Nordic Credit Rating

FINANCIAL INSTITUTION

Norway
1 Feb. 2023

Kredittforeningen for Sparebanker

Full Rating Report

LONG-TERM RATING

A-

OUTLOOK

Stable

SHORT-TERM RATING

N2

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RATING RATIONALE

Our 'A-' long-term issuer rating on Kredittforeningen for Sparebanker (KfS) reflects the company's strong capitalisation and low risk appetite. KfS is a non-profit credit institution serving Norwegian savings banks. The company has a concentrated loan portfolio, but funds only investment grade savings banks. KfS has never experienced loan losses. The company is funded by senior bonds with approximately the same maturity as the individual loans it makes. It has no obligation to refinance these loans, and refinancing and pricing risk are consequently minimal.

The low interest rate environment has put pressure on KfS' margins in recent years and has also led to lower demand for funding from member banks. However, we now expect higher interest rates to be positive for the company. Since 2021, KfS has helped small savings banks to access green funding, an initiative with the potential to revitalise the company's business model. Adaptation to the finalised EU banking package is a current challenge for KfS. The European Banking Authority (EBA) considers that membership contributions in the form of pure core capital instruments, as practised at KfS, do not meet the requirements. Moreover, the maximum loan limit has been reduced and KfS' capital requirement has increased by 1.5% (the SME discount is not applicable). We believe that KfS will most likely be able to adapt to the new regulations, given that the member banks see the benefit of its services.

STABLE OUTLOOK

The outlook is stable, reflecting the resilience and strong credit quality of the Norwegian savings bank sector and KfS' modest risk profile. We do not believe that possible challenges for the company's business model will result in higher default risk, given its high asset quality and low refinancing and liquidity risk. The business model would, in our opinion, simplify an orderly portfolio run-off, if necessary, without significant deterioration in the company's credit quality or increased liquidity risk.

POTENTIAL POSITIVE RATING DRIVERS

- A combination of two or more drivers, such as stronger market position, stronger capitalisation and/or higher earnings.

POTENTIAL NEGATIVE RATING DRIVERS

- Lower credit quality of debtors, either due to idiosyncratic or macroeconomic stress.
- A renewed fall in business volumes or increased concentration on lower credit quality.
- A total capital ratio below 18%.

Figure 1. KfS key credit metrics, 2018–2024e

(%)	2018	2019	2020	2021	2022e	2023e	2024e
Net interest margin	0.14	0.15	0.14	0.12	0.14	0.16	0.17
Loan losses/net loans	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Pre-provision income/REA	0.37	0.21	0.04	-0.18	-0.05	-0.02	0.03
Return on ordinary equity	1.20	0.66	0.10	-0.56	-0.16	-0.06	0.09
Loan growth	0.8	-7.4	-16.6	3.1	-11.0	3.0	6.0
CET1 ratio	16.9	17.8	18.6	17.5	18.6	17.7	16.9
Capital ratio	22.7	21.5	22.8	24.5	24.7	23.5	22.4

REA–risk exposure amount. e–estimate. All metrics adjusted in line with Nordic Credit Rating (NCR) methodology. Based on NCR estimates and company data. CET1–common equity Tier 1.

