S&P Global Ratings

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Sparbanken Sjuharad AB

Primary Credit Analyst:
Pierre-Brice Hellsing, Stockholm + 46 84 40 5906; Pierre-Brice.Hellsing@spglobal.com

Secondary Contacts:
Antonio Rizzo, Madrid (34) 91-788-7205; Antonio.Rizzo@spglobal.com
Erik Andersson, Stockholm + 46 84 40 5915; erik.andersson@spglobal.com

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Sparbanken Sjuharad AB

SACP	a-

+

Support	0

+

Additional Factors	0

Anchor	a-	
Business Position	Moderate	-1
Capital and Earnings	Very Strong	+2
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Strong	

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating
A-/Stable/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Strong capitalization. • Close ties with major shareholder, Swedbank, which we expect will continue. • Robust earnings capacity.	• Concentration risk due to regional operations and narrow market focus. • Small size and market share relative to main competitors.

Outlook: Stable

S&P Global Ratings' stable outlook on Sparbanken Sjuhärad reflects our view of the stable operating environment in Sweden, where the banking sector is likely to remain resilient despite modest house price decreases. We believe Sparbanken Sjuhärad will maintain its established business position, with close ties to Swedbank, and expect capital and earnings will remain very strong within the next two years.

We could lower our ratings if Sparbanken Sjuhärad's ties with Swedbank weakened considerably, or if its capital decreased materially below our 15% threshold due to higher-than-expected losses outpacing lending growth. In addition, the rating could come under pressure if the bank's overall risk position deteriorates, with a nonperforming loan (NPL) ratio considerably higher than the average for Nordic peers, and top-20 loan exposures as a share of total adjusted capital increasing materially.

A positive rating action is highly unlikely at this stage, since we consider an improvement of other bank-specific factors to be remote.

Rationale

For the ratings we incorporate our view of the Swedish banking industry as a whole and the bank's revenue concentration and narrow regional focus on the west coast of Sweden. The bank's small size and concentration weighs on its business position, but this is partially offset by cooperation with Swedbank. We expect that Sparbanken Sjuhärad will maintain its robust capitalization and good earnings capacity, as well as adequate underwriting standards and unchanged risk appetite. In addition, we regard the bank's funding as aligned with that of the Swedish banking industry but consider its liquidity position slightly better than peers.

Anchor: 'a-' for banks operating only in Sweden

We use our Banking Industry Country Risk Assessment's economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for a commercial bank operating only in Sweden is 'a-', based on an economic risk score of '2' and an industry risk score of '3'.

We believe that Swedish banks will continue to benefit from a stable and low-risk operating environment. We view the Swedish economy as highly diverse and competitive, with high household incomes and net financial assets, but believe that high property valuations, in tandem with increasing household debt, have created material economic imbalances. Nevertheless, we think that increased housing supply, rising central bank policy rates, and the requirement for amortization of new residential mortgage loans, in particular on high debt-to-income levels, will mean imbalances likely moderate over 2019-2021. We project Swedish banks' credit losses and NPLs will remain manageable in the still-low interest rate environment.

We view the banking sector's stability and the absence of distortion and complexity as strengths. We consider Swedish banks well placed to benefit from sound margins and high efficiency rates, in part thanks to advanced digitization, as reflected in an average cost-to-income ratio of 46% between 2015 and 2018. Combined with low credit losses in the prevailing operating environment, this leads to sound profitability and high capital levels despite elevated dividend payout ratios. Sweden's banks rely on a large share of foreign wholesale funding relative to customer deposits, a key risk factor for the confidence-sensitive sector. That said, the country's private-sector debt capital markets and the government's willingness to ensure a well-functioning domestic covered bond market mitigate this risk, in our view. We consider the regulatory environment in Sweden to be in line with that in other EU countries, despite comparatively high capital buffer requirements and a history of capital and liquidity support to the sector.

