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# Credit quality of Swedish developers deteriorates as systemic risk builds up in the domestic banking sector

by Raghav Mathur

- **NUS-CRI Agg PD shows a build-up of credit risk in the Swedish housing market in line with the decline in property market valuations and interest rate hikes.**
- **Though the current credit quality of Swedish banks is relatively safe, stress tests suggest that further weakening in the credit quality of the Swedish real estate industry may lead to significant systemic risk build-up.**

Alarm bells are ringing across the Nordic countries as their biggest economy's housing market shows stark signs of an incoming crisis. Sweden's housing market has been dealing with one of the worst routs in the continent as home prices have declined by over 15% since their peak in Apr-2022. The impact of the housing market decline in value is already being felt by Sweden's domestic real estate industry, with the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) rising steadily since the beginning of the year, crossing two notches from A to BBB when referenced to PDiR2.0 bounds[1]. Though the industry, on aggregate, is still considered to be within the investment-grade territory, the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[2]) term structure shows a worsening outlook, with the Forward PD crossing BBB- lower bound over the next 18 months.

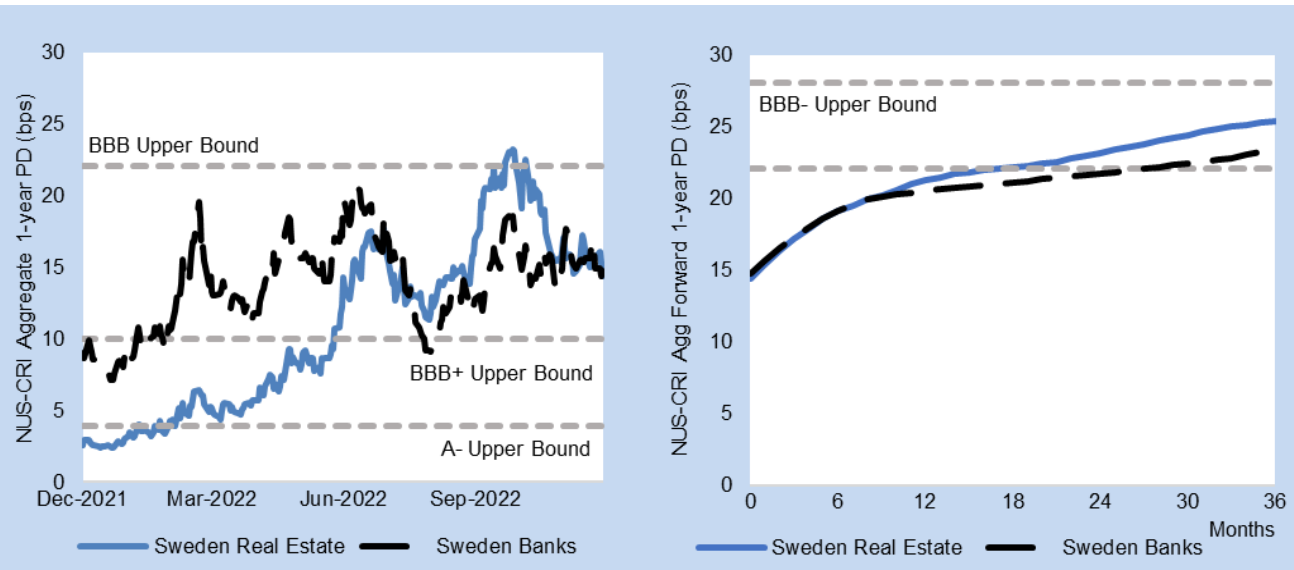


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Sweden's Real Estate and Banking sector with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Sweden's Real Estate and Banking sector as of Dec-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Rising interest rates, in conjunction with high inflation and high household indebtedness, have raised concerns of weaker economic growth for the country next year[3], with household consumption poised to decrease. Household mortgages that are especially sensitive to interest rate changes, with the majority of the country having short-term mortgages, are facing an increasing debt servicing burden that is reducing the volume of new

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[3] The European Commission forecasts that GDP growth will contract by 0.6% in 2023, while analysts are expecting a contraction of close to 1%.

homes purchased. Furthermore, the Swedish 3-year mortgage rate has nearly tripled since the beginning of this year from 1.5% to 4.2% in Oct-2022. Rising rates and lower property values are therefore adding pressure to the profitability of Sweden's real estate industry in the near future, which has already been embattled by increasing input costs. Signs of this cost pressure are already seen with the median return on capital for the industry already reducing from 10.23% in Q2 2022 to 7.84% in Q3 2022.

Adding to the woes of the property value slump for the industry are its upcoming debt maturities. As seen in Figure 2a, the industry has close to USD 4bn of debt maturing in 2023 (15% of total debt), and close to USD 5bn of debt maturing in both 2024 and 2025 respectively (around 20% of total debt maturing each year). The property slump accentuates the impact on the amount of liquidity the industry needs to service its upcoming maturities. With the industry's median total debt to total capital remaining relatively stable since the beginning of this year at around 52%, refinancing upcoming maturities at higher rates poses upward pressure on developers' leverage levels. This potential increase in leverage in the next few quarters, in conjunction with low turnovers, profitability woes and asset value declines, could suggest why the Forward PD for the industry shows a worsening trend.