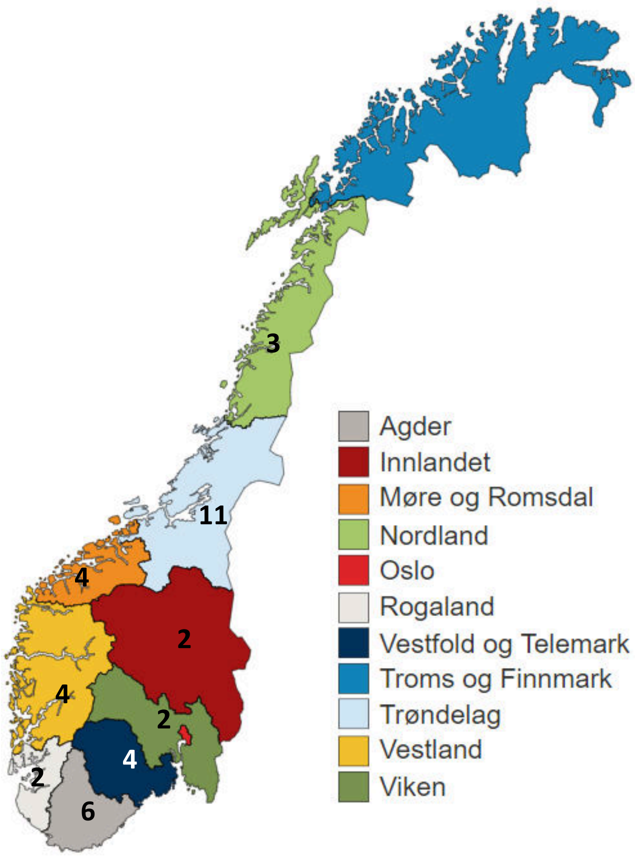
ISSUER PROFILE

KfS is licensed as a credit institution and provides medium- and long-term senior loans to savings banks. It was established in 2004 by Eiendomskreditt AS, a mortgage company that finances commercial real estate, and 49 savings banks to secure funding in difficult market conditions. KfS and Eiendomskreditt are based in the city of Bergen, and parts of KfS' operations are outsourced to Eiendomskreditt. Eiendomskreditt and KfS jointly have 11 employees, five of which are partly allocated to KfS (2.2 full-year equivalents).

KfS is organised as a credit association and is operated according to cooperative principles. Its borrowers, which are solely Norwegian savings banks, become members of the association. The association's non-profit model allows member banks to achieve lower borrowing costs by diversifying their risk across KfS.

KfS is a vehicle for small savings banks with limited access to the bond market. The median gross lending of the member banks is NOK 3.5bn (2021), ranging from NOK 0.7bn to NOK 21.4bn. The members are spread throughout Norway, with the strongest presence in the central county of Trøndelag and the weakest in the north of the country.

Figure 2. KfS member banks (39) by county, year-end 2022



Source: company.

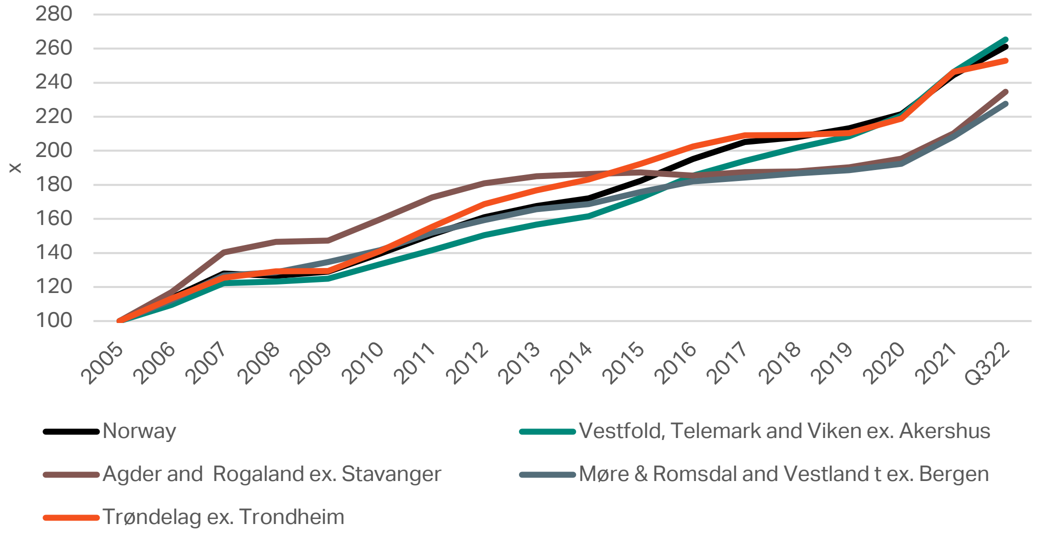
OPERATING ENVIRONMENT

Operating environment assessment 'a-'

Norwegian savings banks are heading into an uncertain 2023 with a degree of positive momentum following relatively strong performance in 2022. Net interest margins have improved materially due to a rebound in interest rates, with the domestic policy rate and three-month NIBOR increasing by 275bps over the past 15 months. We expect the improvement in margins to support pre-provision earnings even as credit growth declines and provide additional buffers as credit losses rise. The implementation of a capital discount for SME customers is helping banks to improve their capital ratios, even though stringent regulatory requirements mean the ratios will remain at already high levels. The operating environment for Norwegian banks is discussed in more detail in Norwegian savings banks carry positive momentum into 2023, published 24 Jan. 2023.

