Norwegian banks: material CRE exposure manageable despite pressures

The robust asset quality of Norwegian banks remains underpinned by a resilient and wealthy economy, a high proportion of residential mortgages with very low default rates, and close supervision. Nonetheless, commercial real estate accounts for nearly half of the total lending to corporate customers. With the pressures on the sector, banks will likely face higher credit costs but this should be manageable given generally solid earnings and strong capital positions. Investors would value more disclosure on CRE exposures, though.

Material exposure to commercial real estate (CRE) is a risk to financial stability. Norwegian authorities have highlighted the significant proportion of CRE loans in banks' corporate portfolios, potentially high loss rates and uncertainties related to valuations.

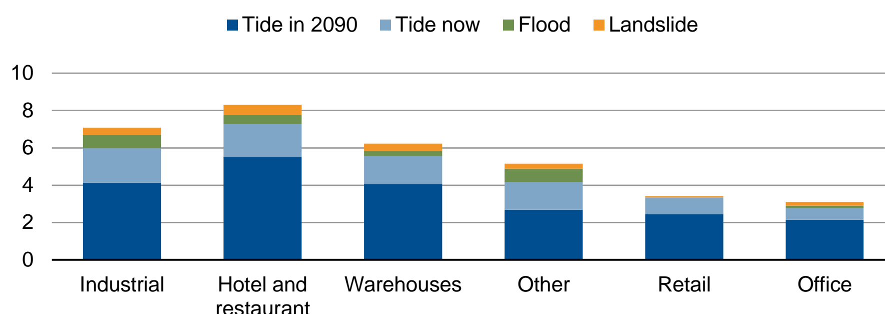
Positively, macroprudential measures are actively used to manage the risks. Since March 2023, the countercyclical capital buffer rate has returned to 2.5%, following the reduction to 1% in March 2020 due to the pandemic. The systemic risk buffer is set to increase to 4.5% from 3% at year-end for banks using the standardised approach for credit risk. National discretion has been utilised since 1989 to set the risk weights for CRE loans under the standardised approach at 100% instead of the 50% minimum under CRR.

For banks using the internal ratings-based approach, the systemic risk buffer was already raised to 4.5% at end-2020. In addition, their CRE exposures are subject to a 35% average risk weight floor.

Given the pressures on the CRE sector, loan-loss provisions are likely to increase. Some banks have started to see some risk migration and are cautious, although credit deterioration is likely to be manageable. Norwegian banks' solid earnings provide them with the capacity to absorb higher credit costs and meet capital requirements.

Banks are expected to include sustainability considerations in their credit assessments and valuations on commercial properties. Many commercial buildings are exposed to physical climate risks, especially storm surges. Hotels, restaurants and industrial buildings are particularly vulnerable. Office buildings, which account for the largest part of banks' lending, are typically located in cities and are less exposed.

Figure 1: Share of commercial buildings exposed to physical climate risks based on square metres (%)



Note: The 2090 scenario assumes a sea-level rise of 50cm-80cm depending on location.
Source: Norges Bank, Financial Stability Report, June 2023.

Analysts

Pauline Lambert
p.lambert@scoperatings.com

Andre Hansen
a.hansen@scoperatings.com

Team leader

Marco Troiano
m.troiano@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

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Scope Ratings UK Limited

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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CRE accounts for nearly half of total corporate lending

Given economic uncertainties and changes to working patterns since the pandemic, CRE is a potential weak spot. Banks and covered bond issuers in Norway have significant exposure: the sector accounts for around 15% of total gross lending and 47% of gross lending to corporate customers (Figure 3).

CRE is typically the largest exposure after personal customers. The sector comprises the buying and selling of real estate, housing associations, rentals, real estate brokerage and property management.

