High real-estate exposure poses climate risk for Swedish and Norwegian banks

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Norwegian and Swedish banks have the highest exposure to real estate relative to total lending among European peers. While exposure to real estate through commercial lending can increase volatility in the loan book, we generally view the strong securitisation of loan assets as beneficial to the credit assessment of banks' portfolios. However, banks' real-estate exposure leads to climate risk, both in terms of physical and transition risk, as was recently highlighted in the new Pillar 3 reporting guidelines from the European Banking Authority (EBA) and other publications.

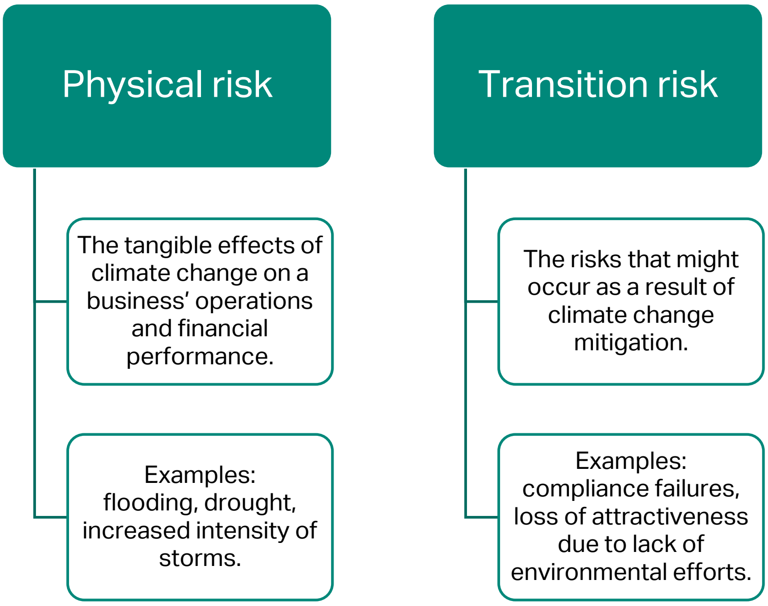
This article looks at the transition and physical risks that the Norwegian and Swedish banking sectors are facing as a result of their real-estate exposure. It examines action by regulators and the banks themselves to increase transparency about these risks and how they can be mitigated.

Nordic Credit Rating (NCR) expects banks to become more aware of the impact of climate risk on their credit portfolios and to continue integrating these risks into their credit processes in a more rigorous and systematic manner. We also expect this to become increasingly important in our assessment of credit processes. We do not, however, believe recent developments and improved reporting are likely to warrant any rating reviews for our rated issuers.

OVERVIEW OF CLIMATE RISKS FACED BY COMMERCIAL AND PRIVATE REAL ESTATE

This article focuses on financial materiality, i.e. how a company or financial institution is affected by climate risk, as opposed to impact materiality – how the operations of a company affect climate. Climate risk itself can be broadly defined under two categories: physical risk and transition risk (see Figure 1).

