Nordic Credit Rating

FINANCIAL INSTITUTION

Sweden
16 Dec. 2022

Sparbanken Västra Mälardalen

Full Rating Report

LONG-TERM RATING

BBB+

OUTLOOK

Stable

SHORT-TERM RATING

N3

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RATING RATIONALE

Our 'BBB+' long-term issuer rating on Sweden-based Sparbanken Västra Mälardalen (Sparbanken VM) reflects the bank's strong capital position, low risk appetite, and relationship-based deposit profile. The bank has a cooperation arrangement with Swedbank AB, which enables material diversification of product offerings, shared IT costs, and the opportunity to finance retail mortgages. We expect higher interest rates to support the bank's core earnings profile, which is complemented by dividend revenues from its holdings of Swedbank shares.

The rating is constrained by the bank's concentrated exposure to the Västra Mälardalen region, which has historically demonstrated volatility associated with its key role as a centre of manufacturing, and by its regional retail banking and SME customers, and real-estate collateral. We project that credit losses and non-performing loans will increase over the next two years, given the uncertain economic environment.

STABLE OUTLOOK

The outlook is stable, reflecting our expectation that Sparbanken VM will maintain strong capital buffers through a harsher economic climate. It also reflects projections of below-average population and economic growth in its core markets and the bank's modest risk appetite. The outlook also takes account of the bank's continuing relationship with Swedbank and expectations of increased credit losses in our forecast.

POTENTIAL POSITIVE RATING DRIVERS

- Improved core pre-provision income (PPI) to risk exposure (REA) above 2.5%, with maintained asset quality.
- A material improvement in economic conditions and growth prospects in the bank's local market.

POTENTIAL NEGATIVE RATING DRIVERS

- A sustained reduction in the common equity capital ratio to below 18%.
- A material deterioration in asset quality metrics.
- A long-term economic recession in the bank's operating region that negatively affects economic activity and employment.

Figure 1. Sparbanken VM key credit metrics, 2018–2024e

%	2018	2019	2020	2021	2022e	2023e	2024e
Net interest margin	1.4	1.5	1.5	1.4	1.6	1.8	1.8
Loan losses/net loans	0.18	0.02	0.14	-0.04	0.11	0.19	0.18
Core pre-provision income/REA	1.6	1.5	1.8	1.6	1.9	2.3	2.3
Return on ordinary equity	5.4	8.3	4.6	8.4	4.6	7.2	7.3
Loan growth	4.4	9.3	5.9	9.7	4.0	4.0	5.0
CET1 ratio	22.3	24.0	23.1	26.2	25.7	25.4	25.1
Tier 1 ratio	22.3	24.0	23.1	26.2	25.7	25.4	25.1

Based on NCR estimates and company data. e–estimate. CET1–common equity Tier 1. All metrics adjusted in line with NCR methodology.

ISSUER PROFILE

Sparbanken VM is operated without an owner and focuses on customers in and around Köping Municipality in central Sweden. Like most Swedish savings banks, the bank shares a history and cooperation with Swedbank, which enables product diversification, shared costs on IT solutions, and the opportunity to finance retail mortgages via Swedbank Hypotek, Sweden's largest issuer of covered bonds.

Sparbanken VM is based in Köping, with other core markets in Kungsör and Arboga municipalities in Västmanland County at the western end of Lake Mälaren, which extends to Stockholm to the east. These three communities have a total of about 50,000 residents and are located in the Västra Mälardalen region, a geographical triangle comprised of the municipalities of Örebro, Eskilstuna and Västerås that includes nearly 750,000 inhabitants and a strong manufacturing industry.

Figure 2. Sparbanken VM core markets

Municipality	Population, June 2022	Expected population change, 2021–2040	Unemployment, Oct. 2022	Unemployment, Oct. 2021
Köping	26,150	1.1%	8.4%	9.4%
Kungsör	8,758	1.1%	8.2%	9.9%
Arboga	14,099	1.4%	7.3%	8.4%
Sweden	**10,487,859**	**8.9%**	**6.6%**	**7.3%**

Source: Statistics Sweden, Arbetsförmedlingen (Swedish Public Employment Service).