KfS' member banks operate in rural or semirural regions with low to moderate unemployment and lower housing prices than in more urban areas. However, growth prospects are also lower than in more urban regions, and we generally assess the operating environment for savings banks exposed to rural areas as weaker than the wider national economy.

Figure 3. Norwegian regional housing prices (indexed), 2005–Q3 2022



Source: Statistics Norway.

RISK APPETITE

Risk appetite assessment 'a'

KfS has a low-risk business model, with a focus on achieving the best possible loan terms in the capital markets for its members. The company has never experienced credit losses, is strongly capitalised and has ample liquidity reserves. We find that risk governance and internal risk reporting are adequate, considering the company's risk profile and lack of complexity.

Simple business model and adequate risk governance

Risk governance 'bbb'

KfS has a relatively simple business model and low transaction volumes. The company has few employees and key-person risk is not insignificant. However, the company has adequate risk governance, a competent board of directors, and its cooperation with Eiendomskreditt provides access to additional and flexible resources. We believe that risk resources are proportionate and adequate given the company's risk profile.

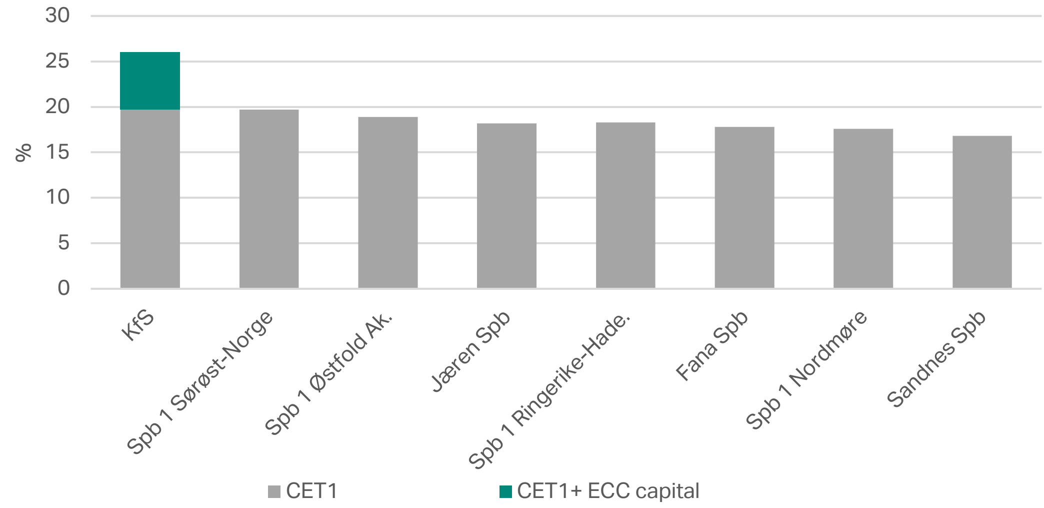
Changes in capital structure due to regulatory changes

Capital 'a+'

When a savings bank receives a loan from KfS, it places a member reserve of at least 3% of the loan with the company (equivalent to a common equity Tier 1 (CET1) ratio of 15% for bank exposures). This is refunded after the loan is repaid. These member reserves are regarded as core equity and have lower priority than other capital, including equity capital certificates (ECCs). Since ECC capital has higher priority, it is considered Tier 2 capital and is not included in the calculation of CET1. However, ECC capital is equity capital and NCR considers it as such in its assessment of KfS' capitalisation. KfS' reported CET1 ratio was 19.6% as of 30 Sep. 2022, while its capital ratio (including ECC capital) was 25.9%.

An announced increase in the regulatory countercyclical buffer to 2.5% from 31 March 2023 and a 1.5pp increase in the systemic risk buffer from year-end 2023 mean that the required CET1 ratio (including an expected Pillar 2 requirement of 0.3%) will increase from 11% to 14%. In addition, risk weights for loans to unrated savings banks are set to increase from 20% to 30% from 2025.

