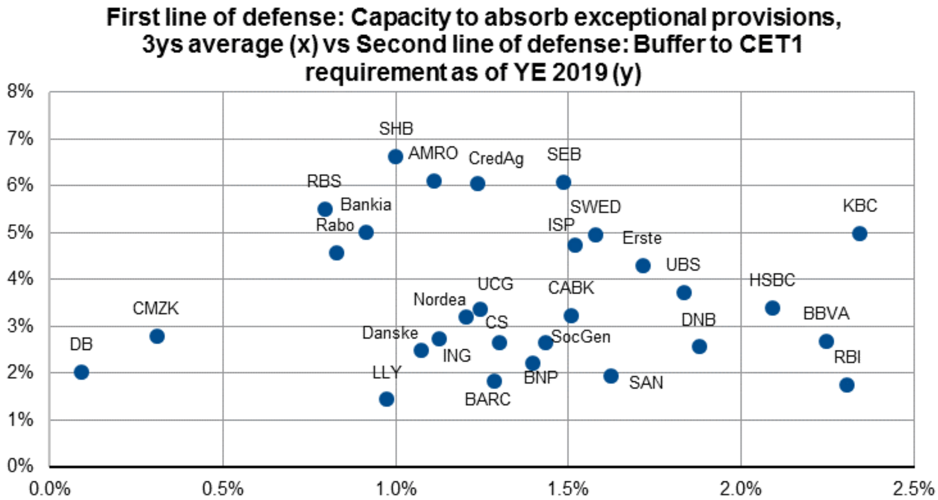


Notes: Loan figures have not been adjusted to include loans transferred to jointly owned covered bond companies. Excess capital figures have not been adjusted to reflect any retention of 2019 profits following the FSA's recommendations.

Source: SNL, Scope Ratings

The financial position of Norwegian banks compares well to European peers, both in terms of pre-provision profitability as well as excess regulatory capital buffers (Figure 3).

Figure 3: Most European banks could absorb over 100bp of loans in excess provisions a year without eating into their capital bases



Source: SNL, Scope Ratings

Room to provide banks with further flexibility

As in other parts of the world, Norway is taking strong monetary and fiscal measures to offset the economic impact of Covid-19. On the monetary front, the Norwegian central bank has cut interest rates twice, 50bp on 12 March and a further 75bp on 20 March, bringing rates to 0.25%. Extraordinary F-loans (the instrument the central bank uses to provide liquidity to the banking system) with terms up to 12 months are also being offered to banks to provide liquidity. As well, the countercyclical capital buffer for banks was reduced to 1% from 2.5%.

Capital buffer requirements could be reduced further

If needed, we believe Norwegian banks could see further flexibility. Many European countries have reduced countercyclical capital buffers to zero (usually from low levels) and cancelled planned increases. Similar reductions are also being made to national systemic risk buffers. For Norwegian banks, the systemic risk buffer currently stands at 3% but is scheduled to increase to 4.5% for those using the advanced IRB approach by year-end.

Various supervisory authorities are also relaxing rules around capital and NPL recognition. The Single Supervisory Mechanism (SSM), the ECB's banking supervision and the Bank of England have communicated that capital buffers are meant to be used, including the capital normally held to meet Pillar 2 Guidance (P2G) and the PRA buffer, respectively.

The ECB and the Bank of England are also encouraging banks to use IFRS transitional arrangements (allowing IFRS 9 impacts to be temporarily filtered out of capital). For IFRS modelling purposes, they further recommend that the current adverse economic scenario be viewed as temporary and the unprecedented measures from governments and central banks to support the economy be incorporated.

A softer supervisory stance on NPLs is possible

Further, the SSM has communicated a softer supervisory stance on NPLs. With respect to the classification of unlikely-to-pay obligors covered by Covid-19 related public guarantees, banks will be able to delay booking provisions against these loans for the first seven years. Meanwhile, the Bank of England has communicated that the use of payment holidays should not automatically result in loans being moved into Stage 2 or Stage 3 for the purposes of calculating expected credit losses under IFRS 9 or trigger a default under the Capital Requirements Regulation (CRR).

Norwegian banks face a difficult operating environment

As people have been encouraged to work from home, many bank branches are closed. However, due to the high level of internet use in the country and well-developed digital capabilities, banks continue to serve their customers, with most of their employees working remotely.