OPERATING ENVIRONMENT

Operating environment assessment 'bbb-'

We consider a balance of national and regional factors in our assessment of the operating environment. Sparbanken VM operates in a few relatively small municipalities, with a high share of exposures associated with the local economy, which has higher unemployment and lower population growth than the Swedish average.

National economy weakening

National factors 'a-'

Despite slowing economic activity and falling housing prices, we anticipate that Swedish banks will generally benefit from a return to positive interest rates. We expect the economy to slow in 2023 as the country adapts to higher borrowing and energy costs, although strong public finances support our outlook for the wider banking sector. In addition, we expect the government to repeat its recent support for households if energy prices reach unaffordable levels in the months ahead, but note that much uncertainty remains about support for companies.

Domestic inflation rates remain exceptionally high, which, combined with rising interest rates and high energy prices, is putting significant pressure on many households and businesses. However, unemployment remains moderate and despite expectations of a recession in 2023. This strengthens our belief that housing prices are falling back from recent unjustified highs, with buyers and sellers reluctant to accept the impact of higher borrowing costs. We expect housing prices to decline through the remainder of 2022 before levelling out in 2023, allowing for some regional differences.

Despite some concern about their significant real estate exposures, Swedish savings banks are currently in good health both in terms of earnings and capital (see *Swedish savings banks end turbulent first half of 2022 in good shape*, 12 Sep. 2022). Rising interest rates have only started to translate into higher interest margins, but we anticipate that margins will improve significantly given interest rate expectations, even as banks start raising deposit rates.

Regional unemployment levels higher than domestic average

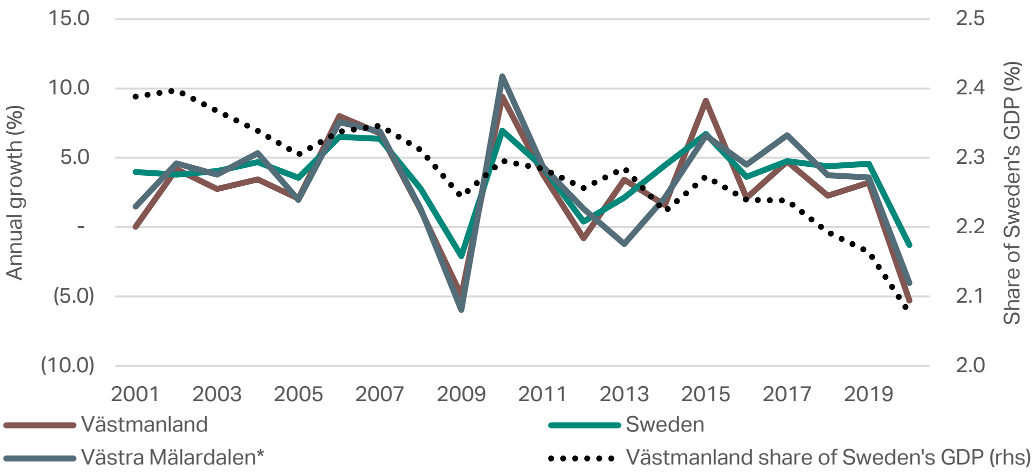
Regional, sectoral, and cross-border factors 'bb+'

Sparbanken VM's small, core market is Västmanland County, and the bank's customers work and operate mainly in the Västra Mälardalen region, comprising the counties of Södermanland, Örebro and Västmanland. The region is an important part of Sweden's manufacturing base. Manufacturing represents 20–30% of employment in Sparbanken VM's three primary markets, compared with 12% at national level. In our view, this represents a vulnerability considering that manufacturing has been negatively affected by rising commodity prices, disruptions in the global supply chain, and sanctions against Russia.

Regional unemployment levels have improved over the past year, but the bank's core markets continue to have higher unemployment levels and slower expected population growth than the Swedish average (see Figure 2). We anticipate the regional economy will see a greater downturn than the national average in 2023 and 2024.

In addition, the counties of Kungsör and Köping are planning to construct about 1,000 new apartments over the next five years. The local real-estate market has been performing well in the past few years, partly due to an increase in working from home, although prices have been impacted by higher interest rates and yield requirements.

Figure 3. Västmanland and Västra Mälardalen's annual economic growth and regional share of Sweden's GDP, 2001–2020



Source: Statistics Sweden. *Västra Mälardalen combines Örebro, Södermanland and Västmanland.

