SWEDISH MORTGAGE RATES FACE UPWARD PRESSURE DESPITE UNCERTAINTY OVER RIKSBANK HIKE

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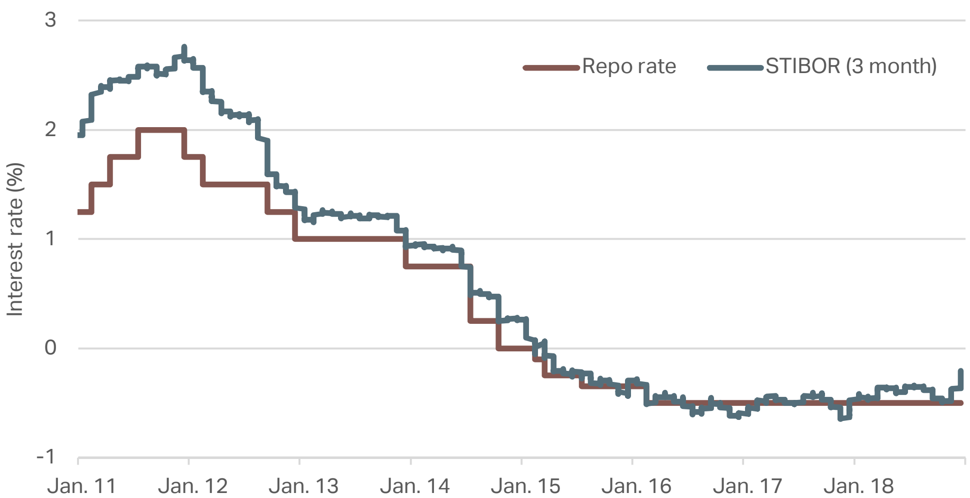
On 20 December 2018, the Swedish central bank (the Riksbank) will announce whether it will raise its primary policy rate, or repo rate, for the first time since July 2011. It is uncertain whether the rate hike will happen now given weak inflation figures, slowing domestic growth, ongoing Brexit negotiations and a growing consensus that the global economy is wavering. However, a recent 25 bps increase in three-month STIBOR could indicate that the market expects a hike (see Figure 1).

Nordic Credit Rating (NCR) believes that although a repo rate hike is likely to result in higher mortgage rates, as was the case after a September hike in Norway, it is only one aspect of the Riksbank's changing monetary policy that could affect mortgage rates. In addition, NCR expects that the end of quantitative easing (QE) in Sweden, i.e. the Riksbank's purchase of long-dated government bonds, will not only increase government bond rates, but also affect covered bond rates and force banks to protect margins.

Furthermore, the factors affecting the Riksbank's path forward present a risk for Swedish mortgage rates. Historically, the spread between government and covered bonds has increased during periods of macroeconomic stress. If markets are concerned about the prospects for Swedish banks, the housing market and the economy in general, the spread between Swedish government debt and covered bonds is likely to increase, with or without dramatic changes in monetary policy.

In NCR's view, the factors working against higher rates – competition, higher deposit margins or a delayed rate hike – are not enough to compensate for the upward pressure, nor to prohibit material increases in mortgage rates. However, despite the possibility to fix mortgages at historically low rates with listed rates below two percent for up to five-year fixing periods, around 70% of new mortgages are still issued with floating rates (three-month rates) in line with the Swedish aggregate.

