IMPROVING CAPITAL COMPARABILITY FOR NORDIC BANKS

ANALYSTS

Geir Kristiansen
+47 90 78 45 93
geir.kristiansen@nordiccreditrating.com

Sean Cotten
+46 732 32 43 78
sean.cotten@nordiccreditrating.com

A significant drawback of regulatory capital measures is the lack of comparability between institutions that employ internal ratings-based (IRB) capital models and those that use less sensitive, but generally more conservative, standardised capital models. Furthermore, the measurement and implementation of risk weighted assets (RWA) may differ between countries due to national discretion that is available as part of current regulations. Even differences between domestic banks' IRB models can lead to different RWA for identical exposures.

On 13 Aug. 2018, Nordic Credit Rating (NCR) released its rating criteria for financial institutions (Financial Institutions Rating Methodology, 13 Aug. 2018). While NCR uses regulatory capital measures as an integral part of our capital analysis, the differences across the Nordic countries are rather large. For example, Norwegian banks are unable to reap the full effect of their IRB models due to the continued use of Basel I floors in the denominator of regulatory capital measures. On the other hand, the Swedish regulator applies a 25% mortgage risk weight floor for residential mortgages in Pillar 2 capital requirements, resulting in higher regulatory capital ratios.

For this reason, in addition to regulatory capital ratios, NCR considers adjusted capital ratios. For example, we adjust for differences in regulatory capital floors and risk weights to increase the comparability of individual banks. By only removing the Basel I floor and converting the Swedish mortgage risk weight floor into Pillar 1, the average adjusted capital ratios of eight large Norwegian banks is higher than the average of the major Swedish banks despite significant advantages for the Swedish banks' official regulatory measures.

NCR expects these differences to decline over time. The new Basel III floor will be phased in from 1 Jan. 2022, which means that IRB banks' RWA will be at least 72.5% of the amount using the new standard method. We also note that on 14 Aug. 2018, the European Commission decided not to reject the Swedish financial supervisor's proposal to move the 25% mortgage floor into Pillar 1 calculations, thus affecting each bank's regulatory capital ratios. While not particularly risk sensitive, the change would better align Swedish banks' capital requirements for mortgage loans with those of their domestic and Norwegian peers, which have floors built into their Pillar 1 IRB models.

NCR FOCUSES ON COMMON EQUITY TIER 1 RATIOS

NCR's capital assessment focuses on the regulatory common equity Tier 1 (CET1) ratio because it reflects the primary focus of market participants, investors and regulators and is the most sensitive measure to changes in capitalisation associated with earnings volatility, changes in the balance sheet and an institution's capital policy.

Nordic banks are among the global leaders in terms of capital ratios for various reasons, including the demands of the national regulators. In some instances, low risk weights from IRB models have resulted in very low RWA for the largest banks in the region, resulting in exceptional capital ratios despite significantly weak leverage ratios. However, there are also many small and medium-sized Nordic banks with high regulatory capital ratios while using standardised capital models.

Figure 1 shows NCR's initial scoring guidelines considering regulatory CET1 ratios and the distance to regulatory capital requirements. The guidance is indicative of issuers using standardised RWA models for credit risk and is calibrated to IRB model users, if appropriate, to reflect the regulatory CET1 ratio and capital requirements. In addition to capital ratios, NCR also considers capital instruments with automatic going-concern conversion or write-down mechanisms, other forms of subordinated capital instruments, capital flexibility of existing regulatory capital buffers and accrued, but unpaid, dividends as well as the strength of a bank's leverage ratios.

