SWEDBANK'S CONTROVERSY SPILLS OVER TO SWEDISH SAVINGS BANKS

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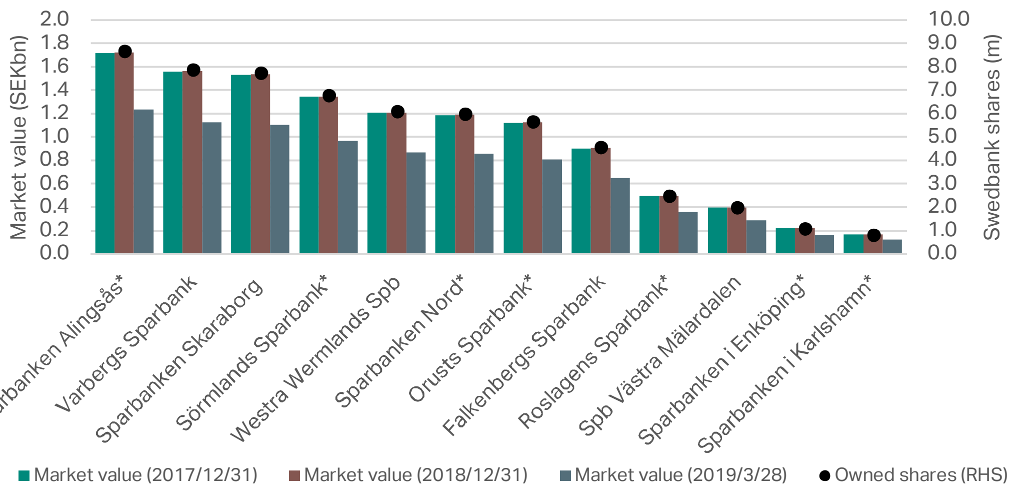
This commentary does not reflect a rating action.

Recent controversy surrounding Swedbank has received significant media attention and resulted in the removal of the bank's CEO. Ongoing investigations by the Swedish Economic Crime Authority and financial authorities in the US could have financial consequences for the bank and its owners. Nordic Credit Rating (NCR) concludes that Swedbank's share price decline of about 28% since 31 Dec 2018 will have only marginal impacts on savings banks' results and capital ratios, though equity will decline due to fair value changes that affect comprehensive income. However, NCR notes that banks with a high share of dividend income to operating income could be affected if Swedbank's dividend policy is adjusted.

At the top of the list of Swedbank's owners is the Savings Bank Group (Sparbankernas Ägareförening) which owns 10.7% in Swedbank as of 28 Feb 2019. The savings banks and Swedbank have a long history of cooperation, dating back to 1942 and largely in its current form since 1997. The relationship includes cross ownership, with Swedbank owning shares of some savings banks and most savings banks owning shares in Swedbank, either directly or via the foundations owning the banks (Sparbanksstiftelser), which own 3.4% of Swedbank. Via Swedbank Hypotek, Swedbank Finans, Swedbank Försäkring and Swedbank Robur, Sweden's savings banks can provide a variety of products and services to their own customers. In addition, Swedbank is the clearing bank for the savings banks and there is cooperation on IT infrastructure, risk modelling and financial reporting, providing economies of scale and cost efficiency benefits to savings banks across Sweden. As of end 2018, Swedbank reports that savings banks account for 30% of its product sales in the Swedish market.

NCR has researched the links between the savings banks and Swedbank to determine how a selection of 12 savings banks representing nearly 50% of shares owned by the Savings Bank Group could be affected by Swedbank's recent share price fall and the potential for legal issues and fines to affect Swedbank's dividend policy. NCR has issuer ratings on Sparbanken Rekarne (A- and owned 50% by Swedbank) and Sparbanken Västra Mälardalen (BBB+), both are on stable outlooks.