Figure 4. KfS and selected Norwegian savings banks' capitalisation, Q3 2022



Based on company data. CET1–common equity Tier 1.

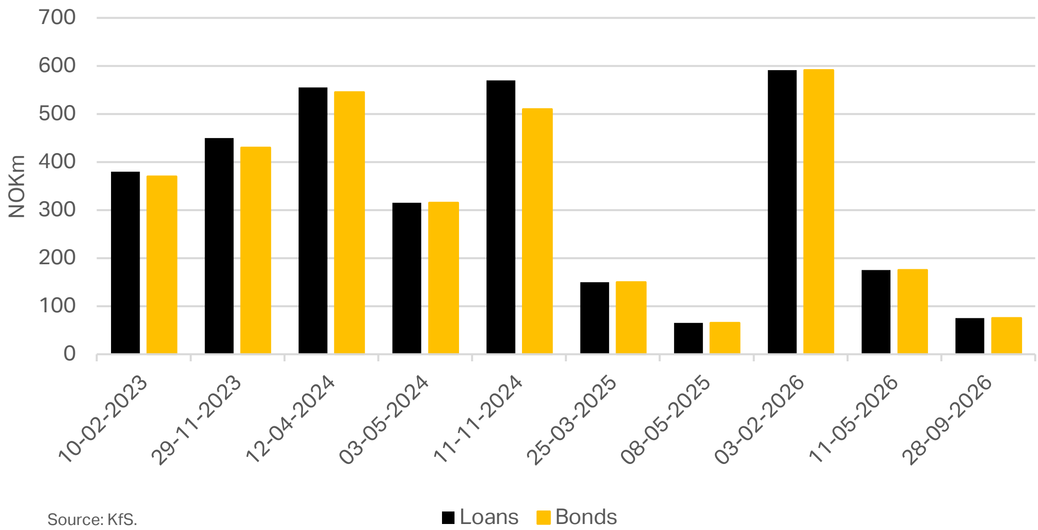
KfS has a process in place to adapt its capital structure to satisfy the requirements of the EU's CRR2 prudential regulatory package. Since the maximum individual loan exposure will be measured against Tier 1 capital and not total capital, the company has decided to apply to the Norwegian financial supervisory authority for permission to write down its entire equity certificate capital of NOK 50m, while issuing hybrid Tier 1 securities for the same amount. Moreover, the EBA considers that membership contributions in the form of pure core capital instruments, as practiced at KfS, do not satisfy the requirements. KfS is in discussions with the Norwegian FSA about how to comply with the requirements.

Fully matched funding and lending

Funding and liquidity 'a+'

KfS is funded by senior bonds that are virtually matched in terms of maturity with the loans that it issues (see Figure 5). Individual loans are bundled and, in some cases, several individual loans mature on the same date. The company has no obligation to refinance loans, so refinancing and pricing risk are minimal.

Figure 5. KfS debt maturity profile, 31 Dec. 2022



Source: KfS.

