NATIONAL BANKING MARKET ASSESSMENT

SWEDEN

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Nordic Credit Rating (NCR) applies a score of 'a-' for the Swedish banking market and views the domestic operating environment as stable. Swedish banks have outperformed most international peers in recent years due to steady lending growth and increased margins. Sweden's economy has been spurred by significant construction activity to address a material housing shortage and accommodate the growing population. However, we expect rising interest rates and a recalibration of housing prices to reduce the pace of capital investment and weigh on economic growth over the next two years. The banking market score is a component of NCR's issuer ratings for financial institutions. Depending on the nature of the rated entity's exposure and geographic profile, the score can affect up to 20% of an issuer's overall credit rating.

Figure 1. Sweden – scoring of national indicators

SUBFACTOR	SCORE	RATIONALE
Sovereign strength	aa	Major credit rating agency average: AAA, minimum: AAA.
Output growth	a	We expect slowing economic growth due to a reduction in recent capital investment.
Credit growth	bbb	Credit growth is more than twice GDP growth, but growth remains stable and we expect it to slow as interest rates normalise.
Housing prices	bbb	As of Sep. 2018, nominal housing prices have a three-year annual growth rate of 3.5%, but price levels are uncertain given increasing volumes of newly produced apartments.
Unemployment	a	Unemployment is higher than in Nordic peers in large part due to high unemployment rates of recent immigrants. Long-term unemployment is the lowest in the EU.
Available stable funding	a	Available stable funding in the form of deposits and domestic covered bonds falls short of monetary financial institution (MFI) private-sector loans, but access to other forms of long-term senior financing remains strong.
International cycle	bbb	Global growth prospects are improving, though supported by significant monetary stimulus. Increasing trade rhetoric and the prospect of the UK leaving the EU without a trade agreement could affect economic growth. Asset prices are at or near peak levels.

Figure 2. Sweden – key banking metrics

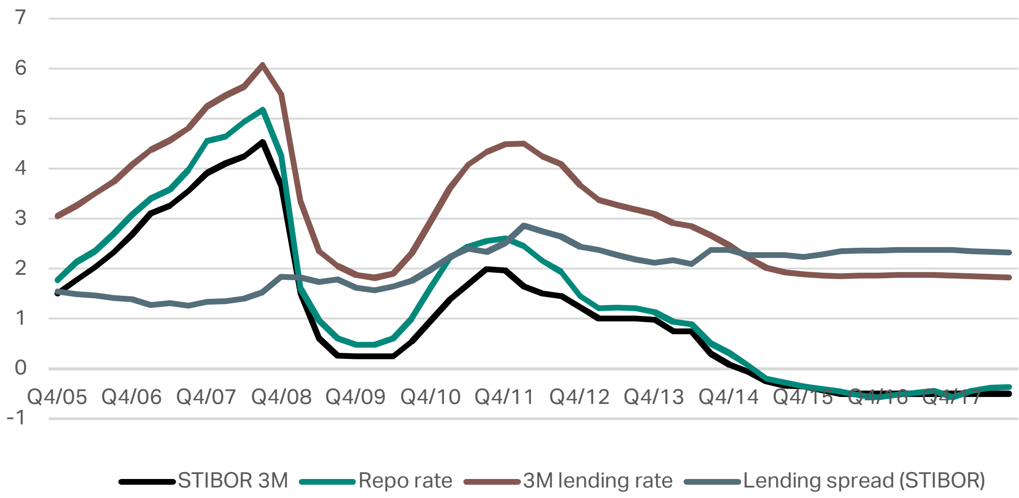
	2015	2016	2017	2018e	2019e	Trend
Growth in credit to the private non-financial sector (%)	(0.4)	(3.6)	3.3	4.5	4	Slight increase
Real housing price growth (%)	13.2	7.6	4.5	4.5	1.5	Slight increase
Net interest margin (%)	1.0	1.1	1.1	1.1	1.0	Slight decrease
Problem loans/ gross loans (%)	0.6	0.7	0.7	0.7	0.7	Flat

Source: BIS, aggregated bank reports

NATIONAL ECONOMY

The consensus view is that Swedish GDP growth will be 2.9% for 2018, fuelled by low interest rates, a weak currency, stronger exports, an expansionary fiscal policy, high immigration and still-high investments in housing and construction. However, there are expectations for lower growth of 2% and 1.8% in 2019 and 2020, respectively, as housing investments drop from peak levels. Consequently, unemployment is expected to fall to 6.1% in 2019 before rising slightly, propped up by a 15% foreign-born unemployment rate and mismatches between recent immigrants' skillsets and available employment. NCR expects the current low interest environment to persist in the coming years, with the Swedish repo rate remaining below zero until the latter half of 2019 and growing steadily thereafter.