Table 1

Sparbanken Sjuharad AB Key Figures

		--Year-ended Dec. 31--			
(Mil. SEK)	**2019***	**2018**	**2017**	**2016**	**2015**
Adjusted assets	24,392.5	23,442.8	21,450.4	19,637.8	17,926.5
Customer loans (gross)	19,174.0	18,399.4	15,076.1	14,325.8	13,621.7
Adjusted common equity	2,404.4	2,333.3	2,181.2	2,019.3	1,843.1
Operating revenues	158.6	560.8	556.9	544.1	504.7
Noninterest expenses	65.5	266.1	253.7	234.3	231.4

Table 1

Sparbanken Sjuharad AB Key Figures (cont.)					
		--Year-ended Dec. 31--			
(Mil. SEK)	**2019***	**2018**	**2017**	**2016**	**2015**
Core earnings	71.1	220.5	226.9	226.3	199.2

*Data as of March 31.
SEK--SEK-Swedish krona.

Business position: Stable savings bank business concentrated on the local market

Sparbanken Sjuhärad has a narrow and concentrated business profile, but remains a leading retail bank with a regional focus in the Borås region in southwestern Sweden. We consider the cooperation with Swedbank a condition for its competitiveness, given its small size and the importance of scale and efficiency in a low-margin market. Furthermore, due to increased demand for digital products and increasing regulatory requirements for governance and transparency, we view Swedbank's involvement key for increasing scale and supporting compliance and innovation. We recognize that the Borås region is comparatively well positioned as a center for the retail and textile trade and wholesale distribution logistics, while also being located close to the automotive cluster of Gothenburg. However, we believe that Sparbanken Sjuhärad's geographic concentration and reliance on a limited customer base will continue in the medium term.

We expect the bank's market shares--about 50% in the household segment and 40% in the commercial banking segment in the municipalities of Borås, Mark, Svenljunga, and Bollebygd on Sweden's west coast--will remain stable. The bank's revenue is built on corporate and retail loans and deposits, as well as commission income from mortgage loans and asset-management products sold on account for Swedbank. In our view, Sparbanken Sjuhärad's long history as a relationship bank in the region and full range of offerings has led to high customer loyalty and revenue stability.

Swedbank provides all Sparbanken Sjuhärad's information technology (IT) systems and product infrastructure, including extended mortgage lending capacity via Swedbank Mortgage AB. Moreover, Sparbanken Sjuhärad uses Swedbank's scoring models and capital allocation tools and cooperates with Swedbank on regulation and compliance. In our view, Sparbanken Sjuhärad's cost-to-income-ratio of about 47% at year-end 2018 indicates that cooperation with Swedbank provides very real economies of scale. Still, similar to peers, the bank reported increased costs in 2017-2018 related to IT projects following new regulations and the implementation of International Financial Reporting Standards (IFRS) 9, which explains the higher cost-to-income ratio compared with 2016. We believe that cost pressure stemming from IT investments will remain elevated over the next two years, only partially offset by other cost-saving initiatives.

Sparbanken Sjuhärad earns meaningful net commission income from loans passed on to Swedbank and the intermediation of funds and insurance. We expect commission income to fall, however, because using Swedbank for capacity purposes has become less beneficial. In 2015, Sparbanken Sjuhärad changed its lending approach by maintaining a larger share of mortgages on its own balance sheet rather than passing them on to Swedbank. After renegotiations in 2018, corporate loans are also being kept on its balance sheet in the medium term, and thereby swap commissions to interest income. This led to loan growth for 2018, with about half of the 22% increase coming from repatriated loans from Swedbank's balance sheet.

Naturally, keeping all new loans on its own balance sheet creates capacity constraints, leading us to expect a more moderate 5%-7% loan growth rate in the next 18-24 months, which is still moderately above the market. We also expect Sparbanken Sjuhärad's net fee and commission income, currently at about 40% of revenue, to decrease due to the negotiations with Swedbank and the implementation of the EU Markets in Financial Instruments Directive (MIFID 2).