The market downturn is not limited to Sweden's real estate industry as the contagion effects also impact the credit risk outlook of the country's banking sector. As seen in Figure 1a, since Q3 2022, the Agg PD for the Swedish banking sector has also been increasing in line with that of the real estate industry. Swedish banks have up to 43% of their loan portfolio in commercial real estate, and with the ongoing property slump, the proportion of bad debt arising from this loan segment likely increases over the next few quarters. Furthermore, links between the property and the banking sector suggest that with rising financing costs, vulnerable real estate companies with lower access to cheap credit might have to make large write-downs on property values and raise funds by conducting fire-sales of properties. This may imply that the Swedish banking segment sees an increasing credit loss arising from the commercial real estate industry, as liquidity deteriorates, which may affect their profitability and asset quality through a decline in mark-to-market revisions on floating-rate loans and higher loan loss provisions.

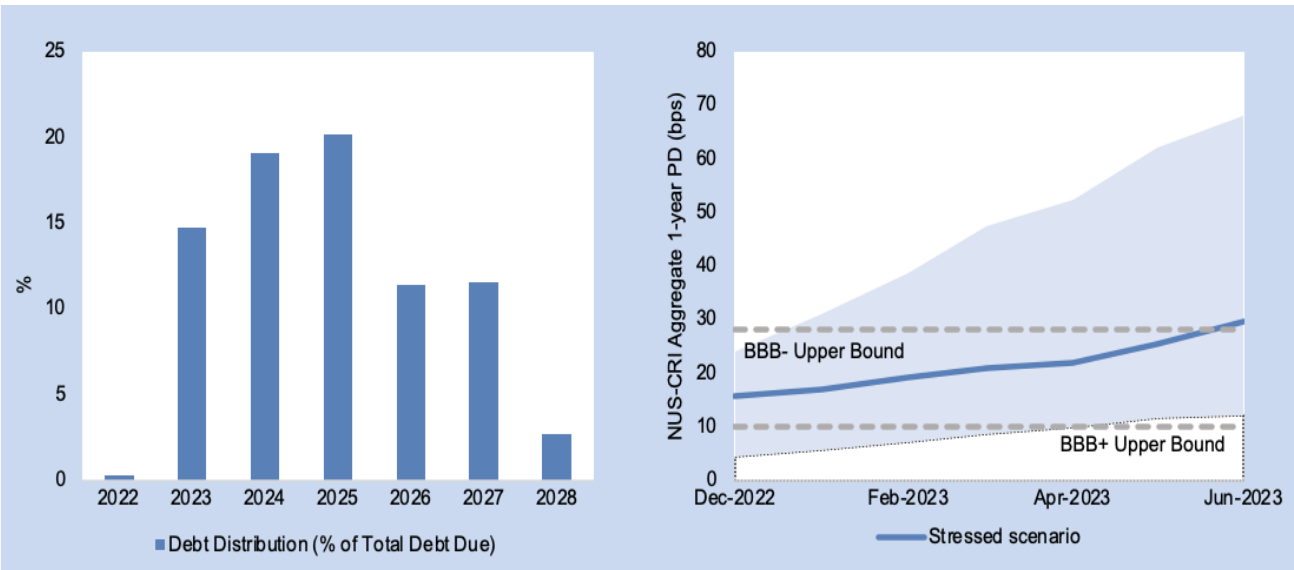


Figure 2a (LHS): Debt maturity distribution of Sweden's real estate industry from 2022 to 2028. Figure 2b (RHS): NUS-CRI Agg (median) 1-year PD for Sweden's Banking sector stressed on credit cycle index of the real estate industry with reference to PDiR2.0 bounds and their interquartile range. *Source: Bloomberg, BuDA V5.2.1*

To see how the banking sector's credit health is going to respond to a further shock in the housing market, stress tests can be conducted using the NUS-CRI bottom-Up default Analysis Toolkit (BuDA v5.2.1). As seen in Figure 2b, in a stress scenario, where the NUS-CRI Sweden Real estate CCI gradually worsens by 0.2bps over the next 6 months, the stressed PD of Swedish banks shows gradual worsening past the BBB- upper bound and into non-investment grade territory. The trend of the median PD also stays relatively muted, compared to those vulnerable companies that are above the upper quartile of the distribution that experience a faster deterioration in their credit profile. Vulnerable real estate companies, especially, must manage their funding woes, as the breaking of financial covenants may lead to lenders seeking higher collaterals, which may lead to further asset sales and deterioration of asset quality for the banking sector. Thus, real estate companies are intrinsically linked to the loan book of the domestic banking sector for Sweden, which opens the country's financial system up to systemic-risk buildup that may require further policy intervention over the coming months by the Swedish Central Bank, Riksbank.