Figure 3. Swedish interest rates, 2006–2018



Source: Statistics Sweden, Riksbanken

Despite gridlock in forming a new government following parliamentary elections in September 2018, NCR does not anticipate any material side effects for the national economy and monetary policy or dramatic changes in fiscal policy, regardless of the eventual political outcome and given restrictions on changes to income taxes until a government is formed and given restrictions on changes to income taxes until a government is formed. Government finances remain exceptionally strong, with a recent history of budget surpluses and declining government debt to GDP.

Figure 4. Sweden – key national metrics, 2014–2020

	2014	2015	2016	2017	2018e	2019e	2020e
Real GDP growth (%)	2.7	4.3	3.0	2.5	2.9	2.0	1.8
CPI growth (%)	(0.2)	(0.1)	1.0	1.8	2.1	2.1	1.9
Unemployment rate (%)	7.9	7.4	6.9	6.7	6.2	6.1	6.2
Current account balance/GDP (%)	4.5	4.5	4.2	3.3	3.9	4.1	4.1
Central bank policy rates	0.0	(0.4)	(0.5)	(0.5)	(0.5)	0.1	0.7

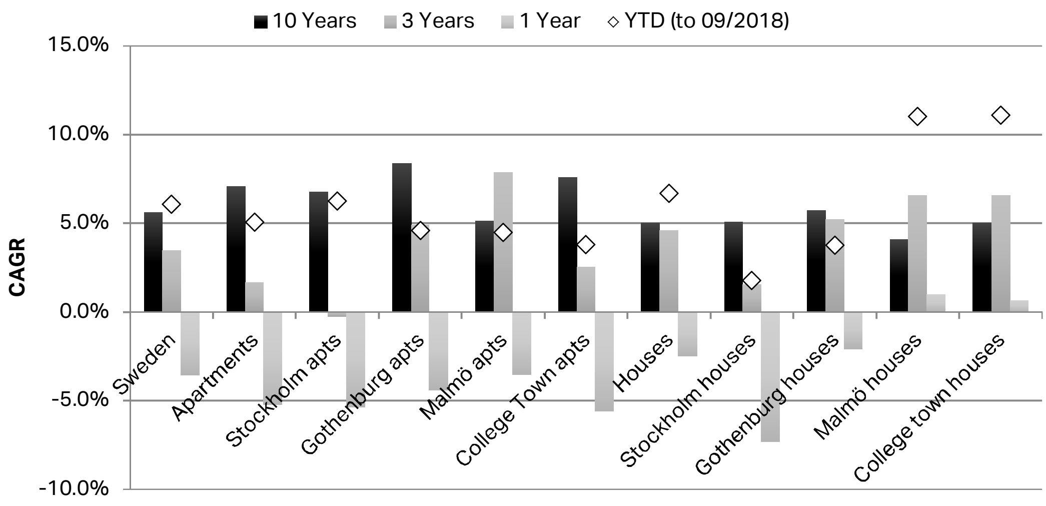
Source: Economist Intelligence Unit, NCR consensus estimates, Riksbanken. e–Estimate.

HOUSING MARKET

Many years of strong housing price appreciation in Sweden, particularly in Stockholm, has been replaced by a modest correction since August 2017 as the market responds to a high level of newly produced residences and the announcement of further tightening of amortisation requirements by the Swedish financial regulator. However, year-to-date housing price growth has been robust (6% annualised through September) as shown in Figure 5, and the market's three-year compound average growth rate (CAGR) of 3.5% indicates that home owners still have plenty of equity. We project real house prices to grow between 4-5% in 2018. The Stockholm market has been materially impacted by higher amortisation requirements for highly indebted individuals and newly completed housing.