Figure 1. Savings banks' Swedbank AB shareholdings and market value, 2017-March 29, 2019

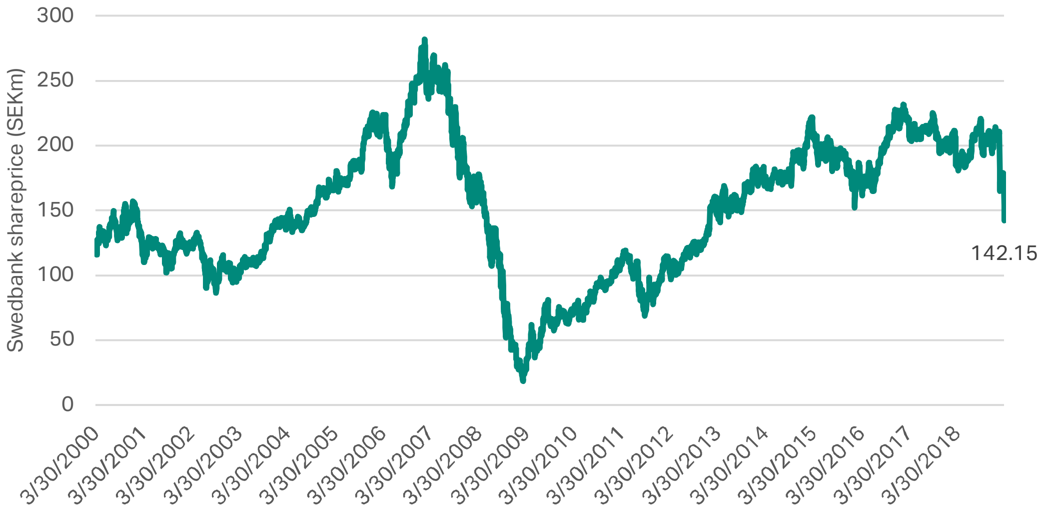


* Based on 2017 figures. Assumes constant shareholdings based on the most recently published annual report for each bank.
Source: Bank reports

FALLING MARKET VALUES

The fall in Swedbank's share price since the end of 2018 has been dramatic at about 28% through 28 Mar 2019, exceeding the fall that occurred between March 2015 and February 2016, but still significantly less than the fall ending in 2009 (see Figure 2). However, the share price has fallen to April 2013 levels and uncertainty surrounding the investigations into money laundering and fraud could have significant impacts on the future of the share price.

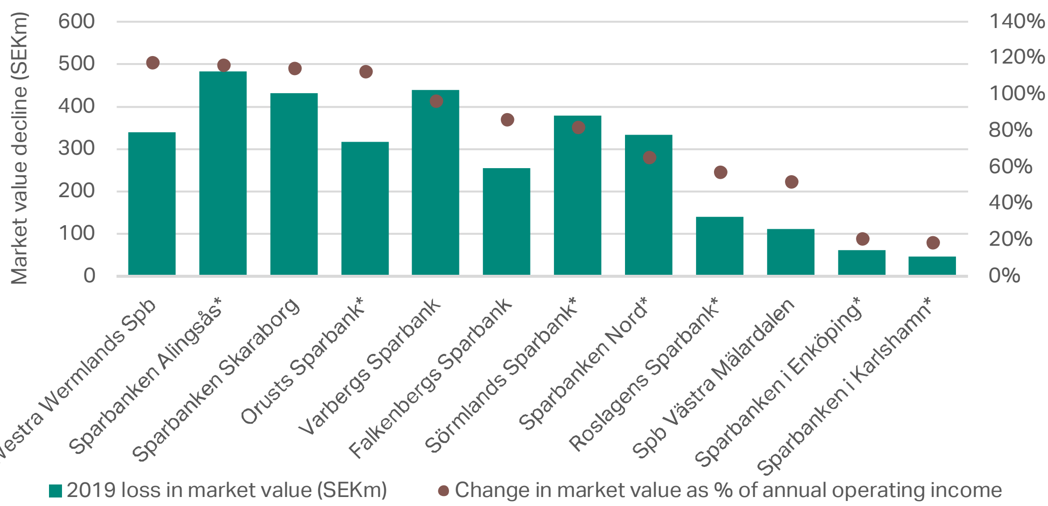
Figure 2. Swedbank shareprice. 2000-28 Mar 2019



Source: CapitalIQ

For savings banks with a relatively large volume of shares, the change in market value of the reported shareholdings has been significant in terms of SEK, but also when compared to the banks' most recently reported annual operating revenues. However, savings banks report the changes in the fair value of their Swedbank shareholdings as other comprehensive income, meaning that the valuation changes affect equity, but not reported net profit.