Figure 1. The key components of climate risk

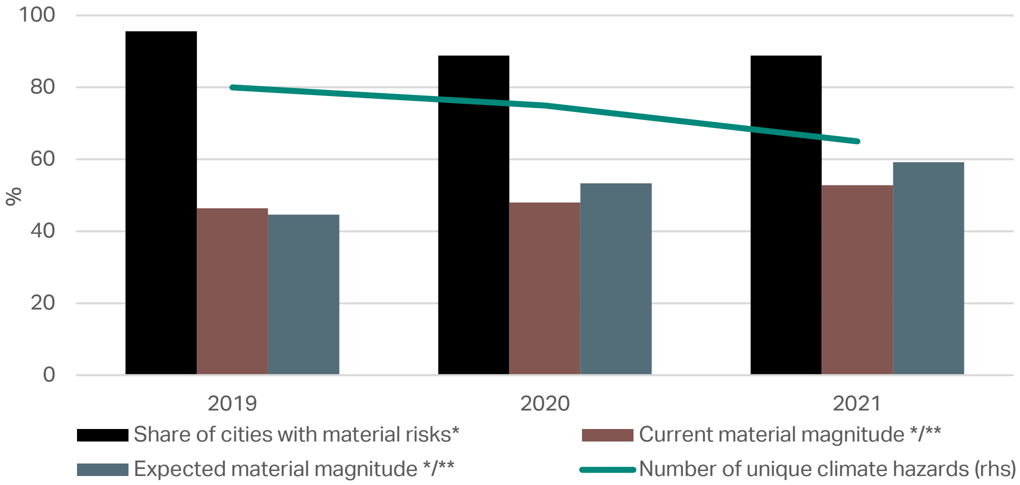


Physical risk to real estate has generally been downplayed in the Nordic region, as it is not as prone to major climate-related disasters as other regions. However, in recent years, flooding and other natural events have increased in frequency and magnitude in both Norway and Sweden, and this is generally accepted to be as a consequence of global climate change. In Norway, flooding events more than doubled between 2010 and 2020 compared with the previous decade, and some regions are prone to mudslides, including a major mudslide in 2020 in which 10 people died.

While flooding is often referred to as a risk for coastal regions due to rising sea levels, excessive rainfall can also lead to flooding and mudslides in non-coastal regions. Properties in affected areas might suffer damage, and, in the worst case, become unhabitable. Preventive measures can reduce the risk of severe damage, but require significant upfront investment. Additionally, frequent flooding or similar in a given area could reduce the value of all local properties and affect potential sale prices. In its own scenario analysis, the Norwegian Financial Supervisory Authority (FSA) estimates a price decrease of 23% for commercial real estate and 9% for housing by 2030 under a disorderly climate transition.

Transition risk covers a broader spectrum, including any risk related to the transition to a low-carbon economy, as well as adapting to a changing climate (separate from what is covered under physical risk). For example, a property manager might face increasing energy costs, the need to accommodate new requirements for a property or increased vacancies as tenants become more environmentally conscious. In addition, we note that an increasing share of market financing for Nordic real estate is classified as green, and lagging behind on this could lead to higher funding costs. These sometimes understated transition risks could compound to increase the single-name or industry-wide credit risk in banks' real-estate loan books.

Figure 2. Norwegian and Swedish cities' self-assessed climate hazard exposure, 2019–2021



Source: CDP Climate Hazard surveys. *Material classified as medium or above. **Number of responses with current or expected material magnitude, as a percentage of total responses.

Consequently, physical risk could lead to acute physical damage to properties, and both physical and transition risk could affect a property manager's financial performance in a multitude of ways. Our analysis of real-estate companies takes account of sustainability factors, including physical and transition climate risk, where relevant when assessing business risk and financial risk.

Many real-estate companies in the Nordic region are actively undertaking environmental efforts, often including environmental certification, energy efficiency improvements and screening for properties with high physical risk, and implementing measures to prevent these. However, we believe that the level of proactiveness and penetration of sustainability in business practices varies significantly between companies.