Exposure to CRE varies given many banks' focus on retail banking

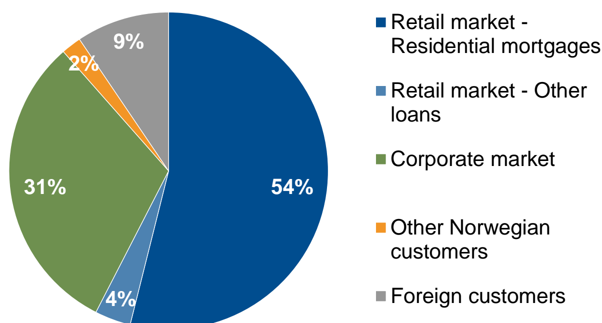
At individual bank level, CRE exposure varies. Norwegian banks, especially savings banks, focus on personal customers and mortgages. In aggregate, the share of lending to households is about 67% for the SpareBank 1 Alliance and about 81% for the Eika Alliance. CRE exposures amount to 14% and 9% of total lending, respectively (Figure 4).

DNB, the largest domestic bank, has a balanced portfolio, with retail customers accounting for nearly half of gross loans and financial commitments. CRE accounts for less than 10% of total gross loans and financial commitments and less than 20% of gross loans and financial commitments to corporate customers.

By building type, largest exposure is to offices

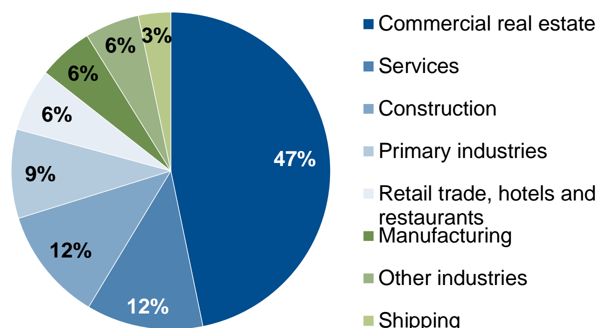
DNB, Handelsbanken, Nordea and Danske Bank finance around three-quarters of commercial buildings with bank financing (Figure 5); buildings in the largest cities represent about half of the estimated market value. Savings banks are generally more exposed to properties in their respective regions. By building type, the largest segment is office (44%), followed by retail (23%), industrial (14%) and warehouses (12%). Hotels and restaurants account for just 6%.

Figure 2: Gross lending breakdown (%)



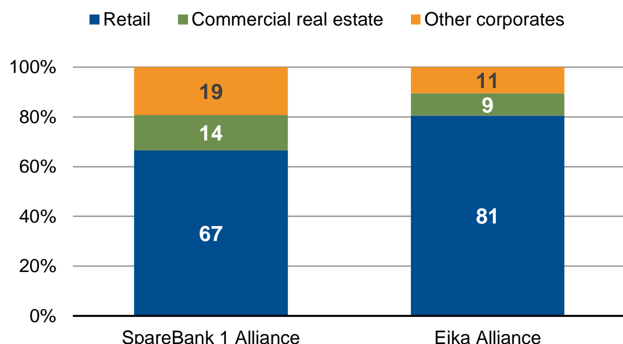
Notes: Data as of end-2022. Gross lending of all banks and mortgage covered bond companies in Norway.
Source: Norges Bank.

Figure 3: Corporate lending breakdown (%)



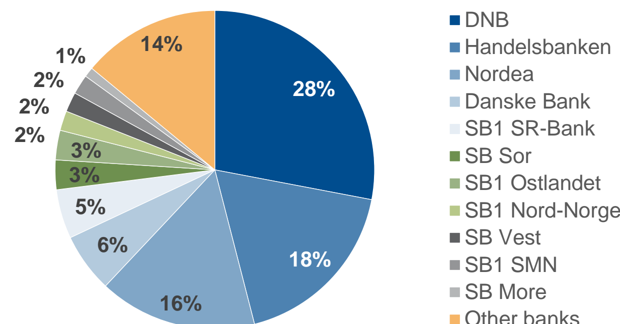
Notes: Data as of end-2022. Gross lending to corporate sector from all banks and mortgage covered bond companies in Norway. Excludes foreign customers. Other industries comprise natural resource extraction, oil services, other transport activities, power and unassigned.
Source: Norges Bank.