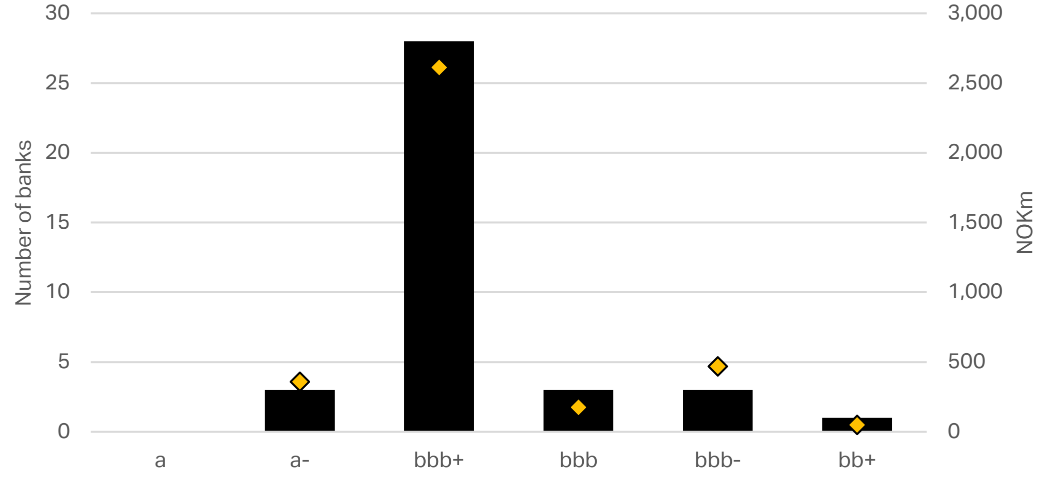
What remains is the risk that one or more banks might be unable to repay debt at maturity, which would put a strain on KfS' liquidity. We believe that KfS has ample procedures in place to handle this risk factor should it arise. For example, individual loans that fall due on a certain date cannot constitute more than one-third of a member bank's capital base or two-thirds of KfS' capital base. KfS must hold or expect liquidity inflow amounting to a minimum of 100% of all bonds maturing in the next 30 days. In addition, the company must hold a liquidity buffer of at least 25% of expected loans due over the next 30 days, as well as an extra liquidity buffer to comply with a regulatory 100% net stable funding ratio requirement.

Low credit risk

Credit risk 'a'

Despite the small number of member banks, NCR assesses KfS' credit risk appetite to be low. The company lends only to Norwegian savings banks, which are heavily regulated and supervised by the domestic financial supervisory authority. KfS uses official ratings or credit scores from up to four brokers to classify the risk of its member banks. A member bank needs to have a rating or equivalent credit score of 'BBB-' or higher to qualify for a loan from KfS. NCR has carried out confidential credit assessments of the banks on the company's loan book and finds that the credit assessments range from 'bbb-' to 'a-', with the exception of one bank with a credit assessment of 'bb+'. The average score of the banks on the company's loan book is 'bbb+'. We believe that our credit assessments are likely to lie within a range of plus or minus one notch of an actual credit rating in most instances.

Figure 6. NCR's credit assessments of KfS member banks



Based on NCR data.

We believe that the main credit risk factor for KfS is concentration risk. With only 39 active members, the company's average loan was NOK 96m at year-end 2022, or 48% of the estimated total capital base. The largest loan was NOK 195m as of year-end 2022, or 97% of the estimated total capital base.

The number of savings banks in Norway is slowly declining and there is a risk that, over time, consolidation will create larger banks of presumably higher credit quality that will have better access to the capital markets directly or larger funding needs than KfS can satisfy. This might lead to a gradual reduction in KfS' credit quality if only smaller or less creditworthy banks choose KfS financing.

We are generally concerned about the risk of real-estate collateral being negatively affected by significant climate events (High real-estate exposure poses climate risk for Swedish and Norwegian banks, publ. 12 Apr. 2022), and note that KfS has not conducted an evaluation of this risk in its portfolio. However, we consider this risk to be lower for KfS than for individual savings banks, due to their significant geographic diversity across Norway, making it unlikely that individual events will impact a large share of member banks.

Other risks

Other risks 'a'

Market risk is negligible, in our view, given that KfS does not trade financial instruments and that it matches the financing and floating rates on both loans and funding (eliminating interest rate risk), maintains low risk limits, and has no currency exposure.