Table 2

Sparbanken Sjuharad AB Business Position					
		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Total revenue from business line (mil. SEK)	158.6	560.8	556.9	544.1	504.7
Retail banking/total revenue from business line	89.4	86.8	88.4	89.5	87.6
Commercial & retail banking/total revenue from business line	89.4	86.8	88.4	89.5	87.6
Asset management/total revenue from business line	10.6	13.2	11.6	10.5	12.4
Return on average common equity	11.9	9.5	10.5	11.4	11.0

*Data as of March 31.
SEK--Swedish krona.

Capital and earnings: Very strong capital ratios, supported by stable earnings

Our assessment of Sparbanken Sjuhärad's capital and earnings reflects its risk-adjusted capital (RAC) ratio of 18.5% at year-end 2018. We expect that RAC will remain stable at about 19% over the next 18-24 months.

In our forecast, we incorporate relatively flat development in earnings, a 30% dividend payout ratio, and about 5%-7% lending growth, with the bank becoming somewhat more weighted on mortgage, and other retail lending than corporate business. The bank has regulatory capital well above the requirements with generous management buffers.

We consider the quality of Sparbanken Sjuhärad's capital and earnings to be strong, based on its business model, which is built around recurring revenue sources and elevated earnings retention compared with larger Swedish peers. We expect the bank's total adjusted capital, our core capital measure, will continue to consist entirely of common equity and retained earnings. Furthermore, we expect the bank will maintain capacity to generate earnings, with an earnings buffer of about 150-200 basis points (bps), comparing favorably with domestic and international peers, even with pressure on net interest margins due to historically low interest rates.

We believe that the funding structure of Sparbanken Sjuhärad, with deposits accounting for 82% of the funding base, makes the bank well placed to accommodate potential interest-rate hikes. However, recent intensified competition in the mortgage market leads us to believe that the central bank's 25 bps interest rate hike in early 2019, as well as the second hike expected in second-half 2019, should lead to modest margin improvements for 2019.

Table 3

Sparbanken Sjuharad AB Capital And Earnings					
		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Tier 1 capital ratio	19.3	20.0	22.2	21.6	20.1
S&P Global Ratings' RAC ratio before diversification	N/A	18.5	18.7	18.6	18.2

Table 3

Sparbanken Sjuharad AB Capital And Earnings (cont.)

		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
S&P Global Ratings' RAC ratio after diversification	N/A	12.0	12.2	11.8	13.3
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Double leverage	N.M.	N.M.	N.M.	N.M.	N.M.
Net interest income/operating revenue	60.2	57.5	53.4	54.4	55.7
Fee income/operating revenue	35.2	44.0	44.4	42.5	43.7
Market-sensitive income/operating revenue	4.0	(2.2)	1.5	2.3	(1.6)
Noninterest expenses/operating revenue	41.3	47.4	45.6	43.1	45.9
Preprovision operating income/average assets	1.6	1.3	1.5	1.6	1.6
Core earnings/average managed assets	1.2	1.0	1.1	1.2	1.2

*Data as of March 31.
N/A--Not applicable. N.M.--Not meaningful.

Table 4

Sparbanken Sjuharad AB Risk-Adjusted Capital Framework Data

(Mil. SEK)	**Exposure***	**Basel III RWA**	**Average Basel III RW(%)**	**S&P Global RWA**	**Average S&P Global RW (%)**
Credit risk					
Government & central banks	1,614	--	--	57	4
Of which regional governments and local authorities	1,425	--	--	51	4
Institutions and CCPs	2,105	325	15	303	14
Corporate	9,771	6,863	70	6,717	69
Retail	12,415	2,438	20	4,610	37
Of which mortgage	8,368	1,138	14	1,941	23
Securitization§	--	--	--	--	--
Other assets†	81	75	93	80	99
Total credit risk	25,986	9,700	37	11,767	45
Credit valuation adjustment					
Total credit valuation adjustment	--	13	--	--	--
Market Risk					
Equity in the banking book	--	--	--	--	--
Trading book market risk	--	--	--	--	--
Total market risk	--	--	--	--	--
Operational risk					
Total operational risk	--	800	--	822	--
(Mil. SEK)	**Exposure**	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global RWA**	**% of S&P Global RWA**
Diversification adjustments					
RWA before diversification	--	11,430	--	12,589	100

