Nordic Credit Rating

FINANCIAL INSTITUTION

Norway
4 Feb. 2022

Kredittforeningen for Sparebanker

Full Rating Report

LONG-TERM RATING

A-

OUTLOOK

Stable

SHORT-TERM RATING

N-1+

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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 loans with approximately the same maturity as its individual loans. It has no obligation to refinance these loans, and consequently refinancing and pricing risk are minimal.

Prospective changes in regulation represent a risk factor for KfS' business model. For example, the EU's bank capital and liquidity package (CRR II/CRD V) will likely have negative implications for the company's attractiveness as a funding source for its member banks. We note that the company's earnings have been negatively affected by low interest rates and reduced business volumes. However, two green bond issues in 2021 represented a successful start to an initiative which could revitalise the company's business model.

STABLE OUTLOOK

The outlook is stable, reflecting the resilience of the Norwegian savings bank sector and KfS' modest risk profile. We believe that possible challenges for the company's business model due to regulatory changes will not 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 run-off, if necessary, without significant deterioration of credit quality or increased liquidity risk.

POTENTIAL POSITIVE RATING DRIVERS

- Stronger market position through, for example, continued success for the green bond initiative.
- A common equity Tier 1 (CET1) ratio sustainably above 22%.

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, 2017-2023e

(%)	2017	2018	2019	2020	2021e	2022e	2023e
Net interest margin	0.12	0.14	0.15	0.14	0.12	0.15	0.16
Loan losses/gross loans	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Pre-provision income/REA	0.2	0.4	0.2	0.0	-0.1	0.0	0.1
Return on equity	0.8	1.2	0.7	0.1	-0.3	0.1	0.2
Loan growth	-4.1	0.8	-7.4	-16.6	2.9	5.0	5.0
Capital ratio	22.7	21.5	22.8	24.5	23.5	23.6	23.6

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

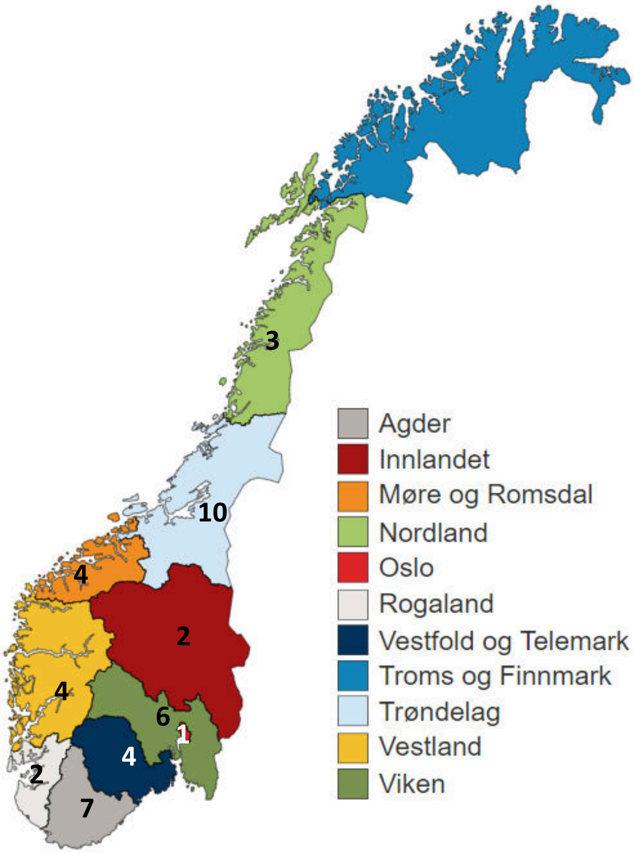
COMPANY PROFILE

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 financing 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, of which five 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 average gross lending of the member banks is NOK 3.8bn (2020), ranging from NOK 0.6bn to NOK 14.3bn. 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 (43) by county, end-2021



Source: company.