We anticipate that the housing market will remain unsettled as highly indebted borrowers adjust to new amortisation requirements, a high level of housing completions and expectations of rising interest rates from historic lows. Some market participants expect steep price falls, while surveys indicate that households are becoming more optimistic about housing prices. The mixed picture is likely to be affected by households' vantage point given indications that higher-valued objects and newly produced exclusive housing projects have been forced to recalibrate their pricing expectations. Sellers may be waiting for a price recovery, while buyers want to be sure prices have bottomed out.

Figure 5. CAGR of Swedish housing prices by region and type, Sep. 2018

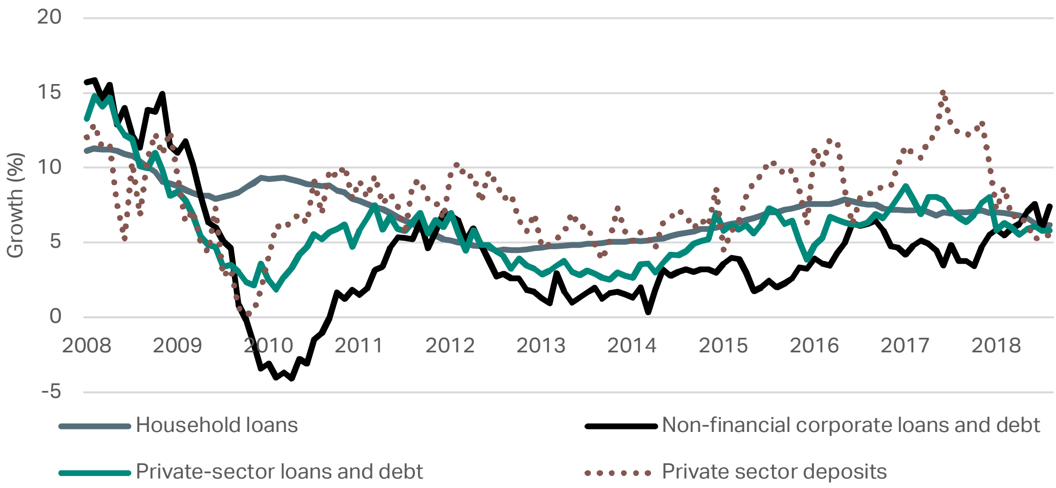


Source: ValueGuard HOX index

CREDIT GROWTH

MFI lending to the private sector is 53% household mortgage loans, 34% non-financial corporate lending (50% of which with real-estate collateral), 5% other household loans and the remainder associated with financial corporations and the public sector. As such, a material share of outstanding loans are backed by real estate collateral.

Figure 6. 12-month growth in private-sector loans by sector and deposits, Aug. 2018



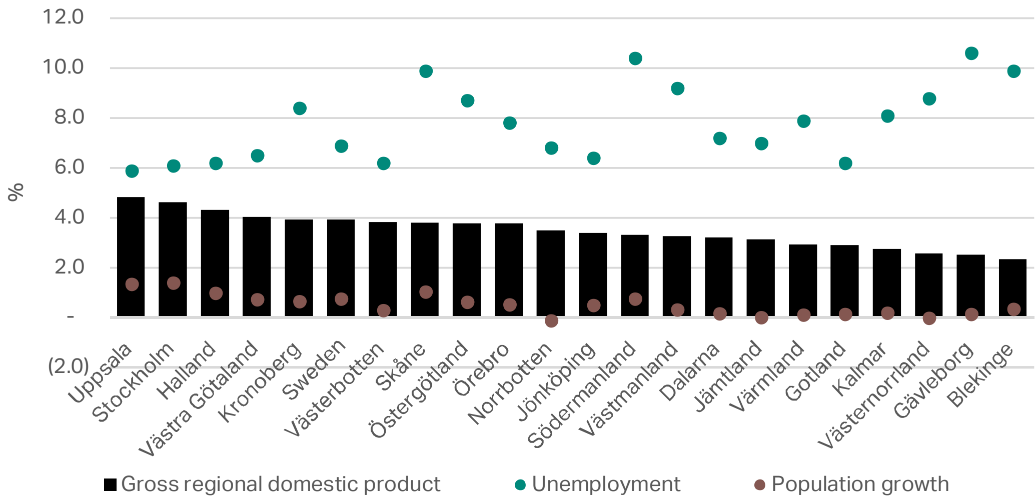
Source: Statistics Sweden

Growth in private-sector loans has shown mean reversion of around 5% since 2009, supported by about 7.5% annual growth in deposits. Households have increased borrowing faster than has been justified by the growth in the economy, which is largely due to rising housing prices, low interest rates and banks willing and able to provide mortgage loans at attractive expanded lending margins. However, a calmer housing market and regulatory initiatives to reduce household leverage have led to slower growth in housing and unsecured consumer lending in 2018 and are expected to dampen growth further in the next two years to around 4% annual growth. Corporate credit demand from MFIs remains rather muted, but growth rates are above the private-sector average for the first time since 2012, in part because of higher debt issuance and attractive borrowing rates available in the capital markets.

