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ISSUER IN-DEPTH
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DNB, SB1 SR-Bank, SB1 SMN, SB1 Nord-Norge, Sparebanken Vest & Sparebanken More

Norway's oil-exposed lenders are insulated against weak oil prices

We expect the six Moody's-rated Norwegian banks with exposure to the oil sector to preserve their current strong capitalisation and creditworthiness, despite an increase in their problem loans due to a steep coronavirus-induced drop in oil prices. The lenders' oil exposure remains relatively limited, and their core profitability is solid, helped by continued good income generation from their dominant mortgage lending operations. While downside risks remain, their strong capital buffers are also supportive of their solvency and ratings.

Oil price slump pushes up problem loans. The price of Brent crude oil fell by 78% between February and April 2020 as the coronavirus-related economic downturn led to a sharp fall in global energy demand, although it later partly recovered. The decline triggered loan repayment difficulties among some Norwegian oil sector borrowers, including owners of offshore service vessels. This was a key factor behind an increase in the six banks' weighted average non-performing loan (NPL) ratio to around 1.9% in Q2 2020 from 1.4% a year earlier. DNB Bank, one of the largest banks and the most exposed to the oil sector, suffered the most significant asset quality deterioration.

Modest exposure and good provisioning capacity are strong mitigants. All six banks have limited exposure to the oil sector, which accounts for between 0.7% and 4.5% of their total loan books. At the same time, their profitability, their main buffer for absorbing loan loss provisions, is solid, helped by good income generation from their core mortgage-lending activities. We expect the Norwegian banks to continue posting strong pre-provision profits, thus generating strong capacity to absorb oil-related loan losses, and continue building capital. Compared with banks in other jurisdictions, which suffered significant credit losses in the first half year 2020, Norwegian banks have been able to comfortably cover the increase in provisions from their pre-provision income.

Banks benefit from ample capital cushion. The banks' Common Equity Tier 1 (CET1) capital significantly exceeds minimum requirements, ensuring that their capital base is well cushioned against potential losses. We do not expect these buffers to change significantly as a result of a scheduled 150 basis point (bps) increase in the systemic risk buffer in December 2020. All banks remain profitable and will generate more organic capital by the end of the year, as the regulator limits their dividend payouts.

Oil price slump pushes up problem loans

World oil prices fell steeply in the first quarter in 2020 as the onset of the coronavirus pandemic halted much economic activity across the globe, triggering a steep fall in energy consumption. The benchmark Brent crude oil price fell by 78% to just over $9 per barrel between February and April 2020. It had partly recovered to approximately $40 per barrel by early October, reflecting a gradual resumption of economic activity as government restrictions designed to halt the spread of the virus eased. We expect the oil price to fluctuate between $40 and $60 a barrel in the medium term.

The drop in oil prices has had negative consequences for oil exporting nations and their banks, which typically have lending exposure to the oil sector. In Norway, the six Moody's-rated banks that have exposure to the country's oil sector – DNB Bank, SpareBank 1 SR-Bank, SpareBank 1 SMN, Sparebanken Vest, SpareBank 1 Nord-Norge and Sparebanken More – all reported an increase in problem loans as more borrowers in the oil sector and related industries began to experience repayment difficulties.

The six banks' weighted average ratio of non-performing loans (NPLs) to gross loans rose to 1.9% in Q2 2020 from 1.4% a year earlier, with DNB Bank suffering the biggest deterioration as its NPL ratio increased to 2.1% from 1.6% over the period (see Exhibit 1).

Exhibit 1

Key performing indicators for the six banks in Q2 2020

	DNB	SB1 SR-Bank	SB1 SMN	SB Vest	SB1 Nord-Norge	SB More
Total Assets	2,652,638	282,913	234,957	217,588	155,632	81,239
CET1 ratio	18.0%	18.3%	17.2%	18.1%	16.9%	17.3%
CET1 requirement	15.7%	12.7%	12.9%	12.7%	12.5%	12.7%
Leverage ratio	6.6%	7.8%	6.9%	7.0%	7.4%	7.7%
LCR	130%	159%	163%	145%	162%	172%
ROE - Q2 2020	8.4%	4.0%	10.3%	12.2%	12.9%	9.2%
ROE - YE 2019	11.1%	14.0%	13.7%	12.1%	15.9%	11.7%
Cost/Income	41.2%	34.2%	45.9%	32.1%	39.2%	43.5%
NPLs - Q2 2020	2.1%	1.7%	1.4%	0.8%	0.4%	1.9%
NPLs - Q2 2019	1.6%	1.0%	1.2%	0.6%	0.4%	1.6%