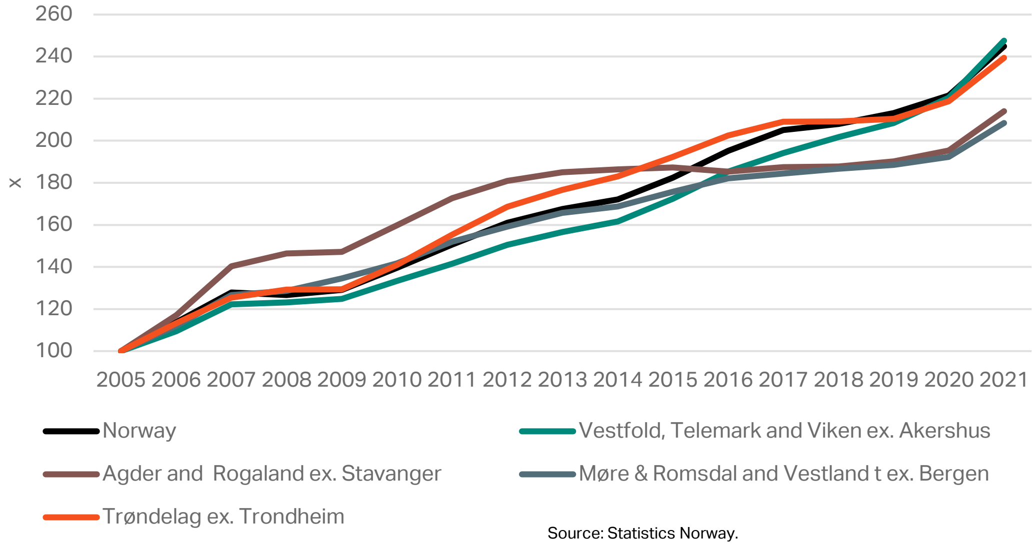
RISK APPETITE

Operating environment assessment 'a-'

The impact of the COVID-19 pandemic on the Norwegian economy has proven less severe than we initially expected, and the country's banks have outperformed our expectations. We expect higher interest rates to benefit net interest margins in the years ahead. In the third quarter of 2021, we revised our score of national factors affecting the Norwegian banking sector back to 'a' from 'a-' to reflect this (see [Nordic banking assessments raised on reduced COVID threat](), published 9 Sep. 2021). The operating environment for Norwegian banks is discussed more thoroughly in [Norwegian banking market demonstrating strength through pandemic](), published 27 Jan. 2022.

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), 2005–2021



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 scores '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.

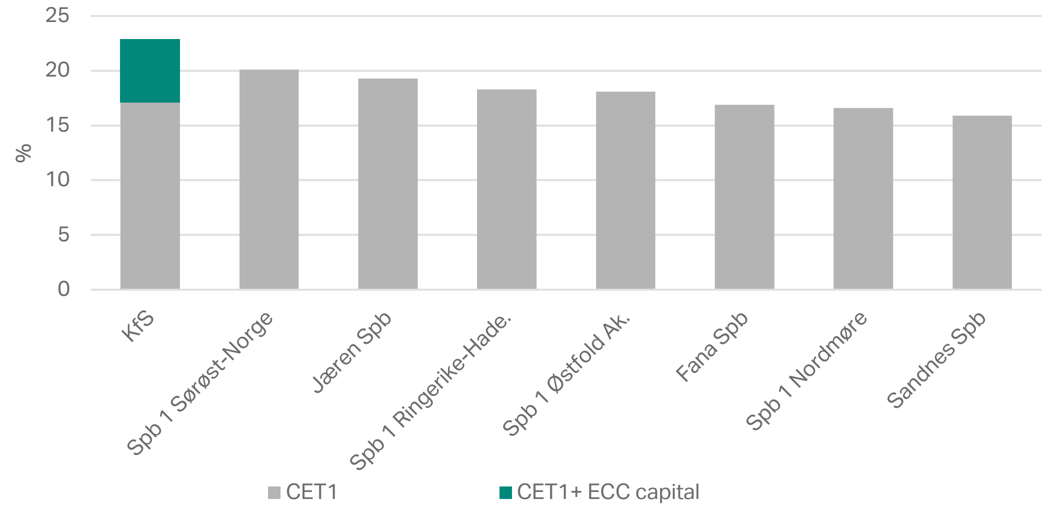
KfS aims to act as a driving force in achieving a sustainable society. To this end, it started to offer its member banks green bond funding in 2021. In addition, KfS has obtained green certification for its own operations. We believe that this could improve the company's value to its member banks, providing 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.