Figure 1. Swedish repo rate and three-month STIBOR, 1 Jan 2011–17 Dec 2018

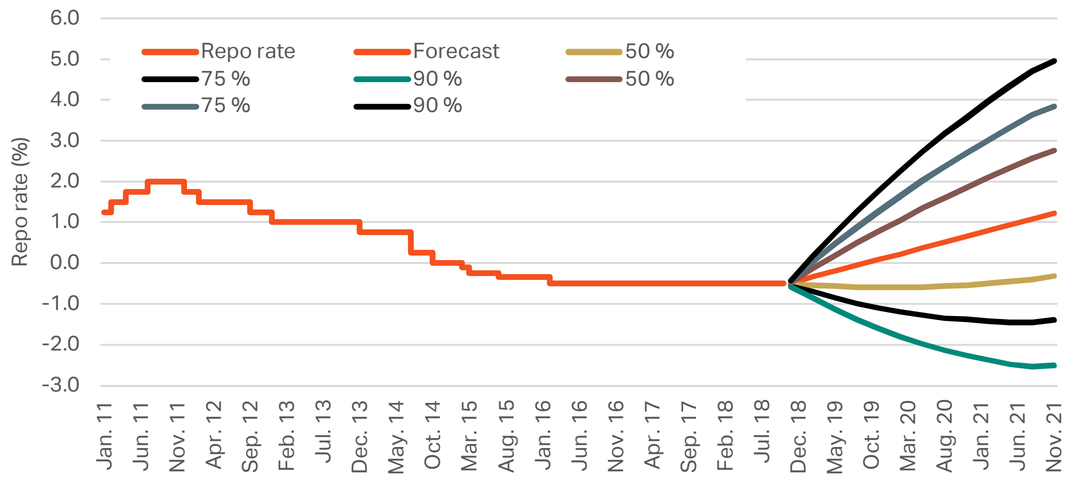


Source: Riksbanken,

REPO RATES PROJECTED TO RISE

The Riksbank has used the repo rate as its primary steering tool since June 1994. Over its history, the average rate has been 2.6%, a level that the repo rate has not exceeded since December 2008. The current -0.5% rate has been in place since February 2016, a year after falling below 0% for the first time ever.

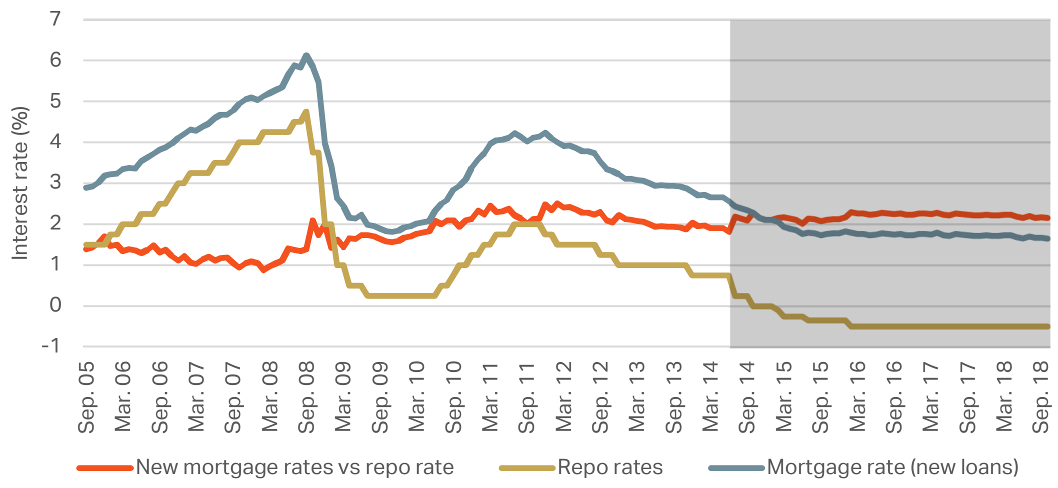
Figure 2. Swedish repo rates and Riksbank projections with uncertainty bands, October 2018



Source: Riksbank

Such a long period of negative rates has normalised negative repo rates, not to mention quantitative easing, which are extraordinary monetary policies. The market's expectation is that the repo rate will increase, as suggested by the Riksbank's own prognosis from October 2018, which indicates a rate increase to -0.25% in either December 2018 or February 2019. The Riksbank remains cautious and news surrounding Brexit negotiations, global trade, a slowing economy, falling housing prices and low domestic inflation could affect the bank's decision.

Figure 3. Swedish repo rates compared with new mortgage rates, 2005–Oct. 2018



Source: Statistics Sweden, Riksbank

However, banks stopped lowering mortgage rates in line with the repo rate in 2014 (see shaded area in Figure 3). The same year, a 25% risk weight floor was implemented on residential mortgage loans, increasing the capital requirement by up to 500%. In addition, banks were unable to reduce deposit rates below 0.0% in practice and compensated by maintaining mortgage rates. With the Swedish regulator expected to make the 25% risk weight floor a permanent fixture in banks' capital ratios in 2019, it is unlikely that residential mortgage margins will return to the levels seen before the 2008 financial crisis.