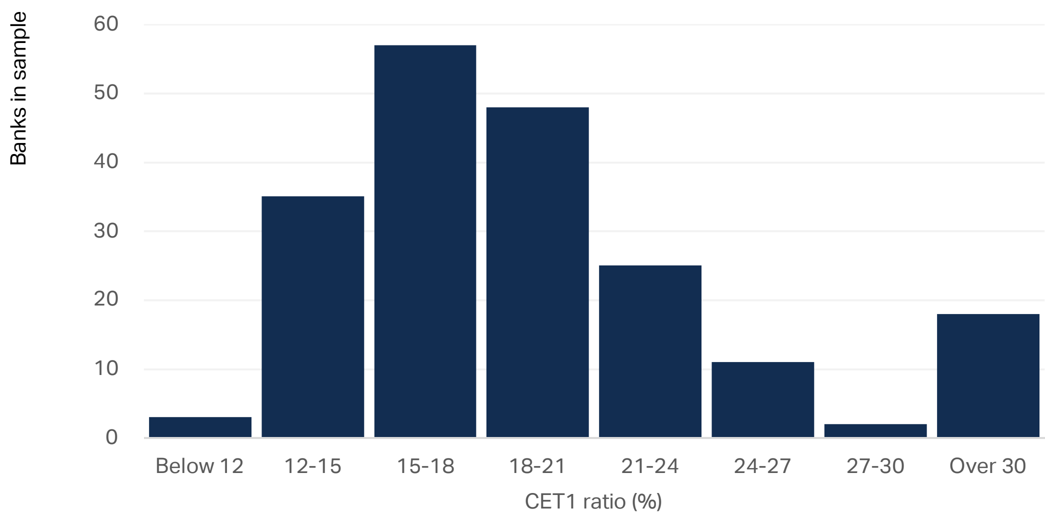
Figure 1. Capital scoring initial scoring guidelines*

SUBFACTORS	aa	a	bbb	bb	b
Capital ratios	Capitalisation and flexibility are exceptional in comparison with regional peers. The regulatory CET1 ratio is typically 22% or higher. Distance to minimum CET1 requirements is usually higher than 6%.	Capitalisation and flexibility are strong or above average in comparison with regional peers. The regulatory CET1 ratio is typically around 18%. Distance to minimum CET1 requirements is usually higher than 5%.	Capitalisation and flexibility are average in comparison with regional peers. The regulatory CET1 ratio is typically around 15%. Distance to minimum CET1 requirements is usually higher than 4%.	Capitalisation and flexibility are below average in comparison with regional peers. The regulatory CET1 ratio is typically around 12%. Distance to minimum CET1 requirements is usually higher than 3%.	Capitalisation and flexibility are weak in comparison with regional peers. The regulatory CET1 ratio is weak, uncertain or deteriorating. Distance to minimum CET1 requirements is usually less than 3%.

* The guideline ratios above may be adjusted to reflect differences in national capital regimes and RWA calculations as described below.

Figure 2 shows the distribution of regulatory capital ratios for a selection of 200 Nordic banks as of the end of 2017. The median CET1 ratio for the sample was 18.2%, implying 'a' level capitalisation prior to considering specific adjustments or additional aspects of each bank's capitalisation.

Figure 2. Nordic banks' CET1 ratios at end-2017



Source: Company data

CHALLENGES IN INTEPRETING CAPITAL METRICS

As mentioned above, a significant drawback of regulatory capital measures is the lack of comparability in the calculation of the denominator (RWA) between institutions that employ IRB capital models or between banks in different countries due to national discretion permissible under regulatory capital requirement regulations. These factors can lead to different RWA for identical exposures[1].

One key difference among the Nordic markets is that the CET1 ratios and capital requirements of Norwegian banks continue to be based on RWA using the Basel I floor[2]. We consider capital ratios excluding the Basel I floor in our capital assessments of Norwegian banks, while remaining aware that the legal requirement is defined by RWA including the Basel I floor. The effect of the Basel I floor on Norwegian IRB banks is illustrated in Figure 3; excluding the Basel I floor improves the average CET1 ratio for these banks by 1.8 percentage points, from 16.4% to 18.2% as of end-2017.