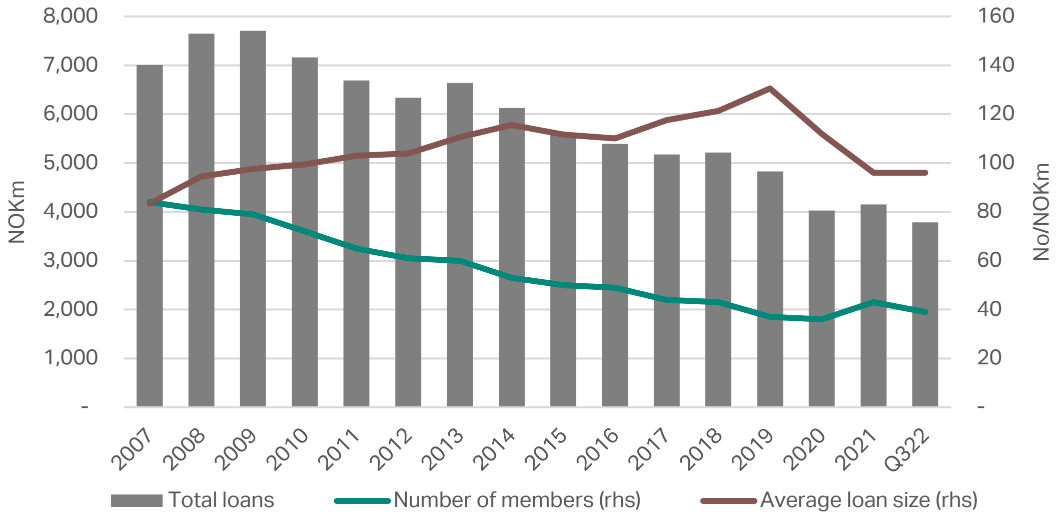
COMPETITIVE POSITION

Competitive position assessment 'bb-'

Deposit growth and easy access to low-cost market funding for smaller banks have undermined KfS' competitive position in recent years. However, increasing bond spreads and higher funding costs for small banks could restore the company's competitiveness. KfS aims to act as a driving force in achieving a sustainable society. To this end, it started to offer its member banks green bond funding in 2021. In addition, KfS has obtained green certification for its own operations. We believe this could improve the company's value to its member banks, providing them with a higher level of sustainable financing and giving them access to green investors. These banks could otherwise face difficulties creating their own green bond frameworks, due to their relatively small loan books and the high initial costs. So far, KfS has issued green bonds amounting to NOK 1.2bn, attracting several new member banks. KfS has published one allocation and impact report, in March 2022, in line with international standards, and we expect it to publish an update this spring.

The new regulations discussed earlier also represent a challenge for KfS' business model, and could have negative implications for the company's attractiveness as a funding source by increasing capital requirements.

Figure 7. KfS gross loans, membership and average loan size, 2007–Q3 2022



Source: KfS.

PERFORMANCE INDICATORS

Performance indicators assessment 'bbb+'

KfS defines itself as a non-profit company, and the lending margin is set at a level that covers costs, dividends on ECCs and tax. This means that profitability has limited loss-absorbing capacity. However, KfS has a record of stable performance, and has never experienced loan losses or non-performing loans. The last default by a Norwegian savings bank occurred in the early 1930s, and increasing capital requirements in the sector and continuing consolidation are resulting in greater stability for the remaining banks.

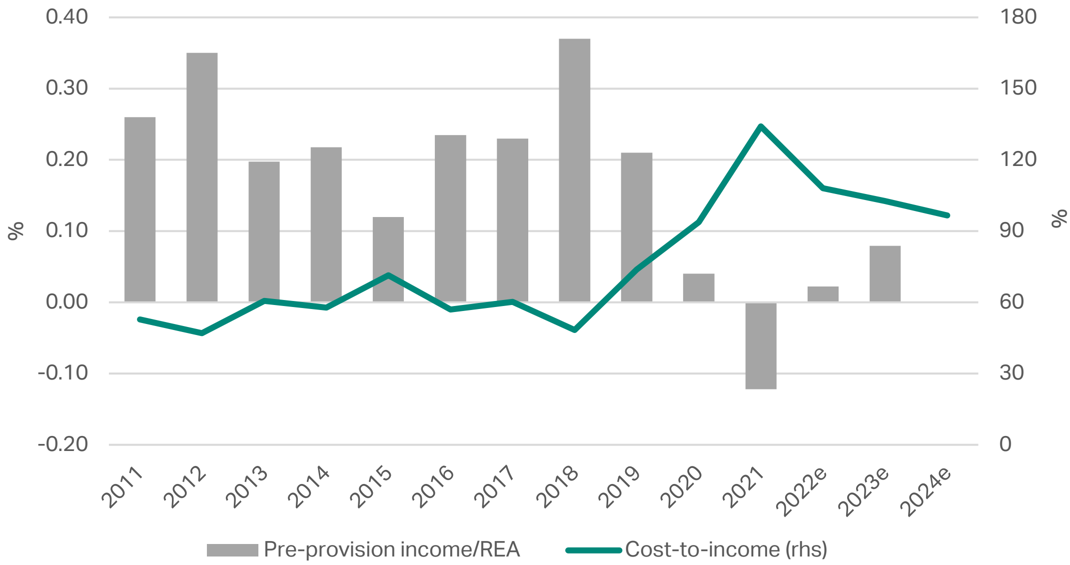
Lower revenues, higher costs

Earnings 'bb'