RISK APPETITE

Risk appetite assessment 'a'

Sparbanken VM's low risk profile is supported by the bank's strong capital ratios, high proportion of relationship-based retail deposits, access to market funding, and the ability to transfer loans to Swedbank Hypotek. A high proportion of secured lending is offset partly by the bank's concentration in its local real-estate market.

Risk governance proportional to complexity and size

Risk governance 'bbb+'

Sparbanken VM's risk governance, risk appetite and limit structure are proportional to its complexity and size, although less developed than those of larger Nordic banks. The bank maintains its own risk resources for anti-money laundering and know-your-customer measures and is increasing its cooperation with other savings banks on these issues, while maintaining its ability to access risk resources from Swedbank. The bank's second-line risk management function is outsourced to Svealands Risk & Compliance AB, which has direct contact with the bank's board of directors by participating in regular risk reporting and board meetings.

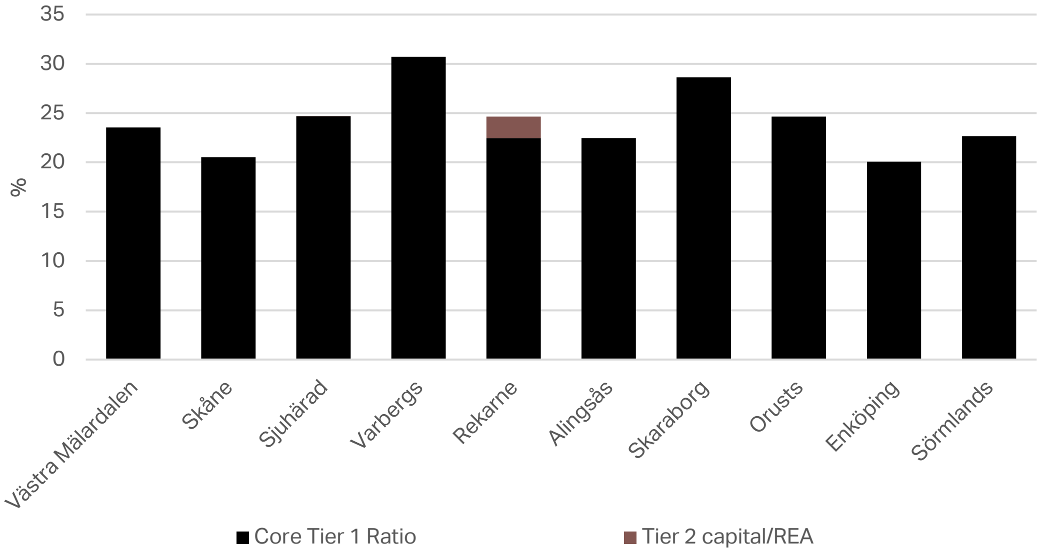
Sparbanken VM has to some extent incorporated environmental, social and governance (ESG) factors into its credit decisions but is awaiting new tools from Swedbank to build its ESG processes. The bank actively seeks to incentivise industrial customers to invest in local, renewable power and supports projects aimed at developing a circular economy. In addition, it is a signatory of the UN's Principles for Responsible Banking. The bank has a green bond framework and issued a first green bond in August 2022.

Strong capital buffers

Capital 'aa'

Sparbanken VM's CET1 ratio was 24.2% as of 30 Sep. 2022 (25.4% including year-to-date profit), more than 15pp above its regulatory CET1 requirement. Our capital projections suggest loan growth of 4% in 2023, 5% in 2023 and improved cost efficiency, resulting in a CET1 ratio projection of over 25% in our forecast, which is exceptionally strong, even within the bank's peer group. Total equity accounts for 15.6% of total assets, including holdings in Swedbank. Holdings of Swedbank shares exceeding 10% of Sparbanken VM's CET1 capital are deducted from regulatory capital, limiting the effect of share price movements on the bank's capital ratios.

Figure 4. Sparbanken VM and domestic peers' capital ratios, 30 Jun. 2022



Source: bank reports.