Note: Total Assets and NPL ratios are Moody's Adjusted figures.
Source: Company reports and investor presentations, Moody's Investors Service

While the increase in NPLs also reflects some coronavirus-related asset quality deterioration outside the oil sector, oil-related problem loans were a key driver of the banks' NPLs and provisioning needs in the first half of the year. In Q2 2020, DNB Bank classified some NOK2.7 billion of loans to the oil, gas and offshore sectors as "Stage 3" loans (having around 3.8% NPL ratio for the portfolio), the most seriously impaired category under the IFRS 9 accounting standard. This compares with NOK1.55 billion in Q1 2020. Over the first half of 2020, the oil and offshore sector accounted for 60% of DNB Bank's provisions of NOK7.9 billion, and for the bulk of SpareBank 1 SR-Bank's total impairments of NOK1.4 billion during the same period.

Norway's non-oil economy began to grow again in late April as restrictions designed to control the spread of the virus were lifted. However, we still expect the country's real GDP to contract by around 4% in 2020, and to exceed its 2019 level only in 2022. The economy will receive some uplift from a reduction in the central bank's benchmark rate to 0% in May 2020 from 1.5% in March 2020. This will support debt affordability and thus the Norwegian banking sector's asset quality, but will also weigh somewhat on its net interest margins.

Modest exposure and good provisioning capacity are strong mitigants

Although downside risk remains, we believe all six banks have sufficient capacity to absorb oil-related increases in credit costs, protecting their capital base. Our view partly reflects the banks' moderate exposure to the oil sector, which has been declining as a share of total lending in recent years. Oil-related loans range from a low of 0.7% of SpareBank 1 Nord-Norge's total loan book to a high of just 4.5% for SpareBank 1 SR Bank as of June 2020 (see Exhibit 2). DNB Bank's oil exposure is the largest of the peer group in absolute terms, but accounts for only 4.2% of the bank's total loan book. This reflects DNB's large size in the local banking system.

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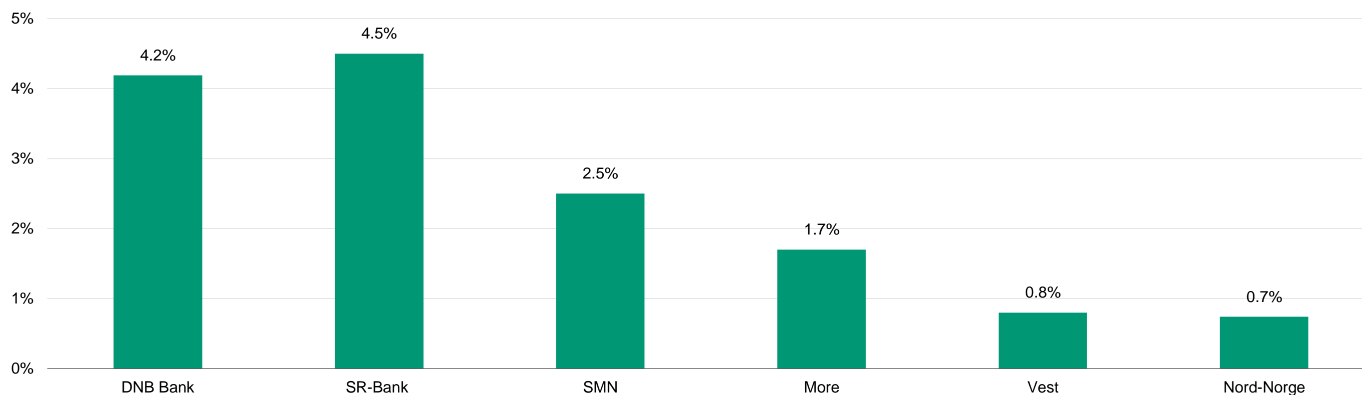
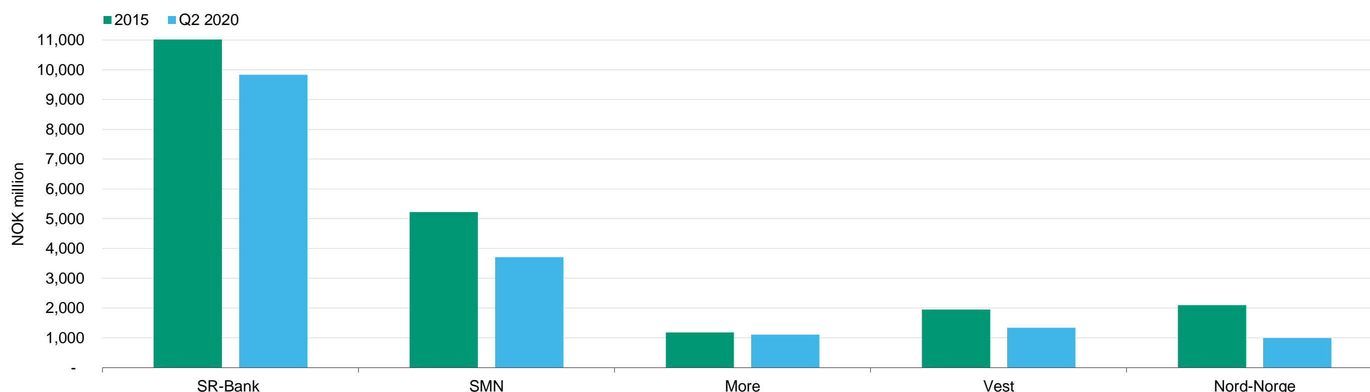
Exhibit 2
Oil-related loan exposure is moderate for all six banks
Reported loan exposure as % of gross lending