In fact, the decoupling of mortgage rates from the repo rate and the higher mortgage margins have buoyed Swedish banks' returns. This is especially true for banks financed by higher shares of covered bonds, which are mostly aligned with three-month STIBOR rates and with short-term yields that followed the repo rate and government bond yields below 0.0%.

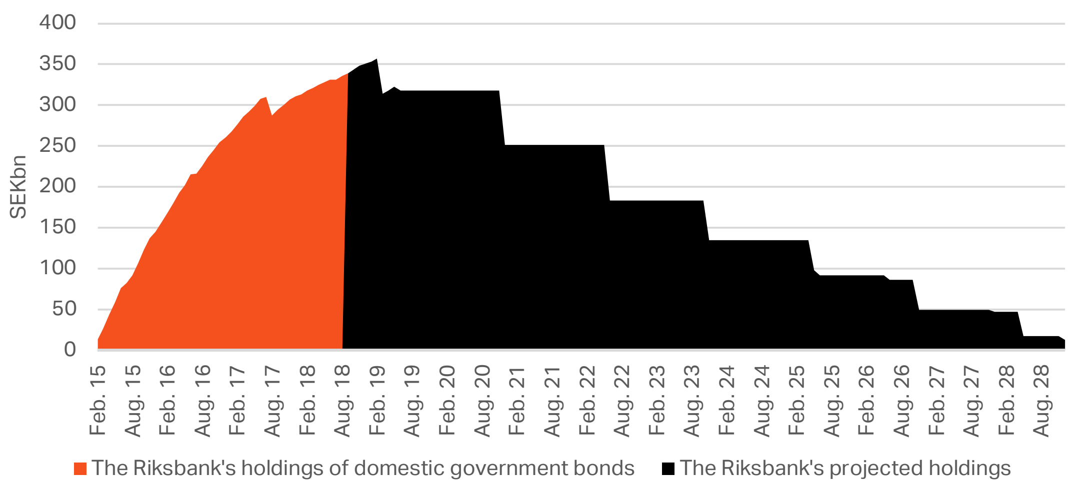
NORWEGIAN BANKS QUICKLY RAISED MORTGAGE RATES FOLLOWING HIKE

Norwegian banks' response to the rate hike by the Norwegian central bank (Norges Bank) on 20 Sept. 2018 provides an indication of how Swedish banks could react when the Riksbank increases the repo rate. The day after Norges Bank's hike, DNB Bank announced a 25bps mortgage rate hike. By the end of the following week, many Norwegian banks (including banks which also operate in Sweden) had increased their mortgage rates, reflecting the 25bps increase in the repo rate. Banks increased mortgage rates, despite the most important reference rate for Norwegian covered bonds, three-month NIBOR, increasing by only about 10bps in the month leading up to Norges Bank's decision.

UNWINDING QUANTITATIVE EASING WILL AFFECT COVERED BOND YIELDS

Rising repo rates are only part of the impact of the Riksbank's unwinding of expansionary policies for mortgage rates. As the bank reduces its purchases of Swedish government bonds, another low-risk asset class will re-emerge for investors. Although the purchasing programme officially stopped in December 2017, the Riksbank's reinvestments of coupons and principle are projected to result in peak holdings in February 2019. Afterwards, the largest buyer of low-risk Swedish debt will withdraw.