Figure 4: SpareBank 1 Alliance and Eika Alliance lending by sector (%)



Note: Includes loans transferred to covered bond issuing vehicles.
Source: SpareBank 1 Alliance, Eika Alliance.

Figure 5: Banks' share of CRE financing based on estimated market value (%)



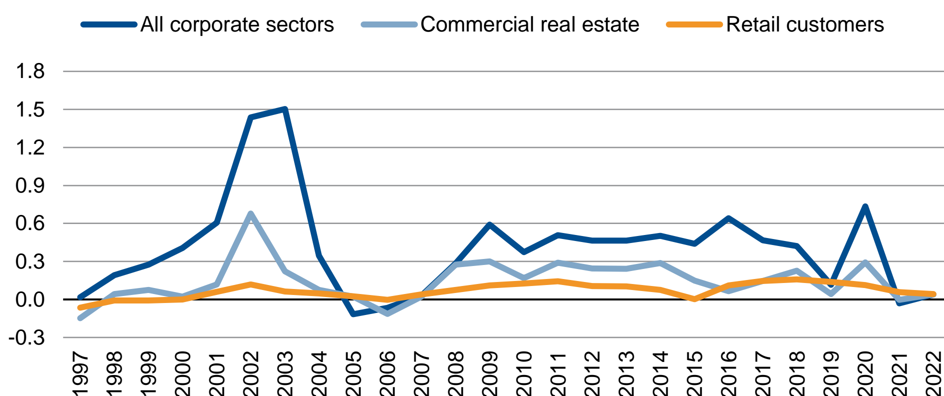
Source: Norges Bank.

Associated risks appear manageable

Loss rate on CRE has been better than on all corporates

Over the last 25 years, the CRE sector has exhibited better loss rates than corporate loans on the whole (Figure 6), although during the 1988 to 1993 Norwegian banking crisis, banks reportedly lost about one-third of their CRE exposures[1]. The sectors with the highest loss rates have been crude oil and natural gas extraction, shipping, and offshore supply and services. Loans to personal customers have a history of low losses, with more than 90% of lending in the form of residential mortgages.

Figure 6: Loss rates by sector (%)



Source: Norges Bank.

Office vacancy rates remain low

So far, the increase in remote working has not significantly affected demand for office space in Norway. Office vacancy rates in the four largest cities remain low at 6%, according to commercial property advisor DNB Naeringsmegling. In its latest semi-annual survey[2], nearly half of the companies said they will need more office space in three years. Less than 10% expect they will need less. The companies surveyed reported that their employees on average worked from home about twice a week, up from zero to one day.

[1] Andersen H. "Næringene som påfører bankene størst tap" [Sectors where banks incur the largest losses]. Bankplassen blog published 24 March 2023.
[2] DNB Naeringsmegling, June 2023. The survey has been conducted every six months since the start of 2020.

To date, a limited supply of new office buildings, high employment rates and strong economic activity have supported rent increases and softened declines in sales prices. Rent inflation has also been high as most office leases are CPI-linked, but this is expected to moderate in line with projected slower growth for the Norwegian economy. Rent on prime office space in Oslo increased by NOK 300 to NOK 6,000 per sqm in Q1 2023, according to data from real estate broker Akershus Eiendom.

CRE property prices are expected to moderate

Following a generally upward trend since 2010, commercial property prices are expected to decline to pre-pandemic levels at end-2024, rising moderately thereafter, driven by moderating rents and higher yield requirements.

While bank financing remains the primary source of funding for CRE companies, Norwegian banks have limited exposure to those with the weakest financial strength and elevated refinancing risks. Loans to CRE companies with elevated refinancing risks account for just 10% of banks' total CRE exposures and only a third of that is to companies with the weakest financials[3]. Market financing accounts for 15%-20% of total funding. By comparison, the proportion of market funding for real estate companies in Sweden is around 40%.