REGIONAL ANALYSIS

Sweden's urbanisation trend is continuing and is apparent not only in the significant historical differences in housing prices between Stockholm and Gothenburg (in Västra Götaland), but also in county level unemployment and population growth statistics (see Figure 7). Regions with growing populations are also the driving force for economic growth and have supported the weaker development in smaller markets. However, fewer than half of Sweden's 21 counties have experienced native-born population growth since 2000 and strong immigration has supported population growth in some regions, creating challenges of integration due in part to higher foreign-born unemployment.

Figure 7. Swedish unemployment (2017), annual GDP & population growth since 2000, by county

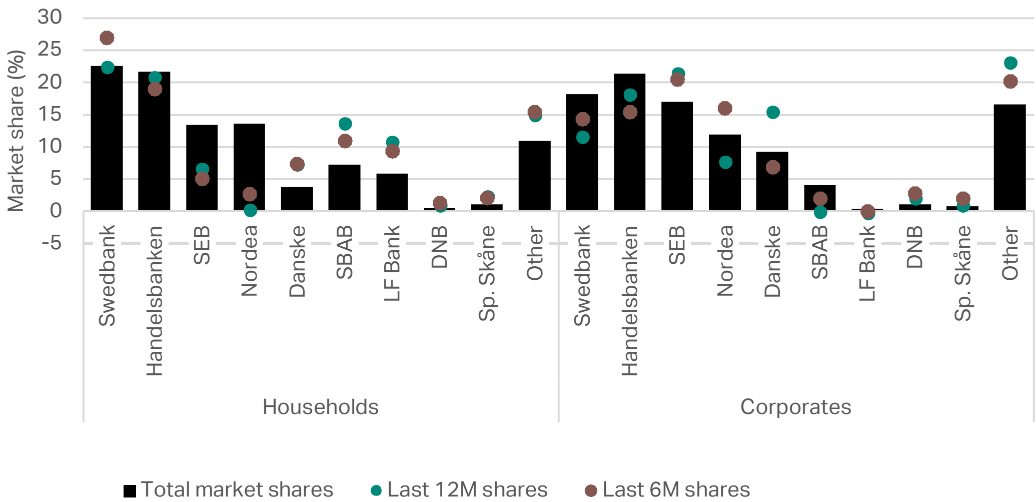


Source: Arbestförmedlingen, Statistics Sweden. Gross regional domestic product CAGR from 2000-2016.

BANKING MARKET

Sweden's four largest banks hold 69% of the lending market and 68% of the deposit market, but both markets are evolving. Nordea moved its headquarters from Sweden to Finland on 1 Oct. 2018, materially reducing the size the domestic banking market, but also creating some badwill and affecting customer volumes at the region's largest bank. As illustrated in Figure 8, Nordea has shown little to no growth in household lending over the 12 months ending Aug. 2018, and has also lost domestic market share in corporate lending over the past year.

Figure 8. Lending market share of banks in Sweden, Aug. 2018



Source: Statistics Sweden, NCR analysis

In the competitive residential mortgage market, incumbents Swedbank and Handelsbanken are maintaining most of their existing share of 24% and 23%, respectively. However, SEB and Nordea combined accounted for only 5% of mortgages in the last 12 months, far below their combined 28% share. In their place, SBAB and Länsförsäkringar Bank continue to grow their market share, with 18% and 15% of the market over the last 12 months, respectively, well above their 8.3% and 6.6% overall mortgage share. In addition, via its recently founded Danske Hypotek, Danske Bank had 8.5% of the mortgage market over the past year as it expands its Nordic strategy.