Satisfying high capital requirements

Capital scores '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 CET1 ratio of 15% for bank exposures). This is refunded after the loan is repaid. The member reserves are regarded as core equity and have lower priority than other capital, including Equity Capital Certificates (ECCs). Since the 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 17.1% as of 30 Sep. 2021 while its capital ratio (including ECC capital) was 22.9%.

Figure 4. KfS and selected Norwegian savings banks' capitalisation and leverage, Q3 2021



Based on company data.

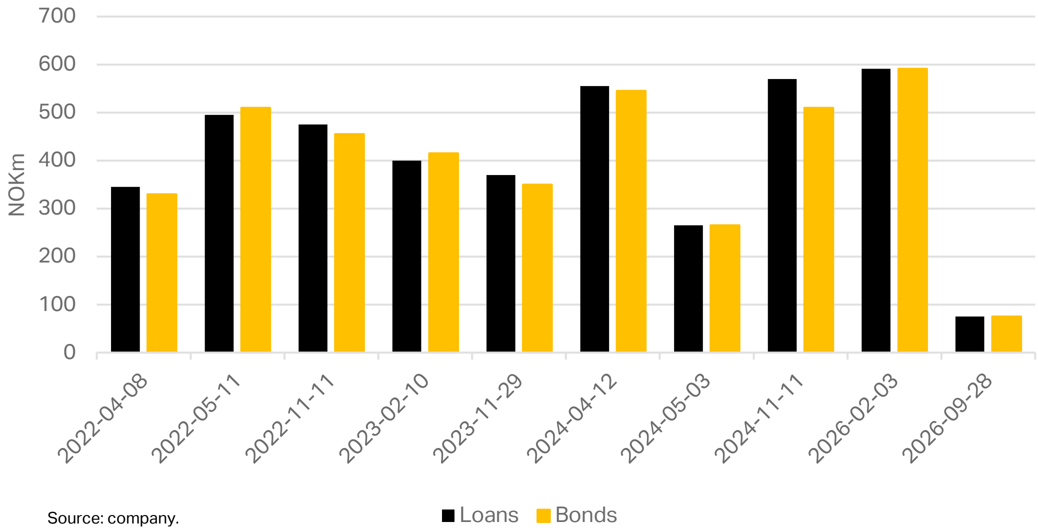
KfS uses the standardised capital model, which implies 20% risk-weight for senior loans to unrated banks. Risk weights are set to increase to 30% from 2025, and the member reserve could then increase to 4.5% to sustain the CET1 level. Moreover, an announced 1% increase in the regulatory counter-cyclical buffer and a 1.5pp increase in the systemic risk buffer from end-2022 mean that the required CET1 ratio (including an expected Pillar 2 requirement of 0.3%) will increase from 11% to 13.5% (14% when the counter-cyclical buffer is increased to 2.5%). KfS is consequently considering reducing its 1.5pp self-imposed management buffer to 0.5pp. We believe that KfS will also consider converting its ECC capital to a form of capital that can be considered CET1 capital.

Fully matched funding and lending

Funding and liquidity scores 'a+'

KfS is funded by senior loans which are virtually matched with loan maturity (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 and consequently refinancing and pricing risk are minimal.

Figure 5. KfS debt maturity profile, end-2021



Source: company.