Loss performance 'aa'

KfS has a strong cost focus and benefits from its shared location and co-operation with Eiendomskreditt. Low margins due to low interest rates and higher fees paid to the deposit guarantee scheme have led to high cost/income ratios and eroded profitability in recent years. However, the company operates close to break-even and we expect that higher interest rates over the next few years will reverse the negative trend. Nevertheless, we believe that KfS will be unable to pay dividends on its ECC capital at a rate commensurate with market interest rates on subordinated debt (which has been the norm) over our forecast period.

Figure 8. KfS earnings performance indicators, 2011–2024e



Source: KfS. e–NCR estimate. REA–risk exposure amount.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS

Moderately positive aggregate ESG impact

ESG factors are considered throughout our analysis where material to the credit assessment. On aggregate, we view the bank's ESG profile as having a moderately positive impact on its creditworthiness.

Figure 9. KfS priority ESG factors

Issue/area	Risk/opportunity	Impacted subsections (impact on credit assessment*)
Sustainable/green bond framework	Ability to offer green funding to savings banks is an advantage, as it allows the banks to diversify funding sources and access additional markets/investors.	Competitive position (++)
Physical climate risk to collateral	Climate-related damage to real-estate collateral (closely linked to supervision of insurance). Longer-term term effects on market values in flood risk areas.	Credit risk (0) Loss performance (0)
Anti-money laundering (AML) capacity	Risk of sanctions and fraud due to insufficient control of customers. Less relevant due to main AML responsibility lying with individual savings banks.	Risk governance (0)
Control of sustainability issues	Credibility of green bond framework depends on rigour of framework and allocation/impact reporting.	Competitive position (+) Risk governance (0)

*Defined according to a 5-step scale ranging from double minus (--) to double plus (++), with (--) representing the most negative impact and (++) the most positive. See ESG factors in financial institution ratings.

ADJUSTMENT FACTORS

Support analysis

Support analysis neutral

We view KfS' ownership as supportive of our standalone credit assessment, but do not raise it by additional notches to reflect support. The company's capital consists mainly of member reserves, and we have taken this structure into account in our capital score.

Figure 10. KfS equity capital certificate ownership structure, 30 Sep. 2022

Owner	Share of ECCs
Eiendomskreditt	10.0%
Sparebanken Vest	8.3%
Sparebanken Sogn og Fjordane	6.4%
SpareBank 1 Sørøst-Norge	5.5%
Sparebanken Øst	5.5%
Other (38 savings banks)	64.3%
Total	100.0%

Source: KfS.

ISSUE RATINGS

Our rating on KfS' unsecured senior debt is in line with the 'A-' issuer rating. NCR considers the underlying credit quality of an issuer in its notching of various instruments. The risk of non-payment of capital instruments by highly rated entities is perceived to be very low. We therefore adapt the notching of individual debt instruments, depending on the underlying credit quality and the ability of a financial institution to repay its debts.