Sweden's banks demonstrate strong performance in key areas. The banks have high regulatory capital ratios, providing valuable capital flexibility and affording large dividend payments to shareholders. The banks have also demonstrated improved earnings and efficiency as margins on mortgage lending have steadily increased and automation and customer behaviour have allowed for significant cost savings, smaller branch networks and reduced staffing even as volumes and revenues rise. Finally, Sweden continues to stand out among European peers with respect to asset quality and loss performance, allowing for efficiency gains to be passed through to shareholders.

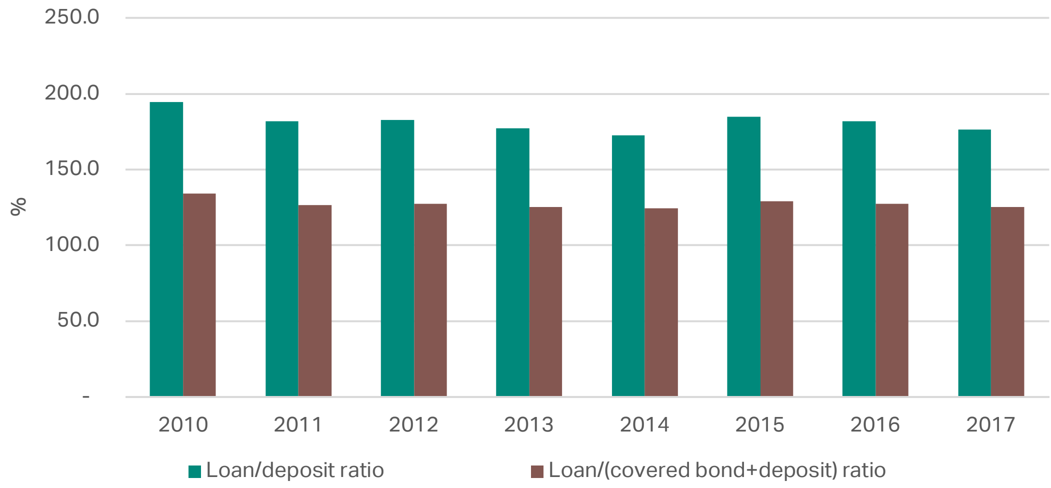
Looking ahead, NCR expects that margin pressure from existing and newly started competitors could affect banks' future earnings from mortgage lending as interest rates begin their rise towards normality. In addition, we expect the Swedish regulator to move its 25% risk weight floor for mortgages into banks' pillar 1 capital calculations, which will have a material impact on banks' reported capital ratios (see *Improving Capital Comparability for Nordic Banks*, 20 Sep. 2018).

AVAILABLE STABLE FUNDING

Given the high share of private savings entrusted to institutional investors via mutual funds and pension assets, the loan-to-deposit ratio for Swedish banks is not an ideal measure of the market's stable funding. Our evaluation of Swedish bank funding therefore considers not only deposit funding, but also covered-bond financing, given the demonstrated resilience, perceived support and liquidity of covered bonds. The exclusion of covered bonds from bail-in and protection from the impact of a bank resolution as part of the bank recovery and resolution directive (BRRD) supports our view of covered-bond financing as stable funding. In addition, the use of long-term senior unsecured financing is a key fixture of Swedish bank financing, in part as an alternative to covered bonds, leaving qualifying mortgages available for contingency financing via issuance and repurchase agreements with the central bank. NCR deems the markets to have a strong interest in Swedish financing at long maturities and reasonable spreads and considers senior unsecured funding with maturities over one year to be stable.

Despite strong access to wholesale financing markets, the loan-to-deposit ratio for Swedish banks (including their international operations) improved to 176% at year-end 2017 from 194% at year-end 2010. This was largely due to high household savings rates, despite available deposit rates being very low or even negative for short-term corporate deposits.

Figure 9. Loans as a share of deposits and covered-bond financing for Swedish banks



Source: Aggregated Bank Data, Association of Swedish Covered Bond Issuers

BANKING MARKET ASSESSMENT

The banking market score of 'a-' for Sweden is a component of NCR's issuer ratings for financial institutions operating in the Swedish banking market. Depending on the nature of a rated entity's exposure and its geographic profile, the score can affect up to 20% of an issuer's overall credit rating. For more information, please refer to *Financial Institutions Rating Methodology*, 13 Aug. 2018.