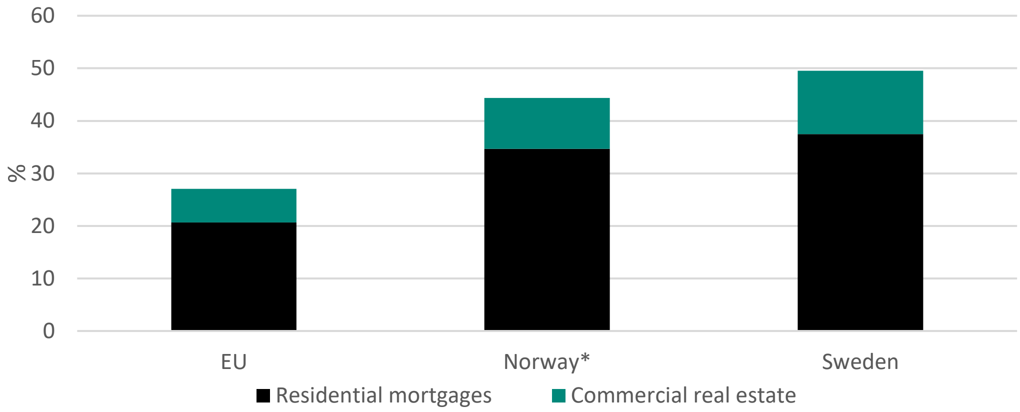
Insurance companies play a significant role in mitigating the impact of physical risk to properties. However, some insurance companies have indicated that terms could change or premiums rise as damaging events increase in frequency and magnitude. At least one major Swedish insurance company is currently refraining from insuring new construction in certain areas due to heightened physical risk, while others have noted the possibility that, in the future, recurring natural events might not be covered under standard home insurance. In Norway and many other developed countries, private insurance companies are complemented by a national disaster fund that helps cover damage from disasters, including those attributable to climate change. However, Sweden does not have such a disaster fund, which increases Swedish insurance companies' individual exposure.

CONSEQUENCES OF REAL-ESTATE EXPOSURE FOR BANKS' CLIMATE RISK

The focus by supervisory bodies and regulators on the climate risk in banks' credit portfolios has increased sharply. In November 2021, the European Central Bank (ECB) released a report on large European banks, which found that less than a third of the banks in question properly integrated climate risks into their credit processes. The ECB will conduct climate risk stress tests in the first half of 2022, focusing on targeted asset classes. While these tests are not expected to have a direct effect on capital requirements, there may be an indirect effect on Pillar 2 requirements. In addition, in January 2022 the EBA published its mandatory standards for Pillar 3 disclosures on environmental, social and governance (ESG) risks. Under these standards, banks are explicitly asked to provide information relating to physical and transition risks in their loan books, including details about real-estate exposure and collateralised property.

Both the Norwegian and Swedish FSAs have indicated that they will start evaluating whether regulated financial institutions' credit processes in their respective countries are taking climate risks sufficiently into account. In a recently published analysis, the Swedish FSA and central bank highlight that the real-estate sector poses a real climate risk to bank portfolios through transition risk, but that the lack of detailed and comparable data makes it difficult to quantify the transition risk faced by the banks.

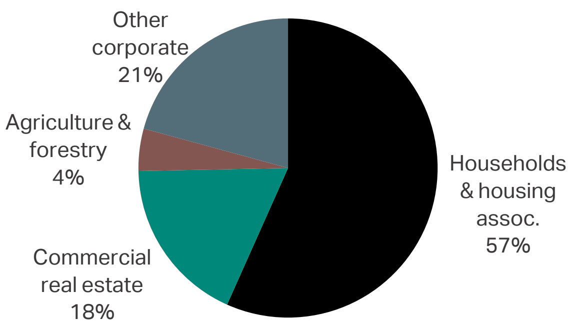
Figure 3. Aggr. banking sector real-estate exposure; share of total loan book, 31 Sep. 2021



Source: EBA Risk Dashbord Q3/2021. *Q1/2021.

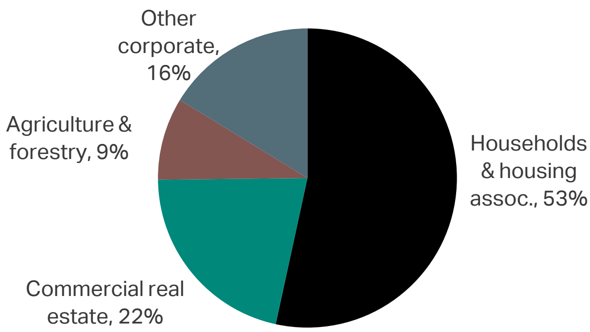
Norwegian and Swedish banks have much higher exposure to real estate than the EU average because of residential mortgages and the commercial real-estate sector. The share is even higher for savings banks in both countries.