Figure 3. 2019 market value decline of Swedbank shares as a share of savings banks' 2018 operating income

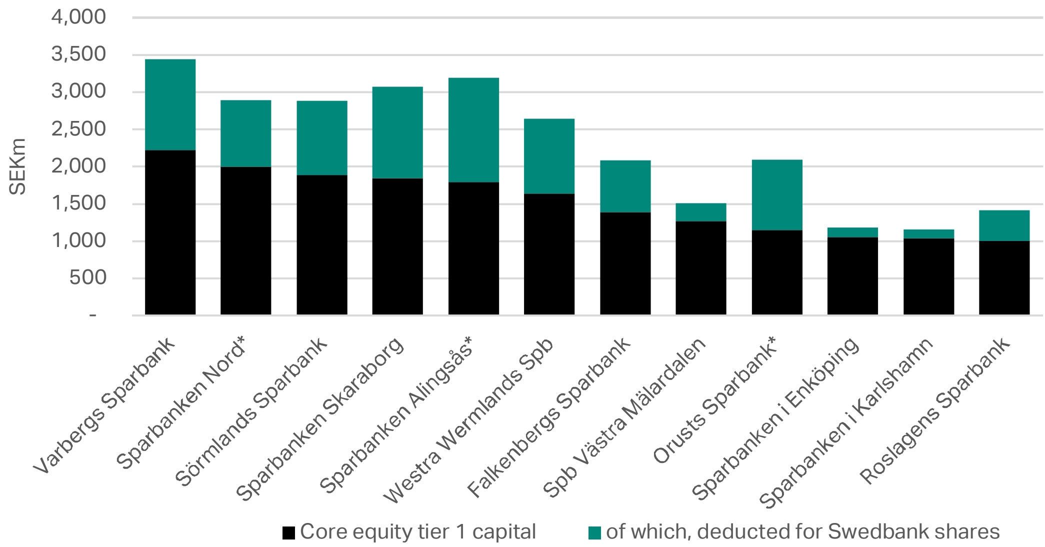


* Based on 2017 figures. Source: Bank reports

CAPITAL IMPACT OF SHAREHOLDINGS

While equity is impacted by the changes in comprehensive income, regulatory capital impacts are mitigated because savings banks deduct their shareholdings in Swedbank which exceed 10% of their common equity tier 1 (CET1) capital. This results in a relatively large buffer for many of the banks in the sample as shown in Figure 4.

Figure 4. Savings banks core equity tier 1 capital and deduction for ownership of Swedbank shares, 2018



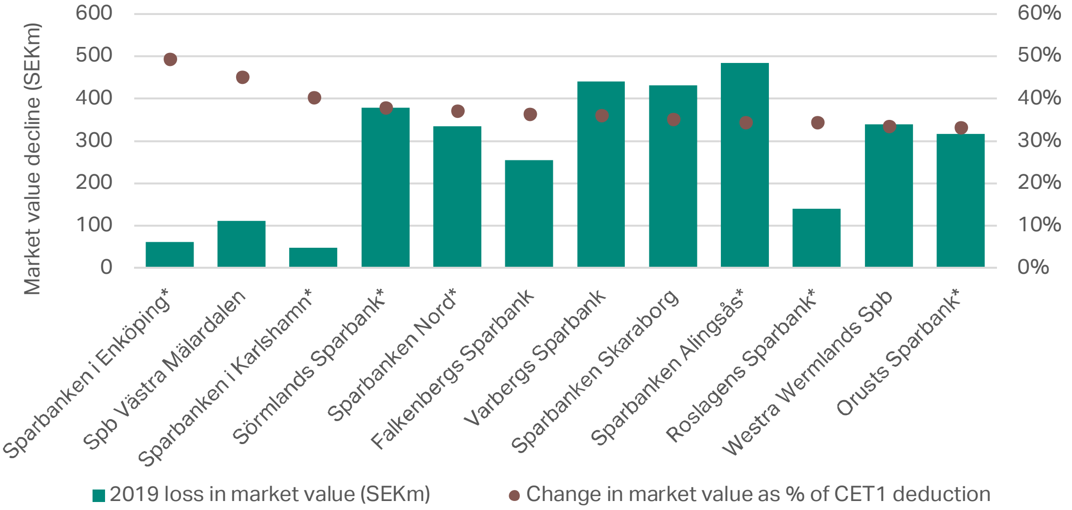
* Based on 2017 figures. Source: Bank reports