Table 4

Sparbanken Sjuharad AB Risk-Adjusted Capital Framework Data (cont.)					
Total Diversification/ Concentration Adjustments	--	--	--	6,787	54
RWA after diversification	--	11,430	--	19,376	154
(Mil. SEK)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		2,286	20.0	2,333	18.5
Capital ratio after adjustments‡		2,286	20.0	2,333	12.0

*Exposure at default. §Securitization Exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. SEK--Swedish krona. Sources: Company data as of Dec. 31 2018, S&P Global Ratings.

Risk position: The bank's main risks relate to its geographic concentration in a small Swedish region

Our assessment of Sparbanken Sjuhärad's risk position balances the bank's geographic concentration and single-name exposures against its lack of complexity and low risk tolerance.

In March 2019, Sparbanken Sjuhärad had a loan book of Swedish krona (SEK) 19 billion with retail and corporate exposures representing 55% and 45% respectively. Although we see benefits from Sparbanken Sjuhärad's product diversification, we also note that the bank has a relatively high share of corporate and small and midsize enterprise loans compared with other small Nordic banks. These loans tend to be more sensitive to economic downturns than residential mortgages.

Despite its concentration on four relatively small municipalities on the west coast of Sweden, Sparbanken Sjuhärad performed in line with the rest of the Swedish banking industry during the turbulence following the 2008 global financial crisis.

In first-quarter 2019, the bank had somewhat higher new loan-loss provisions, at 5 bps, than pure mortgage-exposure peers but these are still historically low. However, its 82% loss reserves to nonperforming assets was above the peer average. In our base-case , we forecast NPLs will remain at a low 60 bps-70 bps of total loans through 2021, from 63 bps at year-end 2018. This reflects the low-interest-rate environment, expected growth in the Swedish economy, and the adequate outlook for the bank's local logistics and retail trade corporate clients.

Table 5

Sparbanken Sjuharad AB Risk Position					
		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Growth in customer loans	16.8	22.0	5.2	5.2	15.6
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	53.9	53.3	57.3	36.9
Total managed assets/adjusted common equity (x)	10.1	10.0	9.8	9.7	9.7
New loan loss provisions/average customer loans	0.0	0.1	0.1	0.1	0.1
Net charge-offs/average customer loans	0.0	0.1	(0.1)	(0.0)	(0.1)
Gross nonperforming assets/customer loans + other real estate owned	0.6	0.6	0.5	0.8	1.4

Table 5

Sparbanken Sjuharad AB Risk Position (cont.)

		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Loan loss reserves/gross nonperforming assets	81.9	77.4	109.9	107.2	57.9

*Data as of March 31.
RWA--Risk-weighted assets. N/A--Not applicable.

Funding and liquidity: Mainly a deposit-funded bank with a substantial liquidity portfolio

Our combined assessment of Sparbanken Sjuhärad's liquidity and funding position is neutral to the rating. Although our assessment is in line with that on the Swedish market, we note that the bank has a higher share of funding stemming from customer deposits.

In our view, Sparbanken Sjuhärad does not possess the ability to maintain a significant capital market presence, in terms of regular issuance, due to its size. Although we believe that capacity at Swedbank Mortgage will reduce in the medium term, the bank will rely on this for a large portion of its loan financing over the next two years. We note that the bank's relationship with Swedbank provides indirect access to financing from the central bank, if necessary. Therefore, we believe central bank borrowing can be drawn as a source of contingent liquidity.

