S P E E C H

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Commercial real estate and financial stability

Hello and thank you for the invitation to speak. Finansinspektionen's (FI) assignment is to promote a stable financial system and good consumer protection and to counteract financial imbalances. We have highlighted on several occasions the risks that are associated with households' high debt and taken measures (such as the amortisation requirement) to counteract financial imbalances. We have also highlighted the risks associated with the Swedish banking system being large and closely interconnected, its dependence on market funding and in turn its dependence on a high degree of confidence among depositors and investors. These continue to be important for FI, but that is not what I would like to talk about right now. Today I thought I would take a closer look at *developments in the commercial real estate sector*, which can also give rise to financial instability and major economic problems.

Historically, the commercial real estate sector in both Sweden and other countries has often played a significant role in major financial crises. The crisis in the 1990s was triggered by a fall in the price of commercial property, and most of the credit losses originated there. As everybody knows, extensive support from the state was needed to avoid a systemic crisis.

In some respects, the situation is certainly different today. Both economic policy and the financial system have undergone major changes since the 1990s. And the financial crisis in 2008–2009 did not lead to any problems on the Swedish commercial real estate market. But the crisis did not lead to any major shocks to the Swedish economy, either. Next time we might not get off so easy. The commercial real estate market is large, the banks and other financial institutions have large exposures to it, and, most importantly, the sector is heavily cyclical. It is therefore crucial that FI regularly monitor this sector, particularly given the unique situation in which we currently find ourselves, with low interest rates and high growth, that has sharply driven up property values. Before I go into FI's assessment of the commercial real estate sector (and what we are doing), I thought I would start with how the market for commercial real estate differs from the housing market.

Stability risks for commercial real estate larger than for housing

The real estate market, somewhat simplified, can be divided into two main segments: homes and commercial property. Homes can include both those that are owned by the occupants (single-family homes and tenant-owned apartments) and apartments buildings with rental units. Commercial property includes offices, retail venues, logistics, warehousing and industrial premises, etc. This category also includes special property, such as property that is used for public activities (healthcare, schools, assistance, etc.).

The market for commercial property has a direct impact on financial stability. Lending to real estate companies constitutes almost 20 per cent of the Swedish banks’ total lending and is their second-largest exposure following mortgages (see Diagram 1). Even if banks’ lending to the commercial real estate sector is smaller than lending to households (collateralised by the home), the credit risk for the banks is significantly larger. The household sector is more stable and cannot shirk its repayment responsibility. It is therefore more likely that highly leveraged households will reduce their consumption than stop paying their loans to the bank in the event of a loss of income or rising costs. Commercial property, on the other hand, is owned primarily by companies, and companies can enter into bankruptcy. The lenders then take over the problems.

In addition, the commercial real estate market tends to be much more cyclical than the housing market. People need homes, but the size of business and industrial premises is dependent on the business cycle. A sharp downturn in the economy could therefore have a major impact on rental income and companies’ performance. The fluctuations are also due to the fact that investments in and new construction of commercial property are largely based on expectations of future returns. When the economy is strong, this can result in too much construction, which can lead to supply surpluses with high levels of vacancies and falling real estate values if the expectations were wrong.

As a whole, this means that the banks have always lost more money on lending to corporates than on lending to households (see Diagram 2). For example, in the 1990s crisis, approximately two-thirds of the credit losses stemmed from the real estate sector, of which the majority came from commercial property.

The Swedish market for commercial real estate is large and booming with falling vacancy levels and rising rents

The Swedish market for commercial real estate is large, amounting to more than SEK 1,700 billion in 2016, which corresponds to approximately 40 per cent of GDP. This is a significantly higher share than in other EU countries (see Diagram 3).[1] Even the transaction volumes are high on the Swedish market, and there are a number of different investors, including pension funds, real estate funds, insurance companies, real estate companies (private and public) and private equity firms. The share of foreign investors is relatively

[1] Real Estate Indicator 2016.

large. Since 2000, international buyers on average have represented 25 per cent of the transaction volume. This means that both investors and lenders are affected by the changes in the price of commercial property.

The economy is strong and employment growth in the service sector is strong. There is high demand for premises in attractive locations, which has led to very low vacancy rates and, subsequently, rising rents (see Diagram 4).[2] Over the past few years interest rates have also fallen to exceptionally low levels, which has lowered the financing costs and yield requirements for commercial property. Despite the low yield requirements, the difference between the yield and the long-term treasury bond rate (the risk premium investors want to invest in real estate) is at an all-time high. This has meant that an increasing number of investors (in their search for yield) have increased their allocation of long-term savings in real estate.[3] Taken together, these factors have contributed to a rapid rise in the prices of commercial property. During economic booms, an upward spiral emerges in which strong growth drives asset prices, which results in more investments and in turn further strengthens growth.

However, the low interest rates and rising real estate prices have also meant that real estate companies need to borrow more. They are not only using bank loans, but also issuing more corporate bonds. From only representing a low percentage of the listed real estate companies' interest-bearing liabilities, bonds now represent approximately 15 per cent. [4] Another instrument that has become more important during the same period is preferential shares. The listed real estate companies' total (interest-bearing) liabilities increased by more than 10 per cent over the past two years.[5] Since the market values increased more than liabilities, loan-to-value ratios have gone down and are now below a historical average. However, given the relatively short interest rate adjustment period the companies have, the build-up of debt means that the real estate companies (like households) are more sensitive to interest rates than they were before. In addition, the maturity of the real estate companies' loans has decreased in recent years. This means a greater refinancing risk, i.e. the risk that the access to financing from the banks is limited when the loans fall due.