Demands for support from customers

Banks are proactively offering aid to customers. They are fielding numerous queries following recent interest-rate reductions and the availability of measures to support liquidity, such as the suspension of interest payments. While there is demand for forbearance, it may be too early for this to materialise in first quarter results. The impact of Covid-19 on loan portfolios and asset quality is likely to appear from second quarter reporting. There remains uncertainty about the exact nature of various support measures and how they will be accounted for. As loans move from Stage 1 to Stage 2 classification, greater loan-loss provisioning will be required.

Mortgage rate reductions of 85-100bps will help

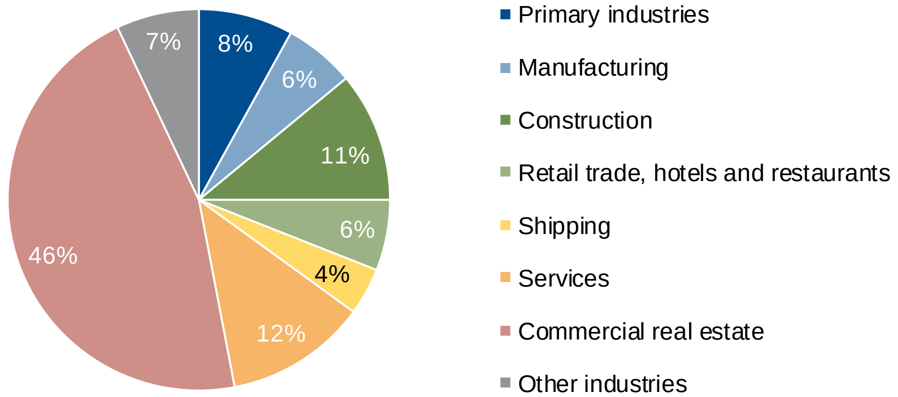
If strict infection control measures remain in place for many months, the current liquidity strains of borrowers could become more serious credit issues. We remain relatively sanguine with exposures to retail clients. Unemployment benefits are robust and mortgages have a strong track record in various economic and financial crises. Most small and medium-sized savings banks in Norway are focused on personal clients, with residential mortgages often comprising 70% of loan portfolios. For the banks rated by Scope, there is also limited exposure to more vulnerable business sectors such as retailing and hospitality (restaurants and hotels).

Corporate loan portfolios are concentrated in commercial real estate

Access to State-guaranteed SME lending scheme is reassuring

For the Norwegian banking system as a whole, lending to commercial real estate companies accounts for the largest share of exposures to the corporate sector – about 45% according to data from Norges Bank (Figure 4). We continue to monitor exposures to this sector in light of relatively high commercial property prices in the country and the more volatile nature of earnings. Regulation adopted 27 March regarding the state-guaranteed SME lending scheme clarifies that commercial property companies are eligible for these loans, which should be supportive.

Figure 1: Distribution of lending to the corporate market by all banks and mortgage companies in Norway (June 2019)



Source: Norges Bank.

Norwegian government has resources to support economy

The Norwegian government also continues to implement measures to mitigate the economic effects of Covid-19. The priority has been to avoid layoffs and bankruptcies in viable companies facing sudden revenue pressures. Second, support is being provided to affected sectors and businesses. To date, implemented measures are expected to offset the loss of income and improve liquidity for households and businesses by approximately NOK 310bn. In comparison, the total output of mainland companies was around NOK 500bn per quarter before the outbreak of the virus.

Unemployment rises to 10.4% from 2.3% – most are temporary layoffs[1]

Measures include reducing the number of days employers are obliged to pay salaries to furloughed workers to two days from 15 days, removing the waiting period for unemployment benefits, support for the self-employed, and changing corporate tax regulations. For SMEs, NOK 50bn in new loans will be made available, backed by a 90% State guarantee. To be distributed by the banks, companies will be able to borrow up to NOK 50m for three years. In line with European capital regulations (CRR), banks will be able to risk weight the State-guaranteed portion of these loans at 0%.

For larger companies, a government bond fund is being reinstated to make bond purchases of up to NOK 50bn. A substantial share of the fund's capital will be invested in bonds issued by non-financial companies but may also be used to support the banking and financial sectors.