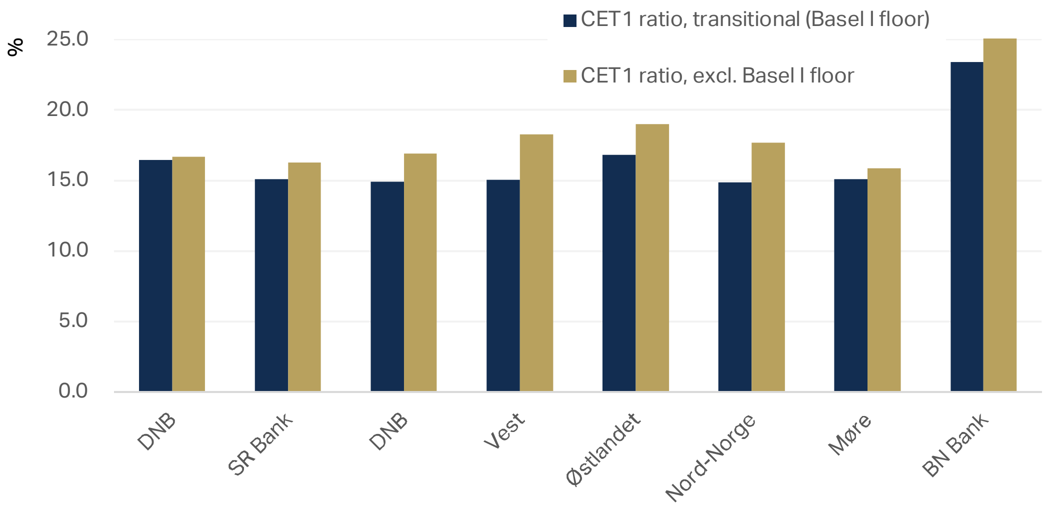
As for the 25% mortgage risk weight floor for Swedish banks, a final decision to move the Pillar 2 requirement into Pillar 1 is expected in the coming months and NCR expects to include the future change in the regulatory calculation and its own assessment of capital ratios. The effect of this for selected Swedish banks is illustrated in Figure 4. The weighted-average CET1 ratio for these banks is reduced from 21.2% to 17.3% as of end-2017.

---

[1] It should be noted, however, that the CET1 ratios in Figure 2 and Figure 5 are not adjusted for these discrepancies.

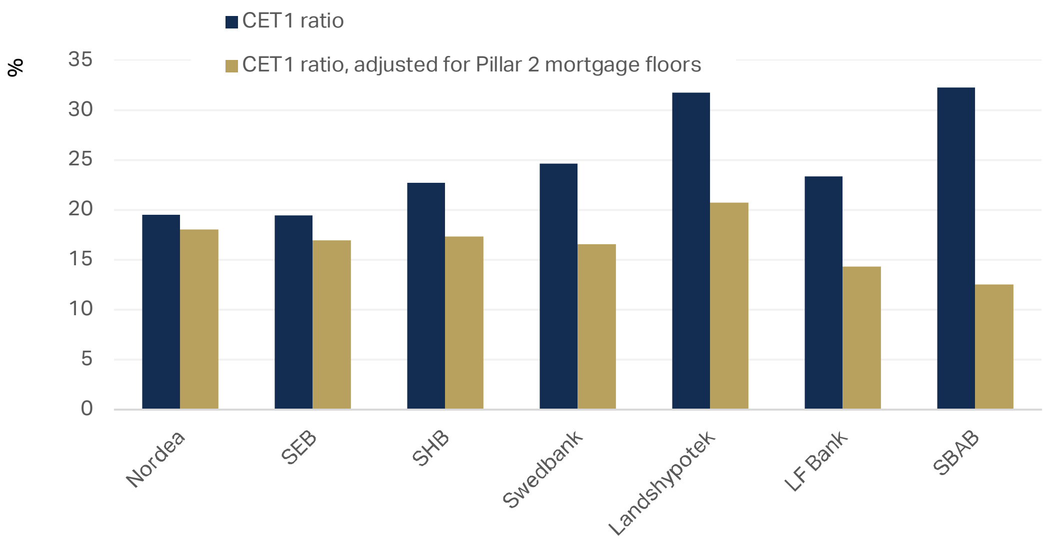
[2] Total calculated Basel III RWA cannot be lower than 80% of RWA using Basel I calculations.

Figure 3. CET 1 ratios for selected Norwegian banks with and without the Basel I floor, 2017



Source: NCR estimates using company data. From left: DNB ASA, SpareBank 1 SR-Bank, SpareBank 1 SMN, Sparebanken Vest, SpareBank 1 Østlandet, SpareBank 1 Nord-Norge, Sparebanken Møre, BN Bank