Increase in customer savings has supported lending growth

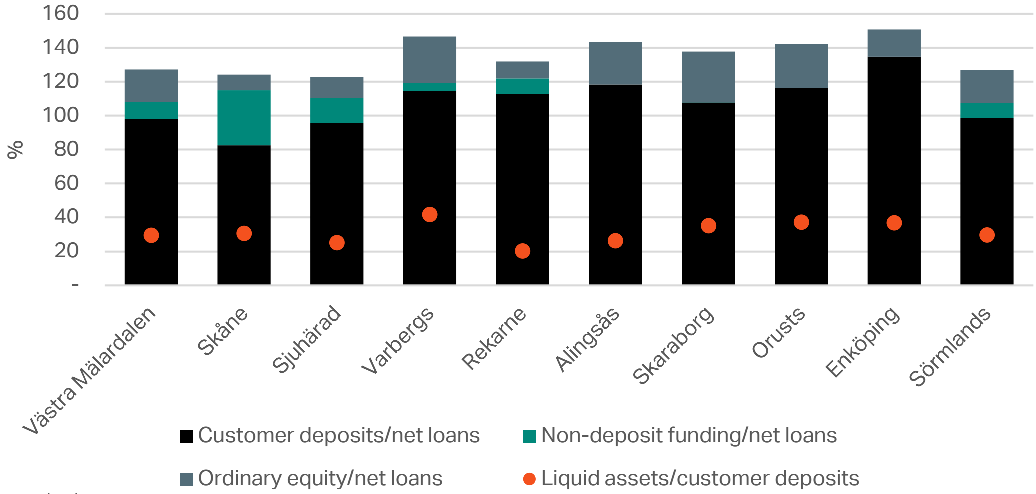
Funding and liquidity 'a'

We regard Sparbanken VM's funding and liquidity position as strong. Existing liquidity buffers are strong given the bank's relationship-based retail deposits and the ability to transfer mortgage loans to Swedbank Hypotek. As of 30 Sep. 2022, the bank's net stable funding ratio was a robust 137% and the liquidity coverage ratio is regularly above 200%, well above regulatory and internal limits. In addition, the loan-to-deposit ratio was 102%, despite loan book growth. The bank has historically maintained a strong liquidity buffer of over 30% of customer deposits, though this has decreased since 2021, and we forecast it will remain slightly below 30%.

Sparbanken VM's senior funding consists of two SEK 300m bonds maturing in March 2023 and August 2024, and a SEK 200m loan from Swedbank maturing in 2025. We anticipate that the bank will generally increase its capital market financing, but keep a near-term focus on refinancing outstanding senior unsecured bonds at maturity and maintain its liquidity buffers to manage volatility in the capital markets.

Sparbanken VM's cooperation with Swedbank allows it to transfer residential mortgages to Swedbank Hypotek, in return for a commission. The volume of transferred loans has been stable since 2017, with most of the bank's new lending growth on its own balance sheet. We note that the bank has a relatively low proportion of loans held at Swedbank, increasing its flexibility during weak market conditions.

Figure 5. Sparbanken VM funding profile vs Swedish savings bank peers', 30 Jun. 2022



Source: bank reports.

Credit risk concentrated in regional real-estate lending

Credit risk 'bbb-'

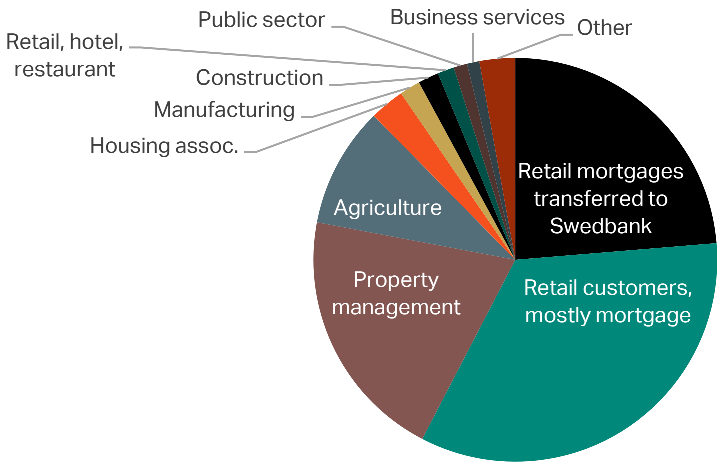
Sparbanken VM has a material concentration of regional real-estate collateral given that at least 80% of its customers are based in its three core markets. Over half of the bank's credit exposures (see Figure 6) are residential mortgages and loans to housing associations (including loans of SEK 2.8bn transferred to Swedbank), while its largest corporate exposures are to property management and agriculture. As a result, about 88% of on-balance-sheet lending is associated with regional property. Housing prices and real-estate values in the region have increased in tandem with the wider Swedish market in recent years, and we now expect them to decline as values fall nationally. We are increasingly concerned about the commercial real estate sector, which is facing sharp rises in interest rates and whose tenants are negatively affected by high inflation. Lending to the agricultural sector is diverse, with a material proportion extended to family-owned farms and forest owners.