Many banks have addressed the capital impact in their 2018 annual reports, noting the price fall since the end of 2018. For example, Sparbanken Skaraborg reported that despite a value reduction of 9.8% through their report date, a reduction of SEK 150m in market value, the impact on their capital base would have only been SEK 15m, or 10% of the fall. Varbergs Sparbank reported that the value of the bank's shares had fallen SEK141m by 19 Mar 2019, with a direct effect on total equity, but decided that the impact on the capital ratios was limited and would not affect the board's decision about 2018 dividend payments. Seven of the 12 banks in Figure 4 have yet to publish annual reports and are likely to have similar comments about the capital impact of Swedbank's share price decline in their reports.

Despite the large reported CET1 deductions, the change in market value of the shares has reduced these capital buffers since the end of 2018. Figure 5 shows the market value decline through 28 Mar 2019 as a share of the CET1 deductions shown in Figure 4. NCR considers these deductions as additional capital flexibility in its assessment of capital given the ability to sell the shares and generate additional capital. However, NCR focuses primarily on the regulatory CET1 ratios and going-concern additional tier 1 instruments in its evaluation of capital strength.

For rated issuer Sparbanken Västra Mälardalen, the reduction in the capital buffer does not have a material impact on our view of their capital situation. Our assessment is primarily driven by the regulatory CET1 ratio, which was 22.3% at end 2018. This excludes SEK 246m of its reported SEK 395.5m shareholdings as of end 2018 (which would be worth SEK 285m given 28 Mar 2019 closing prices).

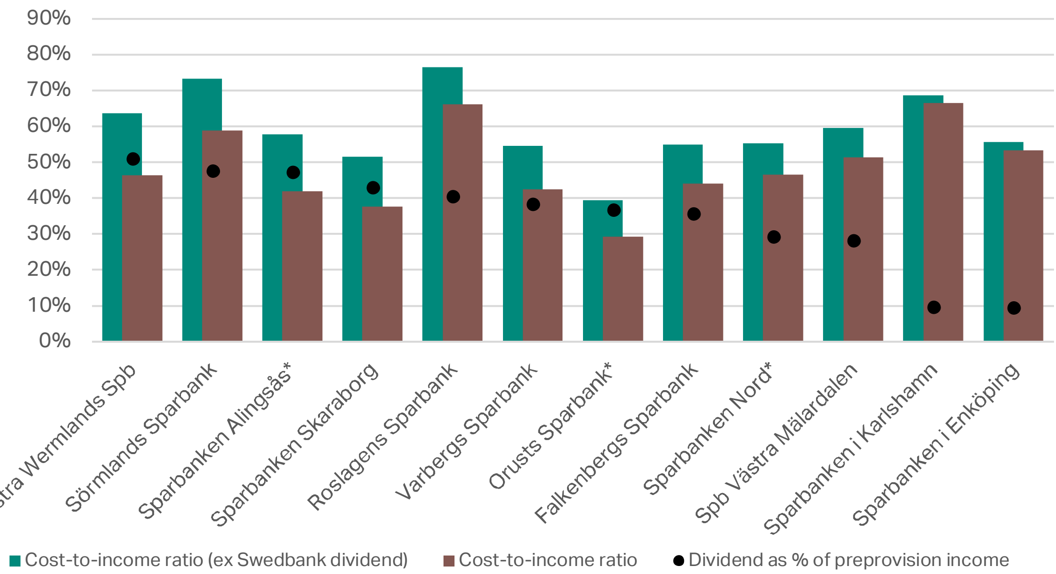
Figure 5. 2019 market value decline of Swedbank shares as a share of savings banks' 2018 CET 1 deduction for Swedbank shares



* Based on 2017 figures. Source: Bank reports

SWEDBANK DIVIDENDS ARE IMPORTANT FOR SAVINGS BANKS' EARNINGS

Figure 6. Swedbank dividend as a share of savings banks' preprovision income and cost-to-income ratios with and without Swedbank dividends, 2018



* Based on 2017 figures Source: Bank reports

Another aspect of the banks' shareholdings in Swedbank is the dividend payments. Swedbank has paid out 75% of net profit for the last 7 years (assuming the proposed dividend is paid), providing a direct return of 6-7% in the last three years. The return on shares is nearly in line with the savings' banks own overall return on equity ratios, which are supressed in large part due to high leverage ratios. The direct return has been attractive to the savings banks, many of which have increased their shareholdings in recent years. The dividends have supported solid cost-to-income ratios for many banks and comprise as much as 50% of pre-provision income in some cases.