Note: The ratios in this chart relate to only on-balance sheet loans, and do not represent exposure at default (EAD).
Source: Company reports and investor presentations

The peer group's exposure to oil and related sectors has declined since the last oil price downturn, which occurred between 2014 and 2016. All of the banks reported lower absolute lending exposure to the oil and offshore industries in Q2 2020 relative to 2015 (see Exhibit 3). DNB Bank's oil, gas and offshore exposures amounted to around NOK100 billion of exposure at default (EAD), or 4.8% of total EAD, as of 30 June 2020, down from NOK167 billion (8.4% of total EAD) in September 2015. The bank's oil-related and shipping exposures have fallen by 40% and 56% respectively since 2014 (see Exhibit 4).

Exhibit 3
Savings banks have lower absolute exposure to the oil sector than in 2015
Reported gross lending to oil/offshore sector by bank

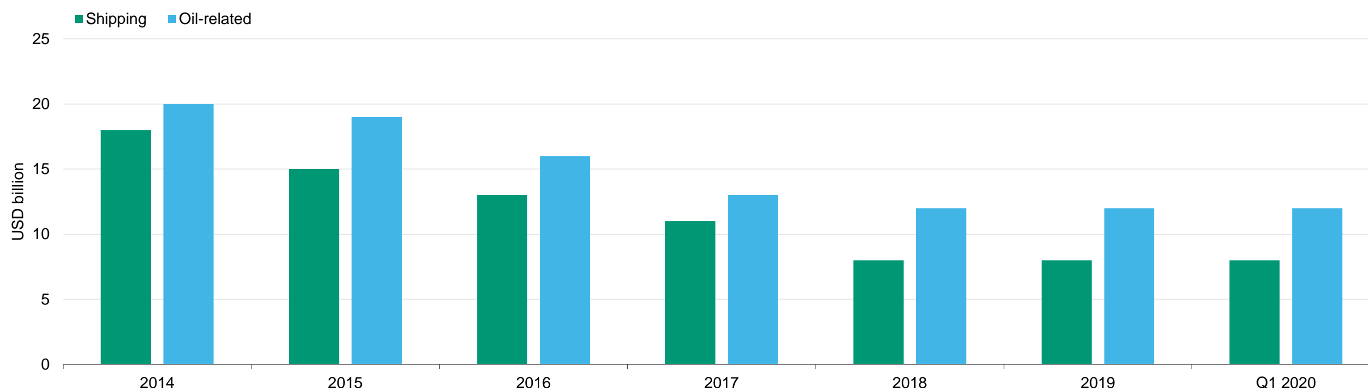


Note: The figures in this chart relate to only on-balance sheet loans, and do not represent exposure at default (EAD).
Source: Company reports and investor presentations

Exhibit 4

DNB Bank's oil-related exposure has fallen significantly since 2014

Exposure at default (EAD)



Source: Company reports and investor presentations

The six banks also benefit from generally strong profitability, reflecting solid income generation from their core mortgage lending operations, robust fee and commission revenue from their non-lending activities, and low cost to income ratios. These factors contributed to satisfactory rates of return on equity (ROE) for the group in Q2 2020 of between 4% and 12%. This was down from 10%-16% as of YE 2019, reflecting higher impairments, margin pressure from low interest rates, and intense competition, especially in the mortgage market.

The banks' strong profitability gives them good capacity to absorb increases in problem loans, and the resulting loan losses, without depleting their capital. In Q2 2020, all six lenders were able to fully fund increased provisions from their pre-provision income (PPI), avoiding bottom-line losses.