Sparbanken VM's lending is focused on private individuals and SMEs within its core markets, which leads to geographic concentrations. This is partly offset by its retail and corporate customers' access to larger markets in Eskilstuna, Västerås and Örebro. Lending directly to the manufacturing sector is modest, although many of the bank's loan exposures could be negatively affected by volatility in the performance of the region's largest manufacturers, especially as the economy slows. The bank has relatively low exposure to high-risk industries, with modest exposures to construction, retail, and hotels and restaurants.

Sparbanken VM's local real-estate collateral could be negatively affected by significant climate events or flooding in the region's lakes or waterways, which in turn could pressure collateral values. In addition, increases in climate volatility and higher temperatures could affect the performance of farming and forest operations in the region.

Sparbanken VM's mortgage loans transferred to Swedbank provide income via commission fees. The volume of transferred residential mortgage loans has increased in the course of 2022 and total transferred volumes stood at SEK2.8bn as of 30 Sep. 2022. While on-balance-sheet residential mortgage lending has remained flat, most of the bank's growth over the past year has been related to corporate, agriculture and real-estate loans. Sparbanken VM has a first-loss risk associated with the transferred loans, which results in a reduction in paid commission in the event of write-downs of transferred loans. The maximum risk on transferred loans is around SEK 20m per year, or the amount of reported loan commission income.

Figure 6. Sparbanken VM total net lending by segment, 30 Sep. 2022



Source: company.

Investment portfolio risk has declined

Other risks 'a-'

Sparbanken VM continues to reduce spread and credit risk in its fixed-income investment portfolio. As a result, over 90% of the portfolio consists of rated investment-grade investments, compared with less than 50% at end-2019. These efforts have improved our view of the bank's market-related risk.

Interest rate risk in the banking book is moderated by variable interest rates on a large proportion of the bank's loans and the use of interest rate hedges. The bank started using hedge accounting for interest rate derivatives in 2021, effectively reducing the negative impact of changes in value on its financial results.

Sparbanken VM owns 3m Swedbank shares, which ensures it has a meaningful voice alongside other savings banks that own shares either directly or via their owner foundations. In addition, the bank has strategic stakes in Indecap Holding AB (jointly owned with over 35 other savings banks), Svealands Risk & Compliance (jointly owned with six other savings banks), and Sparsam Administration Svealand (jointly owned with two other savings banks). It also owns 20% of Portfolio Försäkra AB (jointly owned with five other savings banks).

COMPETITIVE POSITION

Competitive position 'bb+'

Sparbanken VM has a strong position in its core markets and among local individuals and SMEs and reports 40,000 retail and 4,000 corporate customers. The bank's primary local competition comes from Handelsbanken, Nordea, and Länsförsäkringar Bank, while larger corporations in the region are serviced by larger banks. Increased competition from challenger mortgage institutions and local savings banks based is having some negative effect on margins but has not materially impaired the bank's ability to attract and retain customers. Collectively, savings banks have maintained the highest customer satisfaction score among Sweden's banks, with Sparbanken VM scoring above the subsector average. At national level, the bank has only a small presence, with about 0.2% of total deposits and 0.1% of total loans (including loans transferred to Swedbank).

We consider Sparbanken VM's meaningful role and contributions to its local market as a positive rating factor. The bank's primary environmental, social and governance (ESG) attribute is its strong sense of social responsibility in its local communities. The bank pays out 10% of its profit to support local activities.