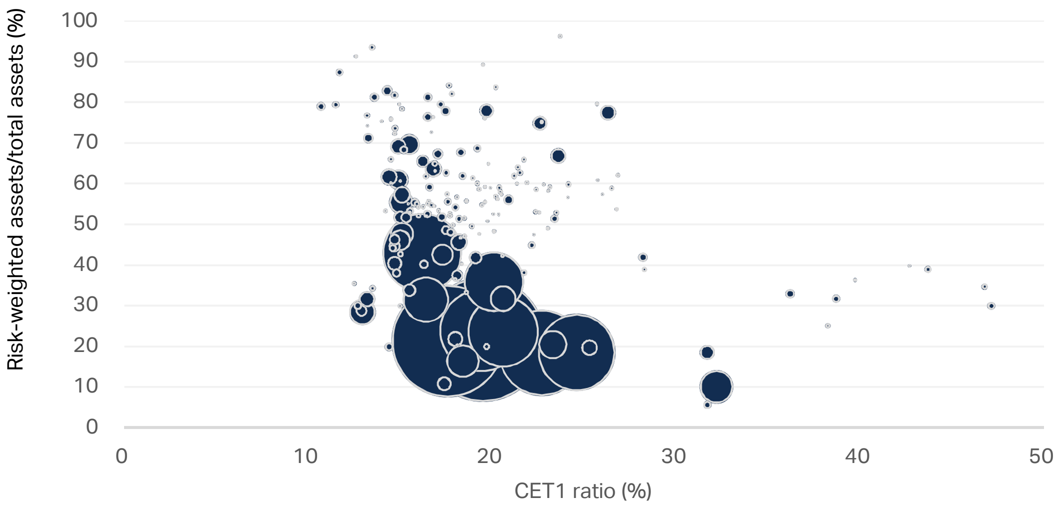
Figure 4. Swedish bank CET1 ratios, actual and adjusted for Pillar 2 mortgage risk weight floors, 2017



Source: NCR calculations based on Swedish Financial Supervisory Authority data. From left: Nordea Bank, Skandinaviska Enskilda Banken, Svenska Handelsbanken, Swedbank, Landshypotek Bank, Länsförsäkringar Bank, SBAB Bank

Even considering the two adjustments above, it is clear that the larger institutions (represented by larger circles in Figure 5) tend to have considerably lower RWA densities (measured as regulatory RWA divided by total assets). This reflects a higher share of short-term, non-loan assets, but is also largely affected by the use of IRB models to calculate their RWA requirements for commercial real estate and corporate exposures. Although an element of such differences can be justified, NCR aims to evaluate banks' capital strength in a manner that is comparable across the region.

Figure 5. Nordic banks' CET1 ratios compared with RWA density at end-2017



Source: Company data

COUNTRY SUMMARY

Below is a summary of the median and average of some of the capital metrics described above for the 200 banks in the selection. The figures reveal some of the material differences between the Nordic countries and demonstrate that there is no single Nordic banking market, but rather five distinct markets which share a number of large cross-border banks but operate in diverse competitive and regulatory environments.

Figure 6. Nordic banks' capital metrics by country, 2017

		DENMARK	FINLAND	ICELAND	NORWAY	SWEDEN	REGION
	# of banks	34	30	5	74	57	200
Median	Total assets, EURm	2,303	2,151	8,271	1,248	1,256	1,454
	Total RWA, EURm	1,234	728	6,123	633	720	763
	CET1 ratio (%)	16.7	26.8	23.6	16.9	19.8	18.2
	RWA/assets (%)	64.8	34.5	66.8	53.8	56.8	54.0
	Equity/assets (%)	12.1	9.5	19.7	10.9	13.2	11.5

		DENMARK	FINLAND	ICELAND	NORWAY	SWEDEN	REGION
Average	Total assets, EURm	26,074	8,415	5,650	7,160	27,618	16,357
	Total RWA, EURm	6,934	2,613	4,035	3,228	6,067	4,595
	CET1 ratio (%)	16.9	30.8	37.8	18.5	23.3	22.0
	RWA/assets (%)	59.8	34.6	59.1	54.3	53.1	52.0
	Equity/assets (%)	12.1	10.0	18.5	11.2	13.7	12.1

NORDIC CREDIT RATING AS

OSLO
Biskop Gunnerus' gate 14A
0185 Oslo
Norway
www.nordiccreditrating.com
post@nordiccreditrating.com

STOCKHOLM
Engelbrektsgatan 9-11
114 32 Stockholm
Sweden

For questions or comments regarding our methodologies please use:
criteria@nordiccreditrating.com