The downturn in the Swedish real estate sector acts as a litmus test for the rest of the listed property market in Europe. Though the country's domestic real estate sector suffers from near term large maturities that hamper debt servicing ability, the industry's European counterparts may be able to use the Swedish example to gauge the ease and accessibility of tapping into private credit markets. Some companies, especially those that are unable to tap the credit market, may rely on distressed rights issues to shore up equity capital. Moving forward, it becomes more likely that further stress build-up by the domestic housing market may be met by stronger regulatory response to ring-fence domestic banks from property sector risks. As such, it may be likely that further deterioration in Swedish banks' credit quality, through the impact on profitability or through asset quality, occurs over the next few months, in-line with the Forward PD's suggestion in Figure 1b.

## Credit News

### Vietnam moves to shore up bond market to ease credit crunch

**Dec 14.** Vietnam's leaders decide to provide support for companies with deteriorating credit outlooks, in order to avoid a potential financial crisis. Faced with a liquidity crunch in the market, Vietnamese companies have trouble with financing and will be under tremendous pressure to repay the corporate bonds of USD 31.5bn about to mature through the next two years. The ministry of finance must take action to cushion the financial market, enterprises, and investors. The existing proposals include debt restructuring, maturity extension, and mandatory credit rating postponement, which should all be under the agreement of the creditors after negotiation. (Bloomberg)

### ECB retreat to put EUR 300bn burden on eurozone debt market

**Dec 14.** Amid soaring inflation, ECB plans to cut its bond holdings which have been increasing since 2015 along with interest hikes of 0.5% - 2%, which confronts investors with a challenge to absorb a substantial amount of debt and exposes governments within eurozone to higher borrowing costs. Broad concerns from analysts and investors have been spurred about the credit outlook for some debt-ridden countries, such as Italy. ECB is expected to execute this tightening plan in a gradual pace and keep reinvesting in its EUR 3.3tn asset purchase programme to avert the repetition of 2012 sovereign debt crisis**.** (FT)

### Bond investors see Indonesia's hot streak extending into next year

**Dec 16.** Indonesian bonds have been relative outperformers among their emerging Asian counterparts, and investors believe that this momentum will continue through next year. The rosy outcome may be attributed to their higher real yields and the anticipation that domestic interest rates are peaking. Relatively higher yields and strong demands by the central banks to purchase government bonds will keep domestic securities strong. (Bloomberg)

### Defaults on US junk loans expected to climb as rate rises squeeze earnings

**Dec 13.** Following Fed's persistent rate hikes, the default rate on leveraged loans of companies with poor credit ratings is set to increase sharply over the next two years. The general consensus is that defaults will be at least 3.2%, twice as high as today's level, and some analysts expect that default rates on risky loans will climb near 10%, the highest since 2019. On the one hand, the floating-coupon bonds, which have taken advantage of the QE environment, will now make the issuers very vulnerable and even insolvent to rising interest rates. In addition, the widely anticipated recession might further erode corporate profits because of higher interest costs. (FT)

### Canada resists call to ease mortgage stress test for uninsured home buyers

**Dec 16.** Despite the benefits of lower borrowing costs to home buyers, Canada decided to continue the uninsured mortgage rate stress test. The Canadian mortgage rate has increased two times of last year, and housing prices have fallen by 11.5% since February as demand subsides. High MQR excludes some home buyers who cannot service their mortgages while providing support for insured mortgages and cushion for potential future economic turmoil. Meanwhile, the latest earnings of Canadian banks hinted that they are preparing for more bad debt defaults. (Reuters)

**China's reopening will speed up rebound in Thai bonds into 2023** (Bloomberg)

**ECB raises rates to 2% and warns of more increases to come** (FT)

**China credit markets show more cracks amid reopening** (Bloomberg)

## Regulatory Updates

**China asks banks to buy bonds via prop desks after market slump**

**Dec 14.** The retail investors are transferring funds from fixed-income products to riskier assets given the anticipated economic recovery. Meanwhile, Chinese regulators turn to some of the nation's biggest banks for help to purchase bonds and stabilize the local market. It is said that the bond purchase targets included bonds issued by Chinese local government financing vehicles. The recent rapid fund outflows have shifted the long-lasting resilience of China's local debt market, bringing the bond prices lower, with 3-year AAA corporate bond spread reaching to 90 basis points. The PBOC has not responded while concern over fund withdrawal and bond price declining persists.(Bloomberg)

**Fed Raises rate by 0.5 percentage point, signals more increases likely**

**Dec 14.** The Fed increased the interest rate by 0.5% on Wednesday, a smaller rise compared to four previous increases of 0.75%, bringing the benchmark federal-funds rate to the highest in 15 years, at 4.25% to 4.5%. Fed Chair Jerome Powell said rate hikes will continue at a slow pace starting from the next meeting to avoid over-tightening, but the final decision is dependent on potential macroeconomic outcomes. Bond markets rallied on the Fed's signaled willingness to a small rate rise, yet the long-term bond yields have fallen due to anticipation of a rapid decline in inflation and a potential recession. (WSJ)

**Indonesia passes law on crisis bond-buying by central bank** (Bloomberg)

**Philippine central bank chief rules out rate pause for now** (Bloomberg)

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