What remains is the risk that one or more banks might be unable to repay debt at maturity, which would put stress 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 100% of all bonds maturing in the next

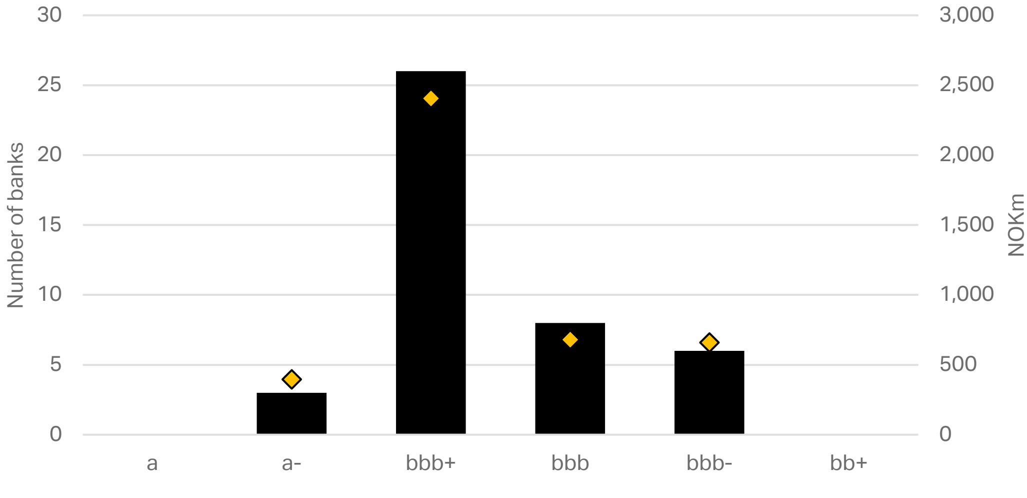
30 days. In addition, the company must hold a liquidity buffer of at least 25% of expected loans due over the next 30 days. Moreover, the company needs to hold an extra liquidity buffer to comply with a regulatory 100% net stable funding ratio requirement.

Low credit risk

Credit risk scores 'a'

Despite the small number of member banks, NCR finds KfS' credit risk appetite 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 risk classify 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 an average score of 'bbb+'. Seven banks which became new members in 2021 also have an average score of '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 company data.

We believe that the main credit risk factor for KfS is concentration risk and, for this reason, we cap our credit risk sub-score at 'a'. With only 43 active members, the company's average loan was NOK 96m as at end-2021, or 48% of the estimated capital base. KfS' maximum exposure to an individual bank is 100% of the lower of the respective bank's or KfS' capital base. The largest loan was NOK 200m as of end-2021, or 100% of the estimated 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 which 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.

Other risk

Other risks score 'a'

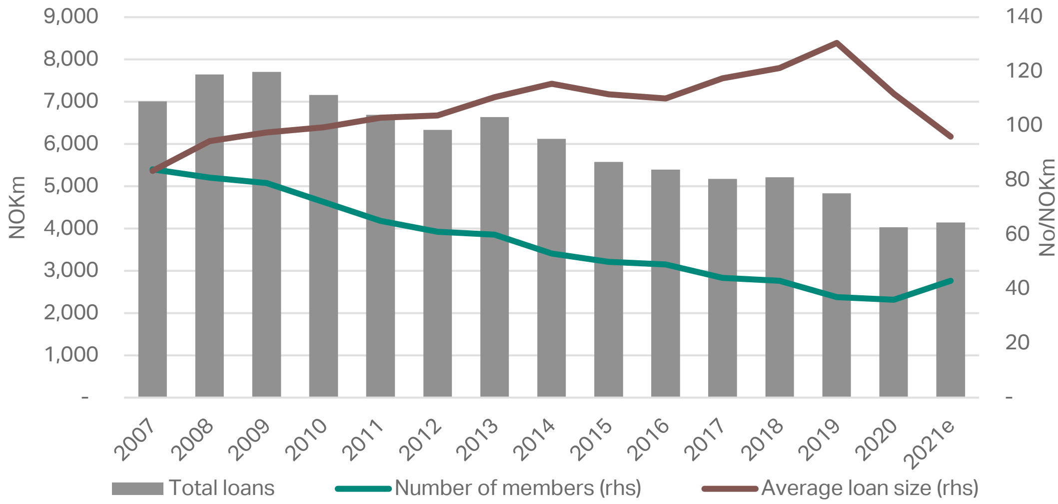
Changes in regulation are the main risk factor for KfS' business model. These changes are discussed in the next section. In our view, market risk is negligible given that KfS does not trade financial instruments, matches the financing and floating rates on both loans and funding (thereby eliminating 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. We note however, that increasing bond spreads and higher funding costs for small banks could restore the company's competitiveness. Moreover, the green bond initiative will enable member banks to offer green loans and tap into a new investor pool in a cost-efficient manner even if they are individually too small to do this themselves. The green initiative has already stemmed the outflow of loans and provides a basis for new growth. During 2021, KfS issued green bonds amounting to NOK 856m, attracting seven new member banks.