Our assessment of funding aligns Sparbanken Sjuhärad with that of the Swedish banking system, with a large and granular deposit base complemented by medium-term notes. Indeed, deposits represented 77% of the funding base and loans to deposits stood at 113% as of first-quarter 2019. The bank has increased its use of wholesale funding over the past few years to diversify the sources and tenor of funding and finance growth in lending on its own balance sheet. This includes a SEK5 billion medium-term note (MTN) program and a SEK1.5 billion certificate program.

The bank's stable funding ratio fell to 113% at year-end 2018 from 120% in 2017. Although it has continued to experience a steady inflow of deposits, the fall was due to the extraordinary growth of the loan book. We anticipate that Sparbanken Sjuhärad will aim to diversify its funding sources further and develop its loan book over the coming two years, which may reduce its stable funding ratio somewhat further.

Our assessment of Sparbanken Sjuhärad's liquidity as strong reflects the bank's position as a positive outlier in terms of balance-sheet liquidity and its conservative approach to liquidity risk management. The bank's liquidity coverage stood at 296% at year-end 2018, while our liquidity ratio (broad liquid assets to short-term wholesale funding) was 4x. This fell from 5.5x at year-end 2017 largely due to the high loan growth, and we expect some volatility given the bank's exposure to relatively few outstanding bond issues. Importantly, we view the deposit base as granular and sticky, with limited expected outflows in a stress scenario.

Sparbanken Sjuhärad's liquid assets covered about 22% of deposits, in addition to all short-term senior maturities, as of year-end 2018. About 15% of the liquidity portfolio consists of cash and deposits at Swedbank, while most of the remainder is invested in highly rated securities.

Table 6

Sparbanken Sjuharad AB Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Core deposits/funding base	77.5	82.1	85.4	83.9	83.6
Customer loans (net)/customer deposits	112.9	106.5	91.8	96.9	101.6
Long-term funding ratio	94.9	95.9	95.9	97.2	97.8
Stable funding ratio	107.6	112.9	121.5	121.0	118.4
Short-term wholesale funding/funding base	5.7	4.5	4.5	3.1	2.4
Broad liquid assets/short-term wholesale funding (x)	2.6	4.0	5.5	7.6	8.7
Net broad liquid assets/short-term customer deposits	11.6	16.5	23.8	24.3	22.1
Short-term wholesale funding/total wholesale funding	25.3	25.4	31.2	19.2	14.6
Narrow liquid assets/3-month wholesale funding (x)	70.8	123.5	56.7	122.9	94.1

*Data as of March 31.

Support: No notches of uplift to the stand-alone credit profile

We consider Sparbanken Sjuhärad as having low systemic importance due to its small size and limited geographic reach.

We currently do not apply our group methodology to reflect Sparbanken Sjuhärad's close ties to Swedbank since the latter does not have control over Sparbanken Sjuhärad. We reflect only ongoing support in terms of IT investments, models, tools, products, and funding from Swedbank through a one-notch positive adjustment within our assessment of Sparbanken Sjuhärad's business position.

Additional rating factors:

No additional factors affect this rating.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Tech Disruption In Retail Banking: Swedish Consumers Dig Digital--And Banks Deliver, May 14, 2019
- Banking Industry Country Risk Assessment: Sweden, April 11, 2019
- Nordic Banks' Strong Capital Will Cushion Them From The Challenges Ahead, March 28, 2019

Anchor Matrix

Industry Risk	Economic Risk									
	1	**2**	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	**a-**	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of July 17, 2019)*	
Sparbanken Sjuharad AB	
Issuer Credit Rating	A-/Stable/A-2
Issuer Credit Ratings History	
24-Nov-2017	A-/Stable/A-2
02-Dec-2015	A-/Negative/A-2
29-Apr-2014	A-/Stable/A-2
Sovereign Rating	
Sweden	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@spglobal.com