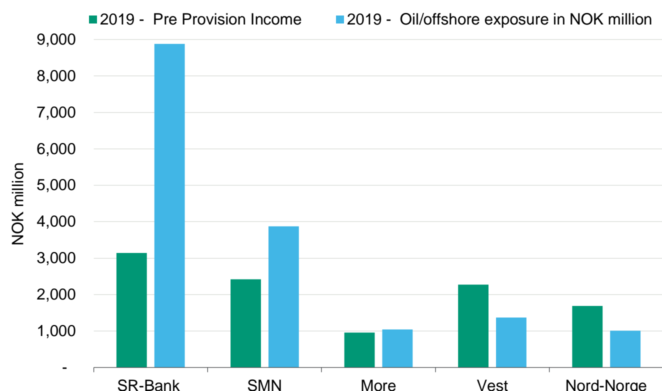
SpareBank 1 SR-Bank booked the biggest proportional increase in credit losses, with total impairments in the first half of 2020 rising to NOK1.4 billion at end-June 2020, from just NOK 30 million at end-June 2019. This amounts to a credit loss ratio (impairments as a proportion of gross lending) of 1.27% in H1 2020, compared with only 0.03% in H1 2019. The change mainly reflects the classification of a handful of oil-related exposures as stage 3 loans with individual impairments. DNB Bank's loan loss provisions increased to NOK7.9 billion in H1 2020 from NOK766 million a year earlier, with its credit loss ratio rising to 0.94% from 0.10%.

As a share of pre-provision income (PPI), SpareBank 1 SR-Bank's impairments jumped to almost 90% as of June 2020 from just 1.8% a year earlier, while DNB Bank's rose to 44.4% from 5.4% a year earlier. The other four banks reported more moderate provisioning increases, with Q2 2020 provisions rising to between 20% and 38% of their PPI. Concurrently, we expect that all banks will also be exposed to the second round effects of the economic impact of lower oil prices, mainly through lower lending to households and other businesses in the oil producing regions of Norway, although the potential effect on their underlying performance is unlikely to be material.

While all banks except Sparebanken Vest and SpareBank 1 Nord-Norge had total oil sector exposure in excess of their PPI at the end of 2019 (see Exhibits 5-6), the potential effect of subtracting the portion of oil sector loans uncovered by PPI from capital would still be manageable, with the biggest impact on SpareBank 1 SR-Bank (see Exhibits 7-8).[1] This demonstrates that the peer group could withstand an unlikely write-off of all their oil sector loans in an extreme-case scenario, and still meet their capital requirements.

Exhibit 5

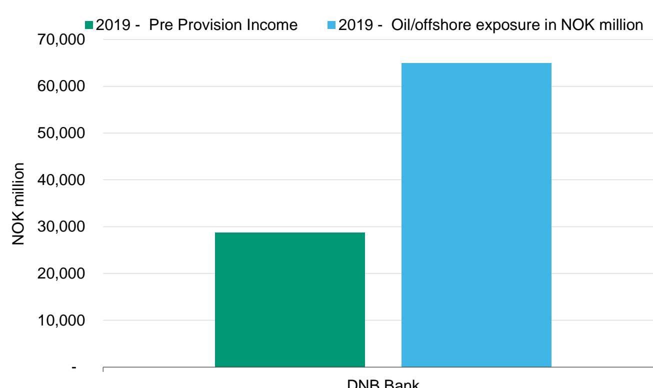
Norwegian savings banks' 2019 pre-provision income relative to their total oil/offshore exposure



Note: The figures in this chart relate to only on-balance sheet loans, and do not represent exposure at default (EAD).
Source: Company reports and investor presentations, Moody's Investors Service

Exhibit 6

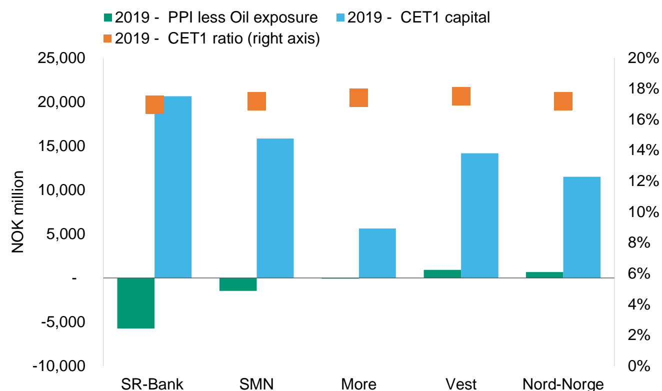
DNB Bank's 2019 pre-provision income relative to their total oil/offshore exposure