Figure 7. KfS gross loans, 2007-2021e



Source: company. e-NCR estimate.

New regulation represents a challenge for KfS' business model. CRR II/CRD V, which most likely will be implemented in Norway this year, could have negative implications for the company's attractiveness as a funding source by increasing core capital requirements, and thus the member reserve requirement, for loans to financial institutions. The European Commission has proposed changes in the regulation of large exposures, which would be measured against core capital and not total capital. While KfS could conceivably convert its existing ECC capital to another form, large exposure rules could reduce maximum loan size by 20%, which would be significant due to KfS' loan structure.

An increase in the member fees would mitigate this effect. However, we are not certain that the member banks would accept a higher member reserve due to higher capital requirements without compensation, especially those with higher creditworthiness or access to capital market funding. Moreover, the EU and the Scandinavian countries' national regulators are engaged in discussions about the legality of member reserves under EU legislation.

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. Conversely, 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 increased stability for the remaining banks.

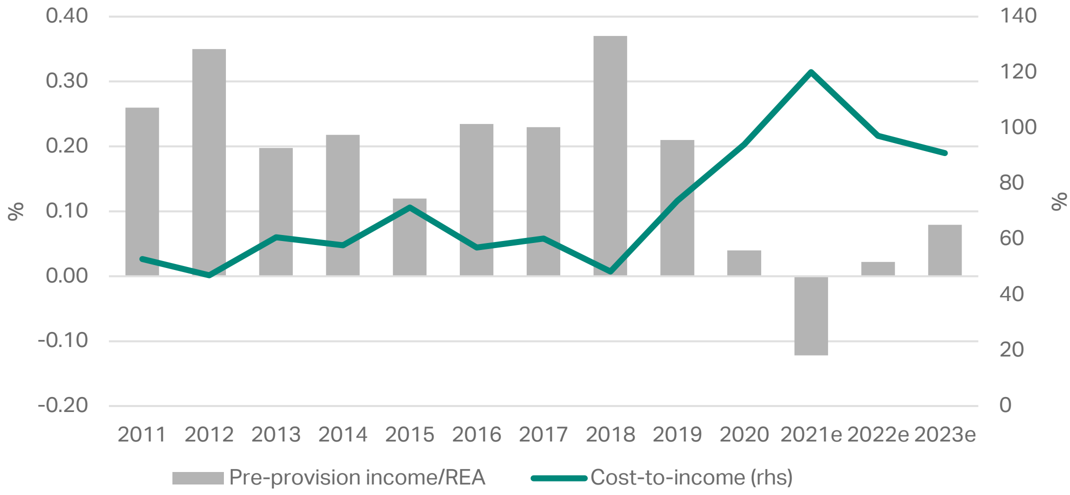
Lower revenues, higher costs

Earnings scores 'bb'

Loss performance scores '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, 2011-2023e



Source; KfS. e-NCR estimate.