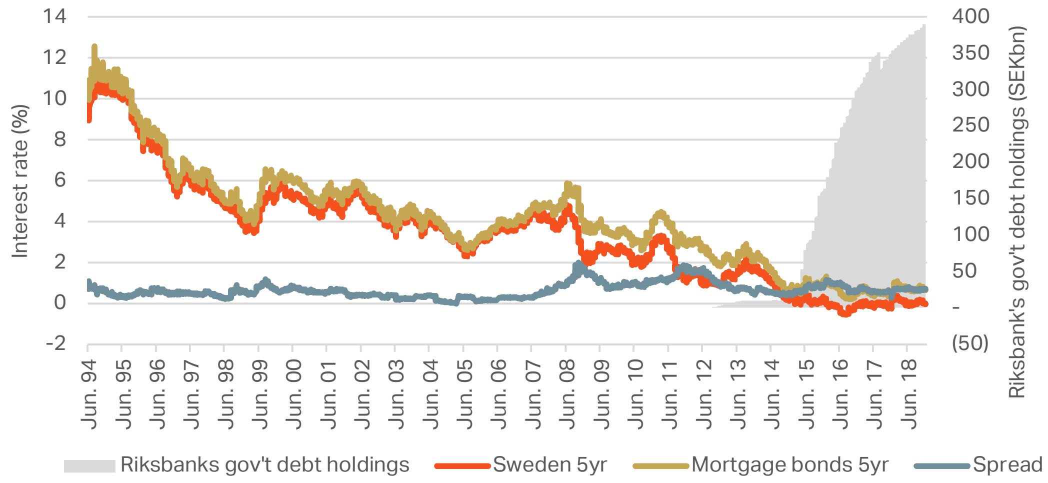
Figure 4. The Riksbank's holdings and projected holdings of government bonds, 2015–2028



Source: Riksbank

Regardless of the repo rate path, the conclusion of the Riksbank's purchasing programme should increase the cost of mortgage financing by increasing long-term interest rates for government debt. Over the last 25 years, five-year mortgage bonds have had a 65bps spread to five-year government bonds, essentially identical to the 68bps average spread in 2018. Banks can therefore expect funding costs for covered bonds to rise in line with government bond rates over time. With such a high volume of variable rate Swedish mortgages, these increases can be quickly passed on to borrowers to support higher mortgage margins for the banks.

Figure 5. Swedish five-year government and mortgage bond interest rates, 1994–Dec. 2018

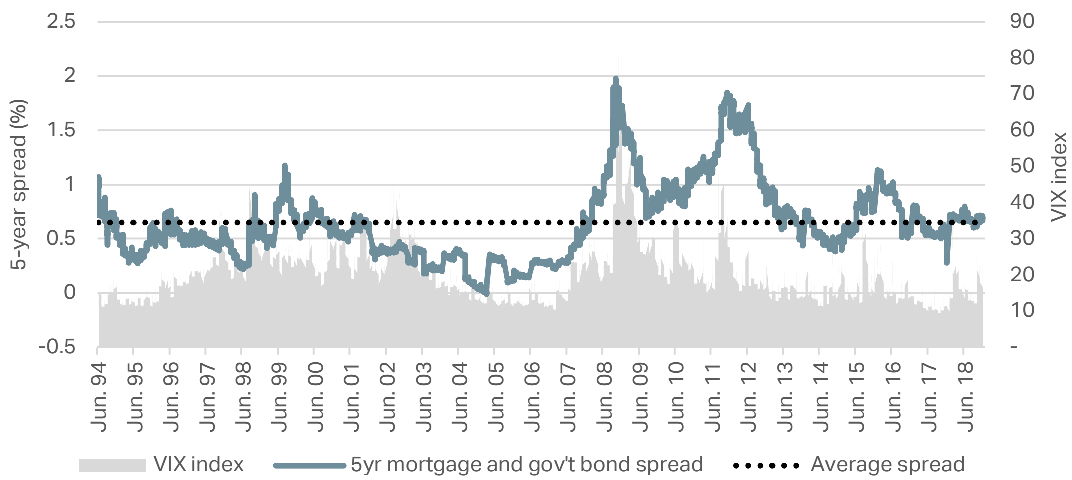


Source: Riksbank

MACROECONOMIC UNCERTAINTY COULD PUSH UP FUNDING COSTS

In addition to the impacts of changing monetary policy, macroeconomic effects, not least of which housing price volatility, could increase risk premiums for mortgage financing. Although current covered bond spreads to government debt are in line with the long-term average, spreads tend to increase during periods of economic stress (see Figure 6).