Source: Company reports and investor presentations, Moody's Investors Service

Exhibit 7

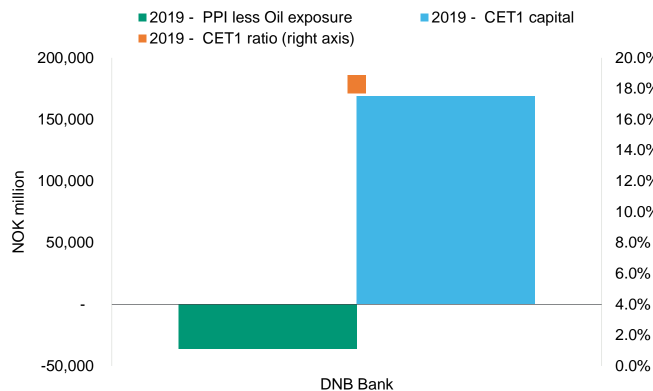
Potential capital impact from writing-off all oil/offshore loans would be manageable for all savings banks



Source: Company reports and investor presentations, Moody's Investors Service

Exhibit 8

Potential capital impact from writing-off all oil/offshore loans would be manageable for DNB Bank



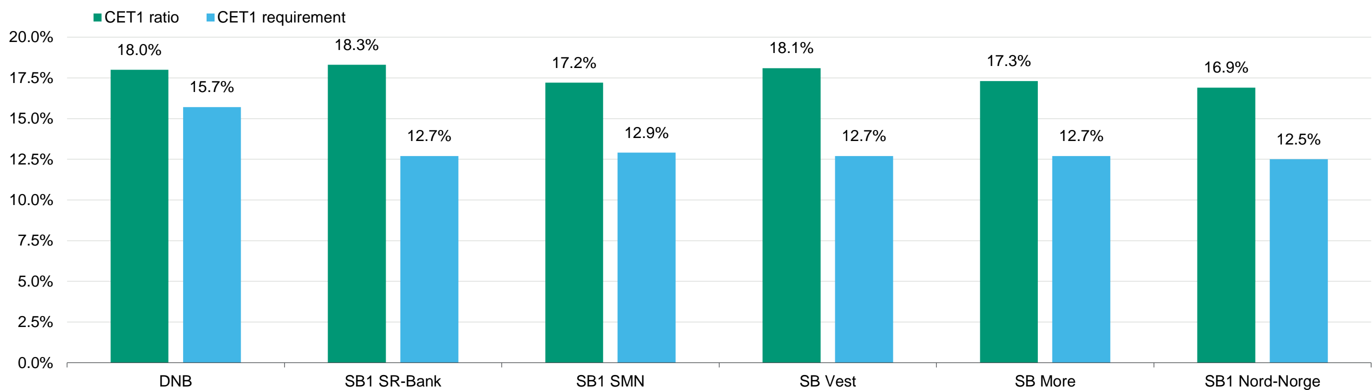
Source: Company reports and investor presentations, Moody's Investors Service

Banks benefit from ample capital cushion

The banks' Common Equity Tier 1 (CET1) capital significantly exceeds their minimum regulatory requirements (see Exhibit 9), ensuring that their capital base is well cushioned against potential losses. This capital cushion increased in March 2020 after the regulatory authorities and the Ministry of Finance reduced the countercyclical capital buffer requirement to 1% from 2.5%, to give banks more financial flexibility during the coronavirus crisis. The regulator's recommendation that banks refrain from paying shareholders dividends this year is also supportive to their capital base.

Exhibit 9

The six banks have ample capital buffers above their regulatory requirements as of June 2020



Source: Company reports and investor presentations

The banks' capital requirements will increase by 150 basis points from December 2020, when the systemic risk buffer is due to rise to 4.5% from 3% for the larger banks that use the Internal Ratings Based (IRB) model. However, we believe that the peer group will still have a comfortable capital cushion above minimum thresholds going forward.

Peer Group:

» DNB Bank ASA

» SpareBank 1 SR-Bank ASA

» SpareBank 1 SMN

» Sparebanken More

» Sparebanken Vest

» SpareBank 1 Nord-Norge

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» Recent oil price weakness will have manageable impact on Norwegian banks' asset quality, Mach 2020

» Largest Norwegian banks to cover NOK230 billion MREL shortfall by 2022, January 2020

Topic pages:

» Coronavirus effects

Endnotes

1 For the purpose of this exercise, any existing loan loss provisions for any oil-related exposures classified as stage 3 loans were not taken into account.

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