PERFORMANCE INDICATORS

Performance indicators 'a-'

We expect Sparbanken VM's core earnings to steadily improve steadily due to higher interest rates and improving net margins. We also expect these improvements to offset a projected increase in credit losses as the economy slows in 2023.

Higher margins likely to improve earnings and cost efficiency

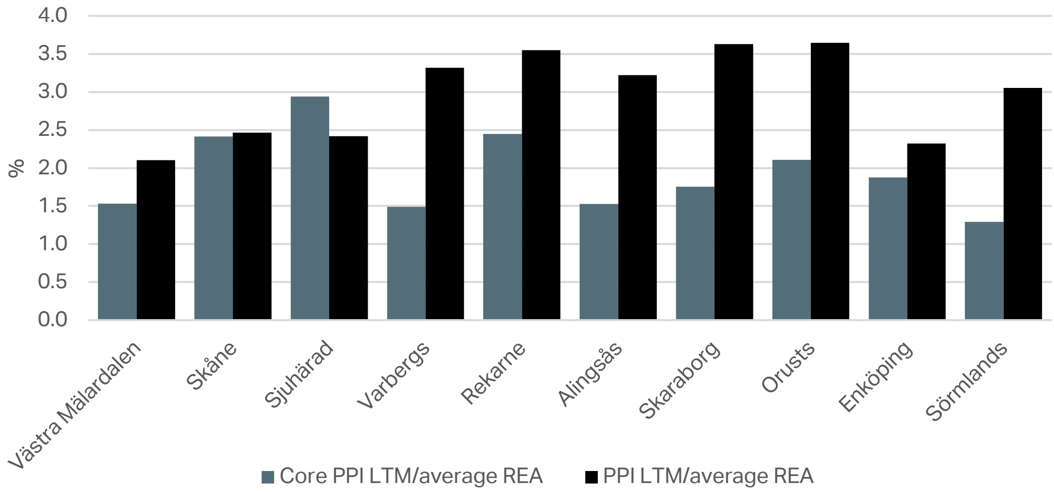
Earnings 'a-'

We expect rising interest rates to significantly improve Sparbanken VM's net interest margins after years of margin pressure due to low interest rates and tough competition for mortgage loans. We also expect that higher interest rates will eventually improve margins on loans transferred to Swedbank, which have fallen in the course of 2022 due to a lag between the realisation of higher lending rates and the more immediate impact of Swedbank's STIBOR-linked funding costs.

In addition, we expect the bank's earnings to continue to improve through scale-driven improvements in core cost efficiency. We estimate that its core cost-to-income ratio will be below 50% by end-2023 (compared with 64% in 2017). We also expect projected improvements in PPI to REA to result in efficiency gains.

Sparbanken VM relies less on Swedbank dividends than many other Swedish savings banks, but earnings were boosted in 2022 by a dividend that reflected 2019 and 2020 profits. Our forecast includes dividend payments of about SEK 40m in 2023 and 2024. However, we believe that Swedbank could reduce or cancel dividend payments over the next few years to offset fines by US and European authorities in connection with alleged money laundering. (See *Swedish savings banks get dividend boost after solid 2020*, 21 Jun. 2021 and *Q&A: Swedbank judgement and share price impacts on Swedish savings banks*, 23 Mar. 2020.)

Figure 7. Swedish savings banks' PPI to REA, LTM to 30 Jun. 2022



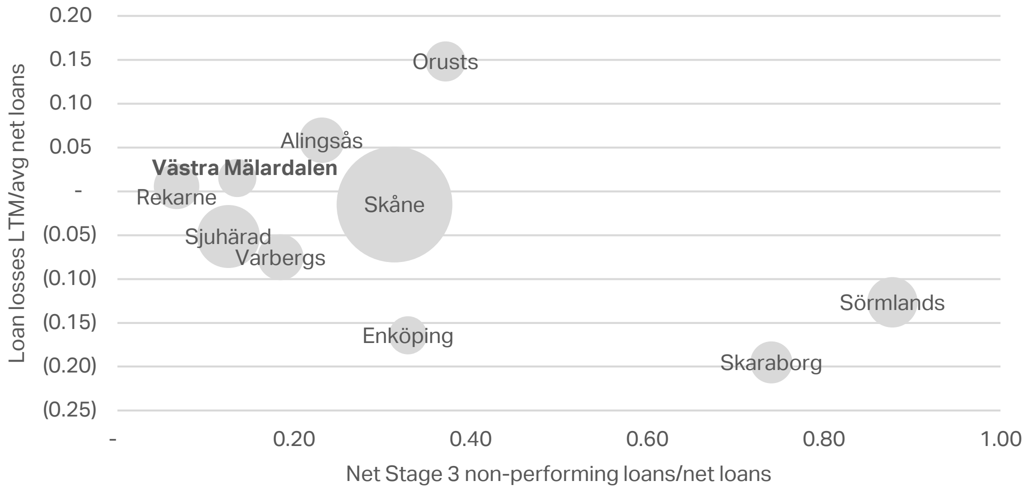
Source: bank reports. LTM-last 12 months