CRE sector remains key focus area for Norwegian authorities

Both Norges Bank and the Norwegian FSA (NFSA) continue to develop their CRE risk monitoring, given the importance of the sector to the economy and to financial stability. They are still working to collect more comprehensive and timely data, such as the share of fixed-rate CRE loans and an overview of maturity profiles.

Thematic inspection on banks' financing of offices

The NFSA's recent thematic inspection and stress test of office financing by seven banks (DNB, SpareBank 1 SR-Bank, SpareBank 1 Nord-Norge, SpareBank 1 Ostlandet, Sparebanken Vest, BN Bank and Handelsbanken) revealed that while they were generally managing their CRE exposures in line with expectations, there were material differences in the robustness of their office financing portfolios. Under the stress scenario, 35% of borrowers on average had negative cash earnings[4]. However, the proportion varied between banks and ranged from 21% to 57%.

The aim of the exercise was to assess the impact of higher interest rates, higher vacancy rates due to increased remote working, as well as shifts in demand for climate-certified buildings. It looked at use of risk limits, credit procedures, and practices for determining credit losses under IFRS 9. The NFSA noted that some banks faced challenges in monitoring and assessing their risk exposures due to data accessibility and quality.

The most helpful takeaways from the NFSA's review are the recommendations for managing CRE-related exposures (Figure 7).

More disclosure on CRE exposures would be valued

We believe investors would view more favourably banks that follow the guidelines and provide good disclosure on their CRE-related exposures. Useful disclosures include the mix of properties financed, vacancy rates, the maturity profile of leases, loan-to-values, and information on the dynamics of local CRE markets, especially given the localised nature of many banks' exposures. An overview of a bank's' risk appetite and approach to managing CRE exposures could also offer investors reassurance.

[3] Norges Bank, Financial Stability Report, H1 2023.
[4] The NFSA calculated an indicator of cash earnings for each loan commitment (CRE company). Cash earnings are defined as rental income minus operating costs and interest expenses.

Figure 7: Key supervisory recommendations

	Recommendations and findings from review
Exposure limits	Set limits for exposure to CRE financing, including limits for different sub-segments (e.g. office, retail, industry, warehouse). Consider setting limits based on geography.
Loan-to-value limits	Set loan-to-value limits. In the review, maximum loan-to-value ratios for the office segment ranged from 60% to 80%.
Equity requirements for borrowers	Set minimum equity requirements for borrowers. Specify when adjusted equity figures can be used. For banks which have set requirements, the minimum equity requirement ranges from 15% to 35%.
Occupancy rates and lease terms	Establish guidelines for minimum occupancy rates and lease terms. Specify conditions which would be required (e.g. a higher equity ratio) in cases of low occupancy rates and/or short lease terms.
Refinancing risks	When granting loans, take into consideration refinancing risks. CRE companies have long-term financing needs, but the term of loan agreements is often short, around two years. Full repayment may take 15 to 50 years. Set requirements or guidelines for the maximum repayment period. Specify whether and in which circumstances, grace periods would be allowed.
Collateral values	Establish a yield/capitalisation rate matrix as a basis for valuing commercial property. Review the matrix at least annually and more often if there are significant changes in macroeconomic conditions. Rental income, operating costs, location and building type as well as potential alternative uses should be considered when determining the value of a commercial property. Use independent valuations.
Loan covenants	Use loan covenants, actively monitor them and follow-up on breaches. Common covenants include loan-to-value, change of ownership clause, dividend clause, interest-rate hedging requirements, minimum equity requirements for the borrower, and maximum debt-to-EBITDA. According to banks in the review, breaches of loan covenants remain limited, both for CRE overall and for the office segment. The proportion of CRE loans with covenant breaches ranged from none to somewhat above 2.5%.
Sustainability considerations	Incorporate sustainability factors in credit assessments and valuations of commercial properties. Understand the energy profile of commercial properties pledged as collateral. Some banks require an energy label before granting loans secured by commercial property. Some have also established a minimum energy class requirement.

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Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
10 avenue de Messine
FR - 75008 Paris

Phone +33 6 62 89 35 12

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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