In Norway, the economic impact of Covid-19 may be further exacerbated by the recent decline in oil prices, with prices hovering around USD 20. Before the price fall, there were

[1] Source: Norwegian Labour and Welfare Administration (NAV). Data for the period from 10 March to 24 March. Stringent anti-infection measures were introduced on 12 March.

already expectations for Norwegian petroleum investment to decline as large projects were nearing completion and fewer large projects are being planned.

Further measures may be needed to mitigate impact of lower oil prices

Positively, the government has acknowledged this risk and has stated that targeted measures will be considered if necessary, as in 2014-2016 when oil prices fell from over USD 100 to below USD 40. Having reduced their cost bases, oil companies are considered to be in a better position to handle lower oil prices. As well, banks like DNB have reduced their exposures to the oil sector.

On 27 March, the government proposed further measures, including a new scheme for cash pay-outs to otherwise sustainable businesses severely affected by pandemic control measures. With the changed outlook for the economy and implemented fiscal measures, the estimated impact on the national budget is NOK 136bn, excluding the cash pay-out scheme which could cost another NOK 10-20bn per month. The Ministry of Finance has stressed that the estimates are highly uncertain, with costs based on a scenario where the strictest infection control measures are kept in place for two months and with a gradual return to normality thereafter.

Figure 5: Estimated cost of various measures and changed economic outlook on budget

	Updated 27 March	20 March
Mitigating income loss for businesses	30.7	24.5
Mitigating income loss for individuals	20.8	18.1
Strenthenging the health sector, municipalities and social security	1.1	0.6
Other compensation schemes	5.5	4.6
Aviation sector, including loss provisions for guarantee scheme	8.7	8.7
Loss provisioning	10	10
Reduced tax revenue	37	24
Increased expenditure on unemployment benefits	18	16
Increased sickness allowance	4	5
Total impact on budget	**135.8**	**111.2**

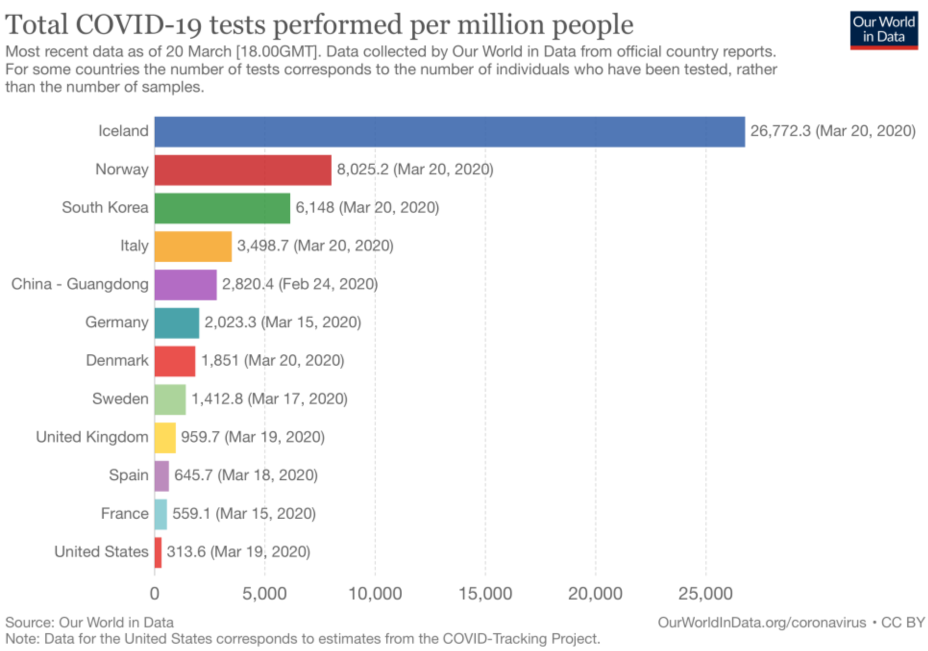
Source: Ministry of Finance

Appendix I – Development of Covid-19

Data shows that once the infection starts to spread widely, the contagion curve quickly turns exponential. Testing is important as it helps to formulate appropriate responses to slow the spread of the disease. The capacity for testing remains low in many countries although the situation is quickly developing. It is not surprising that when more tests are done, the number of confirmed cases is usually higher.

This may help to explain the relatively high number of cases in Norway considering the country's population.

Figure 6: Covid-19 testing in selected countries



Source: Our World in Data.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer

Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Guillaume Jolivet.