ADJUSTMENT FACTORS

Peer comparison

Peer comparison neutral

We believe that KfS' relative strengths are reflected in the 'a-' initial credit assessment and do not adjust this assessment on the basis of a peer assessment or any other factors. NCR has confidential credit assessments (not full credit ratings) on over 300 Nordic banks, of which 223 are savings banks. The average score is 'bbb+', the same as the average score for KfS' member banks.

Support analysis

Support analysis neutral

We view KfS' ownership as supportive of our standalone credit assessment, but do not provide 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 9. KfS ECC ownership structure, 30 Sep. 2021

Owner	Share of ECC
Eiendomskreditt	10.0%
Sparebanken Vest	8.3%
Sparebanken Sogn og Fjordane	6.4%
SpareBank 1 Sørøst-Norge	5.5%
Sparebanken Øst	5.5%
Other (39 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 10. KfS key financial data, 2016–2020

Key credit metrics (%)	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
INCOME COMPOSITION					
Net interest income/op. revenue	87.1	100.3	98.4	96.1	98.1
Net fee income/op. revenue	-0.1	-0.3	-0.3	-0.2	-0.2
Net trading income/op. revenue	13.0	1.3	1.1	4.1	-2.9
Net other income/op. revenue		-1.3	0.8		5.0
EARNINGS					
Net interest margin	0.1	0.1	0.1	0.2	0.1
Pre-provision income/REA	0.2	0.2	0.4	0.2	0.0
Return on ordinary equity	0.8	0.7	1.2	0.7	0.1
Return on assets	0.0	0.0	0.1	0.0	0.0
Cost-to-income ratio	57.0	60.2	48.4	73.8	93.7
Cost-to-income ratio, ex. trading	65.5	61.0	48.9	76.9	91.1
CAPITAL					
CET1 ratio	17.2	18.1	16.9	17.8	18.6
Tier 1 ratio	17.2	18.1	16.9	17.8	18.6
Capital ratio	21.4	22.7	21.5	22.8	24.5
REA/assets	21.2	20.3	20.2	20.2	20.5
Dividend payout ratio	90.7	59.4	67.2		
Leverage ratio	3.7	3.7	3.4	3.4	3.8
GROWTH					
Asset growth	-5.0	-3.8	0.5	-7.6	-16.4
Loan growth	-3.4	-4.1	0.8	-7.4	-16.6
Deposit growth					
LOSS PERFORMANCE					
Credit provisions to net loans	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
Net impaired loans to gross loans	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
Non-performing loan coverage ratio	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
Net stage 3 loans/net loans		0.00	0.00	0.00	0.00
FUNDING & LIQUIDITY					
Loan/deposit ratio					
Net stable funding ratio	0.0	101.0	100.0	98.0	101.0
Liquidity coverage ratio	0.0	148.0	13283.0	15043.0	8397.0

Key financials (NOKm)	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
BALANCE SHEET					
Total assets	5,563	5,350	5,377	4,971	4,156
Total tangible assets	5,563	5,350	5,377	4,971	4,156
Total financial assets	5,547	5,339	5,365	4,970	4,156
Net loans and advances to customers	5,391	5,172	5,215	4,829	4,026
Total securities	146	112	119	136	97
Customer deposits					
Issued securities	5,292	5,090	5,128	4,739	3,946
of which covered bonds					
of which other senior debt	5,292	5,090	5,128	4,739	3,946
of which subordinated debt					
Total equity	253	246	234	228	209
Total ordinary equity	253	246	234	228	209
CAPITAL					
Common equity tier 1	203	196	184	178	159
Tier 1	203	196	184	178	159
Total capital	253	246	234	228	209
REA	1,179	1,084	1,086	1,003	851
INCOME STATEMENT					
Operating revenues	7	7	8	8	7
Pre-provision operating profit	3	3	4	2	0
Impairments	0	0	0	0	0
Net Income	2	2	3	2	0

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

Figure 11. 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		**N-1+**

Figure 12. Capital structure ratings

Seniority	Rating
Senior unsecured	A-

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