Non-performing loans and credit losses likely to increase

Loss performance 'a'

Sparbanken VM has a strong history of low credit losses and has reported an average loss provision of 4bps of net loans since 2011. It has also maintained low Stage 3 non-performing loans in comparison with its peers since resolving a legacy provision in 2019. We believe that credit losses will increase in 2023 and 2024 due to a slowing economy and the likely negative impact on regional customers. In addition, we expect Stage 3 loans to increase as the economy slows. We also expect some additional volatility, as the EU's New Definition of Default regulation could require banks to categorise all loans with relaxed contract terms as non-performing, including loans with suspended amortisation. However, we expect Sparbanken VM to keep its loss metrics broadly in line with those of its peers and covered them with increased pre-provision profits through 2024.

Figure 8. Swedish savings banks' asset quality metrics (%), 30 Jun. 2022



Source: bank reports.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS

Moderately positive aggregate ESG impact

We consider ESG factors throughout our analysis, where they are material to the credit assessment (see Figure 9). In aggregate, we view Sparbanken VM's ESG profile as having a moderately positive impact on the bank's creditworthiness.

Figure 9. Sparbanken VM priority ESG factors

Issue/area	Risk/opportunity	Impacted subsections (impact on credit assessment*)
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 (-) Loss performance (0)
Social engagement in local community	Close connection to narrow regional markets provides a benefit.	Competitive position (++) Funding & liquidity (+) Earnings (+)
Sustainable/green bond framework	Diversity of funding sources, access to additional markets/investors.	Funding & liquidity (+)
Anti-money laundering capacity	Risk of sanctions and fraud. Insufficient control of customers.	Risk governance (0)
Control of sustainability issues	Risk of overlooking sustainability impacts on the bank's underwriting, operations, and customer base.	Risk governance (0) Credit risk (0)

*Defined on 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

Sparbanken VM has no owners. Instead, it has 48 principals who act in the interests of depositors. Half of the principals are appointed by the municipalities of Köping, Arboga and Kungsör, and the other half by the principals themselves. The principals appoint a board and allocate the bank's profit. Given the bank's status, no additional owner capital is held in a foundation or within Swedbank, which is the case at several other Swedish savings banks. Consequently, we do not adjust the rating to reflect ownership support.

ISSUE RATINGS

Our issue rating on Sparbanken VM's unsecured senior debt is in line with the 'BBB+' issuer rating. We rate senior unsecured bonds issued under a medium-term note programme 'BBB+', an indication of our likely ratings on future issuance under the programme.