APPENDIX

Figure 10. Sweden – key credit metrics, 2011–2017

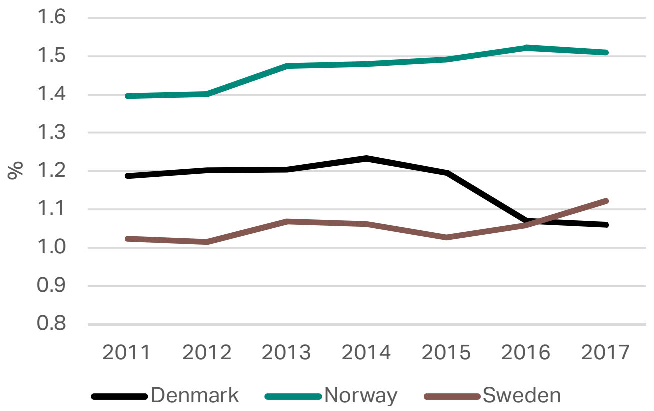
	2011	2012	2013	2014	2015	2016	2017
Credit to households (%)	78.1	80.5	82.3	83.1	83.6	86.0	87.7
Credit to non-financial corporations (%)	149.1	148.6	150.7	151.3	150.5	144.5	146.0
Growth in credit to the private non-financial sector (%)	4.8	1.9	3.9	1.4	(0.4)	(3.6)	3.3
Household savings/disposable income (%)	12.6	14.4	15.0	16.5	15.1	16.6	15.8
Debt service ratios of households	11.5	11.6	11.2	11.2	11.1	11.2	11.4
Nominal residential property prices, 2010 = 100	102.5	103.7	109.4	119.7	135.4	147.1	156.5
Real residential property prices, 2010 = 100	99.6	99.8	105.4	115.5	130.7	140.6	146.9
Source: BIS							

Figure 11. Sweden – key banking market metrics, 2011–2017

	2011	2012	2013	2014	2015	2016	2017
Net interest margin (%)	1.0	1.0	1.1	1.1	1.0	1.1	1.1
Net interest & fee income/op. income (%)	84.5	81.9	84.7	86.1	86.4	83.6	84.3
Cost to income (%)	57.8	54.1	52.3	50.3	50.2	51.9	52.4
Pre-provision profit/avg. RWA (%)	2.4	3.0	3.3	3.7	3.9	3.9	4.0
ROAA (%)	0.5	0.5	0.6	0.6	0.6	0.6	0.6
ROAE (%)	10.9	11.6	11.5	12.6	11.8	11.2	10.8
Loan loss provision/avg. gross loans (%)	0.08	0.15	0.13	0.12	0.11	0.12	0.11
Problem loans/gross loans (%)	1.3	0.8	0.6	0.6	0.6	0.7	0.7
Problem loan growth (%)	(13.5)	(39.0)	(17.6)	8.9	(0.4)	10.3	9.5
CET1 ratio (%)	13.0	14.7	16.4	17.4	18.9	20.4	20.6
Capital ratio (%)	15.8	17.6	19.0	22.2	24.0	26.3	25.8
IFRS Tier 1 leverage ratio (%)	4.0	4.1	4.3	4.2	4.5	4.8	4.8
Net loans/deposits (%)	181.8	182.6	177.1	172.4	184.6	181.8	176.1
Net loans/stable funding (%)	136.2	127.2	135.1	124.3	139.7	127.2	125.0

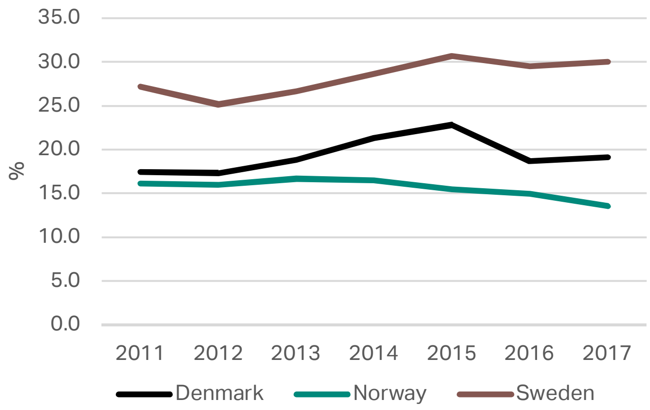
Source: Aggregated bank financials. RWA–Risk-weighted assets. ROAA–Return on average assets. ROAE-Return on average equity. CET1–Common equity Tier 1. IFRS–International Financial Reporting Standards.