Figure 4. Norwegian savings banks' loan exposure, 2021



Source: selected bank reports. Gross values.

Figure 5. Swedish savings banks' loan exposure, 2021



Source: selected bank reports. Gross values.

Industry organisation Finance Norway produces an annual overview of physical climate risk throughout Norway. It highlights, in particular, the importance of insurance, as Finance Norway expects that property damage will increase in the future and that this will affect loan collateral. In addition, according to the Norwegian FSA's scenario analysis, under an unorderly transition bank loan losses will increase significantly by 2100. In a 2020 report, the Swedish Central Bank recognised both the potential effect on bank collateral and, as a consequence, on the financial stability of real-estate devaluations due to an increased risk of flooding over the coming decades. In addition, local banks are conducting their own scenario analyses and mapping the current portfolio, and several have found that a certain portion of the loan book is already, or will be in the near future, at high risk of climate events, particularly excessive rainfall and flooding.

However, it is not impossible to prevent damage from physical climate events. For homeowners, this might involve ensuring there is sufficient drainage to avoid water damage from excessive rainfall, and, in the future, potentially making sure their insurance covers all events. For property managers, it is also important to have contingency plans to avoid losing rental income if a property becomes unusable for a period of time, or to make sure that insurance covers all such losses. Property managers can also mitigate transition risk by looking ahead and, for example, making energy-saving adjustments and installing better temperature regulation when making other renovations, or starting to get buildings certified so they are better positioned for financing and to compete for tenants.

These choices are rapidly becoming an integral part of sound business in the commercial real-estate segment and are therefore also something that creditors should consider in underwriting decisions. Consequently, banks need to estimate the extent to which collateral could suffer damage or lose value, and the quality of a potential client's mitigation against physical and transition risk.

The Nordic region's larger banks are all well on their way to integrating climate risk into their lending processes and assessing their exposure, at least for physical risk. Residential mortgages make up the bulk of these banks' balance sheets, and insurance companies currently cover most climate-related damage under regular home insurance, reducing the risk to the banks. Consequently, we believe it is reasonable for banks to tend to focus on commercial real estate in their climate risk integration efforts. We expect larger banks to continue to lead the way, but note that the importance of incorporating these factors in credit processes is growing rapidly, and we primarily expect the savings banks that we rate to extend their work in this area.

Both large and small regional banks in Norway and Sweden report that they apply sustainability or climate considerations in their credit processes to a varying degree. While some appear to be aware of the credit risk that can stem from climate change, for many it appears to be more a matter of taking responsibility for promoting sustainable choices among clients. The latter does not necessarily imply an awareness of the physical or transition risk for banks. We do, however, note that a dialogue between banks and clients on sustainability matters should bring the most severe climate risks to light and act as a stepping stone for banks to develop a more systematic climate risk assessment process.

NCR-RATED FINANCIAL INSTITUTIONS

Figure 6. NCR ratings on financial institutions

Issuer	Bank type	Real-estate exposure*	Long-term issuer rating	Outlook
Collector Bank AB (publ)	Niche bank	37%	BBB-	Stable
Danske Hypotek AB (publ)	Covered bond	100%	A	Stable
Kredittforeningen for Sparebanker	Savings bank	-	A-	Stable
Nordax Bank AB (publ)	Niche bank	7%	BBB	Stable
Resurs Bank AB (publ)	Niche bank	-	BBB	Stable
Sparbanken Rekarne AB (publ)	Savings bank	76%	A-	Stable
Sparbanken Västra Mälardalen	Savings bank	74%	BBB+	Stable
SpareBank 1 Østfold Akershus	Savings bank	88%**	A	Stable
Sörmlands Sparbank	Savings bank	72%	BBB+	Positive
Varbergs Sparbank AB (publ)	Savings bank	68%	A-	Stable

See NCR's company reports for details. *Net values as a percentage of total loan book at 31 Dec. 2021. **Gross value.

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