While Swedbank is expected to pay 75% of its 2018 result (SEK 14.2 per share) to shareholders on 4 Apr 2019, ongoing investigations and the uncertainty of potential financial punishment could affect future dividend payments, which would have material consequences for the earnings of some banks.

If dividend payments remain high, the falling share price could provide an opportunity for savings banks, which are typically well-stocked with capital, to further increase their ownership and long-term influence over the bank. This could potentially impact the terms of future cooperation agreements which are often renegotiated before maturity (the current agreement is due to expire in 2024).

FUNDING CONSEQUENCES

If the situation does not stabilise for Swedbank, there could be dramatic consequences for the savings banks, which rely on Swedbank for funding of residential and commercial mortgages. Significant increases in funding costs or a tightening of Swedbank's own capital situation due to large financial penalties could affect the margins and commissions Swedbank is willing to pay to the savings banks, potentially increasing the savings banks' appetite for capital market financing.

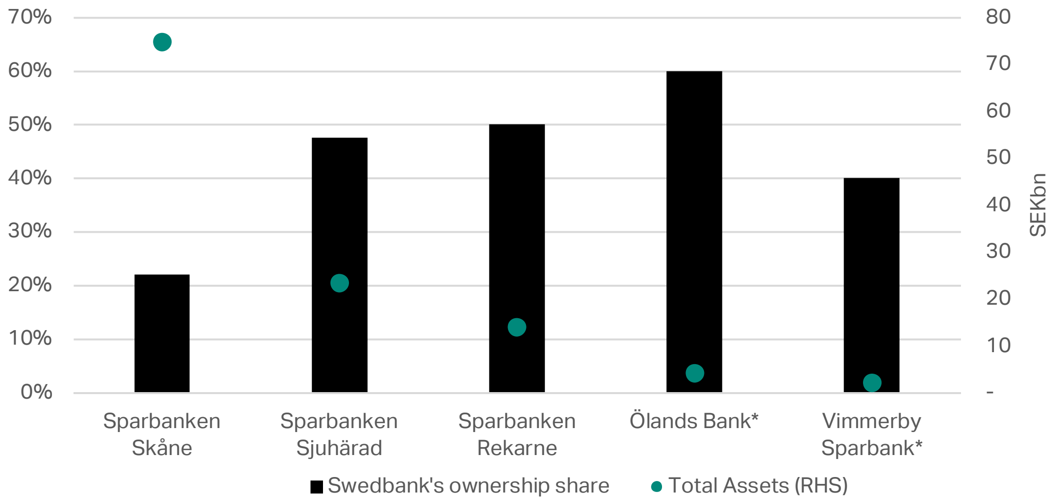
Swedbank's recent reduction in commercial mortgage margins to the savings banks provides an example of how this could occur. Driven by increasing capital charges for commercial real estate loans now and under future capital regulations, Swedbank reduced the savings banks' margin from 50% to 10% incentivising the banks to return the loans to their own balance sheets. This margin reduction has led some banks to reconsider transferring commercial mortgage loans to Swedbank and could increase the banks' willingness to use alternative funding sources in order to finance the loans on their own balance sheets.

SWEDBANK'S OWN HOLDINGS

The five banks in Figure 7 are owned directly by Swedbank and as such do not own shares on their own balance sheet, rather via the foundations which own the remaining shares in each of the five banks. While this reduces the direct impact of recent events on these banks, the liquidity situation in the foundations have been affected, potentially reducing access to additional capital from the foundations.

NCR has an issuer credit rating on Sparbanken Rekarne which includes a notch of support given the 50% ownership of Swedbank and the influence Swedbank has on the bank's return requirements and capitalisation. While not an immediate concern, a deterioration in Swedbank's credit quality beyond our current expectations, measured by NCR's internal credit assessment, could eventually affect our view on the available support from Swedbank to its directly owned banks.

Figure 7. Savings banks owned directly by Swedbank – ownership share and bank assets, 2018



Source: Swedbank annual report 2018

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