Figure 11. KfS key financial data, 2017–Q3 2022 YTD

Key credit metrics (%)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	Q3 2022 YTD
INCOME COMPOSITION						
Net interest income/op. revenue	100.3	98.4	96.1	98.1	109.2	121.7
Net fee income/op. revenue	-0.3	-0.3	-0.2	-0.2	-0.4	-0.3
Net trading income/op. revenue	1.3	1.1	4.1	-2.9	-8.8	-21.4
Net other income/op. revenue	-1.3	0.8		5.0		0.0
EARNINGS						
Net interest margin	0.1	0.1	0.2	0.1	0.1	0.1
Pre-provision income/REA	0.2	0.4	0.2	0.0	-0.2	-0.2
Return on ordinary equity	0.7	1.2	0.7	0.1	-0.6	-0.5
Return on assets	0.0	0.1	0.0	0.0	0.0	0.0
Cost-to-income ratio	60.2	48.4	73.8	93.7	134.1	128.3
Cost-to-income ratio, ex. trading	61.0	48.9	76.9	91.1	123.3	105.6
CAPITAL						
CET1 ratio	18.1	16.9	17.8	18.6	17.5	19.7
Tier 1 ratio	18.1	16.9	17.8	18.6	17.5	19.7
Capital ratio	22.7	21.5	22.8	24.5	23.2	26.0
REA/assets	20.3	20.2	20.2	20.5	20.4	20.3
Dividend payout ratio	59.4	67.2				
Leverage ratio	3.7	3.4	3.4	3.8	3.6	4.0
GROWTH						
Asset growth	-3.8	0.5	-7.6	-16.4	2.6	-8.3
Loan growth	-4.1	0.8	-7.4	-16.6	3.1	-8.8
Deposit growth						
LOSS PERFORMANCE						
Credit provisions to net loans	0.00	0.00	0.00	0.00	0.00	0.00
Impaired loans to gross loans	0.00	0.00	0.00	0.00	0.00	0.00
Net impaired loans to gross loans	0.00	0.00	0.00	0.00	0.00	0.00
Net problem loans to equity	0.00	0.00	0.00	0.00	0.00	0.00
Non-performing loan coverage ratio	0.00	0.00	0.00	0.00	0.00	0.00
Stage 3 loans/gross loans	0.00	0.00	0.00	0.00	0.00	0.00
Net stage 3 loans/net loans	0.00	0.00	0.00	0.00	0.00	0.00
FUNDING & LIQUIDITY						
Loan/deposit ratio						
Net stable funding ratio	101.0	100.0	98.0	101.0	99.0	100.0
Liquidity coverage ratio	148.0	13283.0	15043.0	8397.0	4757.0	5575.0

Key financials (NOKm)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	Q3 2022 YTD
BALANCE SHEET						
Total assets	5,350	5,377	4,971	4,156	4,267	3,913
Total tangible assets	5,350	5,377	4,971	4,156	4,267	3,913
Total financial assets	5,339	5,365	4,970	4,156	4,266	3,912
Net loans and advances to customers	5,172	5,215	4,829	4,026	4,150	3,786
Total securities	112	119	136	97	102	81
Customer deposits	–	–	–	–	–	–
Issued securities	5,090	5,128	4,739	3,946	4,063	3,705
of which covered bonds	–	–	–	–	–	–
of which other senior debt	5,090	5,128	4,739	3,946	4,063	3,705
of which subordinated debt	–	–	–	–	–	–
Total equity	246	234	228	209	202	207
Total ordinary equity	246	234	228	209	202	207
CAPITAL						
Common equity tier 1	196	184	178	159	152	157
Tier 1	196	184	178	159	152	157
Total capital	246	234	228	209	202	207
REA	1,084	1,086	1,003	851	869	795
INCOME STATEMENT						
Operating revenues	7	8	8	7	4	3
Pre-provision operating profit	3	4	2	0	-2	-1
Impairments	0	0	0	0	0	0
Net Income	2	3	2	0	-1	-1

Source: company. FY–full year. YTD–year to date.

Figure 12. KfS rating scorecard

Subfactors	Impact	Score
National factors	10.0%	a
Regional, cross border, sector	10.0%	bbb+
Operating environment	20.0%	a-
Capital	17.5%	a+
Funding and liquidity	15.0%	a+
Risk governance	5.0%	bbb
Credit risk	10.0%	a
Market risk	-	-
Other risks	2.5%	a
Risk appetite	50.0%	a
Market position	15.0%	bb-
Earnings	7.5%	bb
Loss performance	7.5%	aa
Performance indicators	15.0%	bbb+
Indicative credit assessment		**a-**
Transitions		Neutral
Peer comparisons		Neutral
Borderline assessments		Neutral
Stand-alone credit assessment		**a-**
Material credit enhancement		Neutral
Rating caps		Neutral
Support analysis		Neutral
Issuer rating		**A-**
Outlook		Stable
Short-term rating		**N2**

Figure 13. Capital structure ratings

Seniority	Rating
Senior unsecured	A-

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