Figure 6. Swedish 5-year government and mortgage bond rate spread vs VIX index, 1994–2018



Source: Riksbank, Infront

With the Swedish economy projected to slow, unsettled housing prices and equity market volatility higher than in recent years, the downside economic risks outweigh the upside risks. For example, further volatility created by a possible hard Brexit or other external factors for the export-driven Swedish economy have the potential to push covered bond spreads apart again.

Housing prices themselves have been unsettled by new amortisation requirements, the prospect of higher interest rates and a glut of newly produced housing entering the market. A continued sustained decline in housing prices or a period of excessive volatility could lead investors to seek a higher risk premium for purchases of covered bonds. Again, in a market with a high share of short-term interest rate fixings, these increases in financing costs are likely to be passed onto customers.

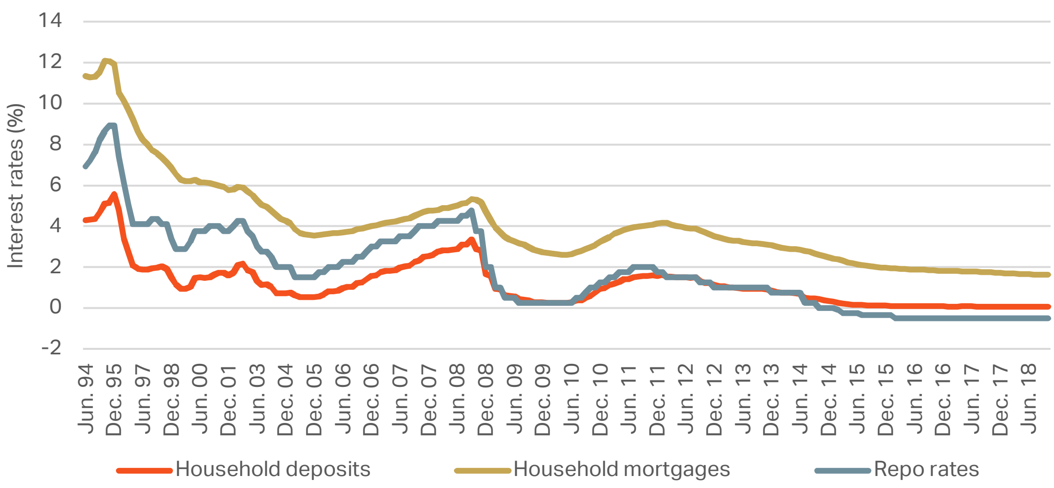
POTENTIAL COUNTERWEIGHTS ARE NOT ENOUGH

Despite market expectation of higher market rates and the potential for higher risk premiums for mortgage financing, there are factors working against a rise in mortgage rates. However, in NCR's view, they are not enough to compensate for the upward pressures described above and will be unable to prohibit a material increase in mortgage rates.

First, there are new competitors in the Swedish mortgage market as well as smaller lenders looking to take market share. These challengers have already dented traditional banks' mortgage margins, forcing floating rates on new mortgage rates down by 15 bps since the end of 2016. However, new types of challengers account for only a marginal share of the market and are typically financed by covered bonds or mortgage-related securities or funds, meaning that many of the factors associated with investors' increasing demands for yield will affect their pricing as well.

Second, higher repo rates should improve margins on deposits. The historical relationship between lending, repo and deposit rates has been affected by the lower boundary of 0.0% that has applied to core customer deposits. The repo rate is meant to be between the lending and deposit rate, but since April 2009 this has not always been the case in Sweden and since February 2012 deposit rates higher than the repo rate has been the rule. Increases in the repo rate are therefore unlikely to be met by higher deposit rates. All other things being equal, banks can maintain net interest margins without matching increases in the repo rate basis point for basis point. However, as noted above, deposits account for less than half of mortgage loan financing, and mortgage rates will need to increase to compensate for higher costs of funding to maintain overall net interest margins.

Figure 7. Household mortgage and deposit rates compared to repo rates, 1994–2018



Source: Statistics Sweden, Riksbank

Finally, a deteriorating economy could result in the Riksbank maintaining existing rates or even reducing them further. The Riksbank provides for this scenario in the 75% downside confidence band of its own bands of uncertainty (see Figure 2), but we view this scenario as highly unlikely and reflective of a material macroeconomic deterioration that is likely to increase covered bond spreads.

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