Figure 10. Sparbanken VM 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	54.1	59.1	51.8	70.0	50.4	70.9
Net fee income/op. revenue	29.8	32.7	24.7	32.6	26.8	29.1
Net trading income/op. revenue	1.8	-8.7	10.2	-5.1	7.6	-22.4
Net other income/op. revenue	14.3	16.9	13.3	2.5	15.2	22.5
EARNINGS						
Net interest margin	1.5	1.4	1.5	1.5	1.4	1.5
Pre-provision income/REA	2.1	1.9	2.7	1.7	2.7	2.0
Return on ordinary equity	6.4	5.4	8.3	4.6	8.4	5.5
Return on assets	1.1	0.9	1.3	0.7	1.3	0.9
Cost-to-income ratio	53.6	51.3	43.7	53.9	45.2	50.9
Cost-to-income ratio, ex. trading	54.6	47.2	48.7	51.3	48.9	41.6
CAPITAL						
CET1 ratio	23.1	22.3	24.0	23.1	26.2	24.2
Tier 1 ratio	23.1	22.3	24.0	23.1	26.2	24.2
Capital ratio	23.1	22.3	24.0	23.1	26.2	24.2
REA/assets	59.2	59.1	60.2	57.8	53.3	52.4
Dividend payout ratio						
Leverage ratio	13.7	13.0	14.0	13.0	13.7	12.2
GROWTH						
Asset growth	9.3	9.9	-0.6	11.1	5.4	4.5
Loan growth	9.2	4.4	9.3	5.9	9.7	3.3
Deposit growth	12.4	12.2	-2.6	12.3	9.0	5.7
LOSS PERFORMANCE						
Credit provisions to net loans	-0.08	0.18	0.02	0.14	-0.04	0.10
Impaired loans to gross loans	0.39	0.84	0.45	0.40	0.39	0.33
Net impaired loans to gross loans	0.20	0.53	0.15	0.02	0.06	-0.08
Net problem loans to equity	0.92	2.45	0.73	0.10	0.28	-0.41
Non-performing loan coverage ratio	49.57	36.43	67.10	95.15	85.17	125.13
Stage 3 loans/gross loans	0.88	0.84	0.45	0.40	0.39	0.33
Net stage 3 loans/net loans	0.70	0.67	0.25	0.19	0.23	0.16
FUNDING & LIQUIDITY						
Loan/deposit ratio	105.6	98.3	110.2	103.9	104.5	102.1
Net stable funding ratio	147.0	147.0	145.0	149.0	143.0	136.7
Liquidity coverage ratio	211.5	159.4	212.1	270.3	231.7	229.0

Key financials (SEKm)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	Q3 2022 YTD
BALANCE SHEET						
Total assets	8,699	9,563	9,510	10,564	11,137	11,633
Total tangible assets	8,699	9,563	9,510	10,564	11,137	11,633
Total financial assets	8,532	9,364	9,412	10,455	10,992	11,453
Net loans and advances to customers	6,639	6,932	7,578	8,021	8,796	9,088
Total securities	1,401	1,670	1,220	1,563	1,513	1,536
Customer deposits	6,286	7,054	6,873	7,719	8,414	8,897
Issued securities	725	844	925	900	600	601
of which covered bonds	–	–	–	–	–	–
of which other senior debt	725	844	925	900	600	601
of which subordinated debt	–	–	–	–	–	–
Total equity	1,427	1,512	1,520	1,596	1,822	1,820
Total ordinary equity	1,427	1,512	1,520	1,596	1,822	1,820
CAPITAL						
Common equity tier 1	1,191	1,261	1,372	1,409	1,556	1,476
Tier 1	1,191	1,261	1,372	1,409	1,556	1,476
Total capital	1,191	1,261	1,372	1,409	1,556	1,476
REA	5,147	5,649	5,729	6,107	5,935	6,101
INCOME STATEMENT						
Operating revenues	220	213	268	215	298	183
Pre-provision operating profit	102	104	151	99	163	90
Impairments	-5	12	2	11	-3	7
Net Income	90	80	125	71	143	75

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

Figure 11. Sparbanken VM rating scorecard

Subfactors	Impact	Score
National factors	5.0%	a-
Regional, cross border, sector	15.0%	bb+
Operating environment	20.0%	bbb-
Capital	17.5%	aa
Funding and liquidity	15.0%	a
Risk governance	5.0%	bbb+
Credit risk	10.0%	bbb-
Market risk	-	-
Other risks	2.5%	a-
Risk appetite	50.0%	a
Market position	15.0%	bb+
Earnings	7.5%	a-
Loss performance	7.5%	a
Performance indicators	15.0%	a-
Indicative credit assessment		**bbb+**
Transitions		Neutral
Peer comparisons		Neutral
Borderline assessments		Neutral
Stand-alone credit assessment		**bbb+**
Material credit enhancement		Neutral
Rating caps		Neutral
Support analysis		Neutral
Issuer rating		**BBB+**
Outlook		Stable
Short-term rating		**N3**

Figure 12. Capital structure ratings

Seniority	Rating
Senior unsecured	BBB+

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