Figure 12: Banks' net interest margin, 2011–2017



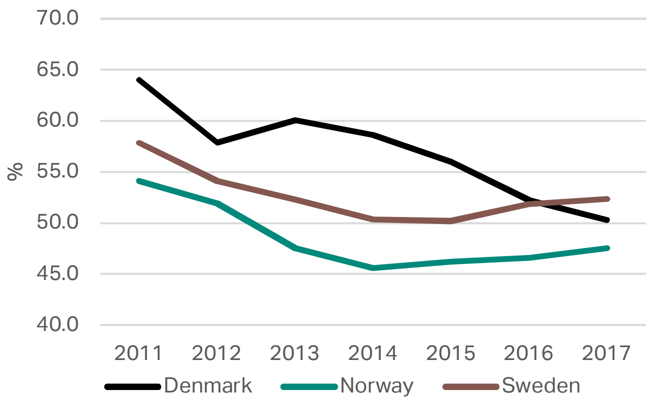
Source: Aggregated Bank Data

Figure 13: Banks' net fees & commission to operating income



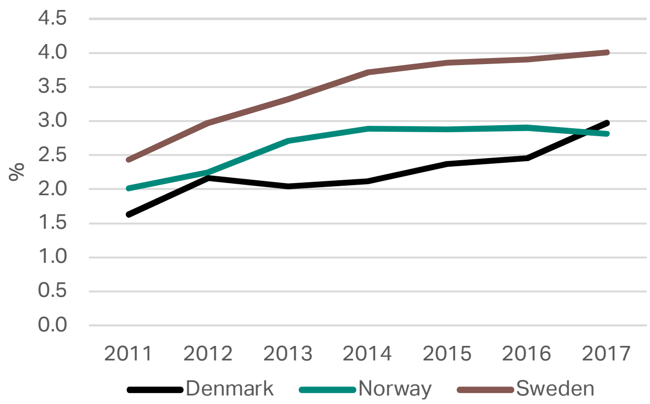
Source: Aggregated Bank Data

Figure 14: Banks' cost-to-income ratios, 2011–2017



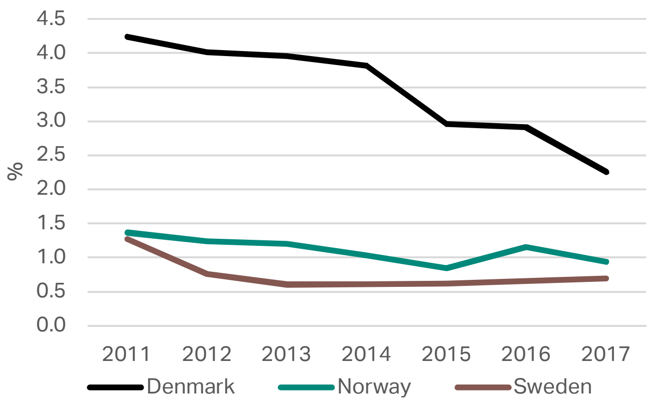
Source: Aggregated Bank Data

Figure 15: Banks' pre-provision profit to avg RWAs, 2011-2017



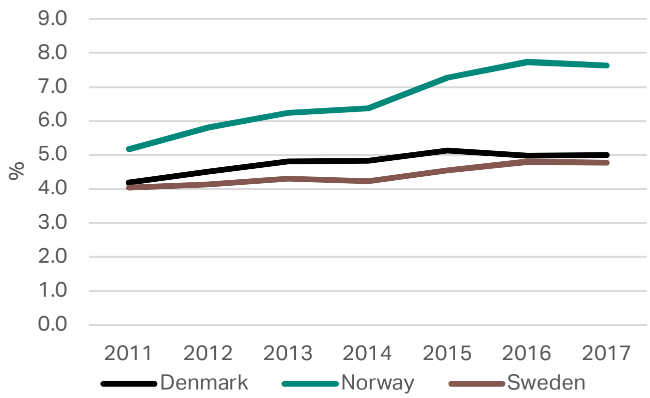
Source: Aggregated Bank Data

Figure 16: Banks' problem loans to gross loans, 2011–2017



Source: Aggregated Bank Data

Figure 17: Banks' leverage ratios, 2011–2017



Source: Aggregated Bank Data

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