The future is bright, but what happens when the clouds roll in?

The economic conditions for real estate companies are currently very good. There are some buffers moving forward since the real estate companies'

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[2] The real estate industry assumes full resource utilisation of offices given a 3-per cent degree of vacancies.
[3] For example, real estate holdings among the largest insurance companies increased by approximately 2 percentage points of their assets in recent years.
[4] Catella CREDI, March 2017.
[5] During the same period of time, the lending of the major banks for commercial real estate purposes only increased by 4.5 per cent.

earnings and payment capacity are strong. The average interest rate coverage ratio, which shows the companies' income in relation to their interest rate expenses, is currently at around a multiple of three. This means that their income is three times larger than their interest rate expenses, which can be viewed as solid. At the same time, interest rates are historically low and debt levels are high. The interest rate coverage ratio can therefore quickly deteriorate if interest rates rise.

Low interest rates and a stable economy also make many agents less risk-averse in their search for yield. Demand for property is high, and the Swedish real estate market is also attracting a growing number of international investors. At the same time, new construction is increasing rapidly. However, this new construction consists mainly of residential property; construction of new commercial property is demonstrating minimal growth (see Diagram 5). More tenant-owned apartments are being built now than during the period of high levels of construction that resulted in the real estate crisis at the beginning of the 1990s (see Diagram 6).

This unique macroeconomic situation in which Sweden finds itself today has made property an increasingly attractive investment. A strong economy and increased demand have together contributed to the very strong growth in real estate prices. This means that risks are accruing that may be triggered by a rapid change in the economic conditions.

It is difficult to predict what will happen with the economy, but one thing we can all be sure of is that today's unique situation will not last forever. When economic growth ends at some point in the future, there is a risk that we instead will see a downward spiral. It can start with less demand for property, higher vacancies and lower rental income as rental contracts are renegotiated, which means deteriorating cash flow and reduced capacity for repaying loans. These factors normally lead to lower real estate prices. The interest rate dynamics also play an important role here; for households, interest rates often tend to go down during an economic downturn[6], which means that it is easier for households to repay their loans. For companies, however, the dynamics can be different. Even if falling rental income to some extent means cheaper borrowing (due to lower interest rates), companies' interest rate expenses are not adjusted downward to the same extent. This is because companies often have higher credit risk premiums in an economic downturn and bankruptcy risks increase. In addition, the companies' dependence on financing also constitutes a risk. This can mean that during an economic downturn the companies not only have higher interest rates (together with lower rental income) but also reduced access to loans since the banks become less willing to lend equally large volumes. Today's low interest rate levels also mean that there is limited room for lowering the interest rate to boost a struggling

[6] Given today's low interest rates, it is not probable that households' interest rates will be lowered much more in the event of an economic downturn.

economy. In a worst-case scenario, the real estate sector could sustain pressure from a combination of rising vacancies, falling rental income and rising interest rate expenses, and can thus find it difficult to meet its commitments to the banks. It is therefore important to have buffers in the real estate sector since conditions can change quickly. The combination of very low interest rates and strong economic growth creates in part a new risk profile for the commercial real estate companies and their lenders.

What has FI done?

The real estate sector is more robust today than what we saw, for example, at the beginning of the 1990s, and the economic policy in place is different. A number of banks have also become more restrictive in their lending to real estate companies in the past year. The banks' assessments of companies' creditworthiness focus on cash flows and repayment capacity instead of the market value of the companies' property, which was one of the more important lessons learned from the crisis in the 1990s. The risks of large credit losses for banks therefore appears to be lower than back then.

But there are still risks, and FI will place more focus on the risks associated with the commercial real estate market going forward. At the same time, we have already taken a number of measures to manage the risks to our financial system created by the commercial real estate sector.

The current capital adequacy regulations for banks are largely risk-based. This means that the higher the risk of an asset, the more capital a bank must hold. Risk-based capital requirements are an important contributor to good risk management and therefore are beneficial for both financial stability and the manner in which the financial markets function. If the banks' risk weights are too low in relation to the underlying risks, the capital requirements could lose relevance and the banking system's resilience to disruptions could become too low.

In May 2016, FI tightened the banks' calculations of the risk weights for non-financial corporates, which creates larger capital buffers if problems were to occur as a result of lending to real estate companies.[7] The risk weights for lending to non-financial corporates had gone down too much over time (see Diagram 7). Even if a part of this reduction was due to improved credit assessments and risk management by the banks, we found in the supervision that the risk weights in certain cases had fallen more than what could be explained by an actual reduction in the risk level. To ensure that the models were better at predicting actual risks, we clarified our expectations regarding the model assumptions used by the banks. In more simplified terms, this means

[7] See FI's memoranda, *FI:s tillsyn över bankernas beräkningar av riskvikter för företagsexponeringar* and *Kapitalkrav för löptidsantaganden inom pelare 2*, published in May 2016. English versions of the translations are available on FI's website.

that the banks are to assume that every fifth year was a “downturn year”. FI also clarified that the banks are expected to use conservative assumptions during these downturn years, for example with regard to how many companies do not repay their loans.

FI made the assessment that none of the major banks could show that they fully met the new requirements and therefore introduced additional Pillar 2 requirements until the banks are able to do so. The banks are now changing their models to meet the new limitations that FI introduced. As the banks gradually change their models, the risk weights will rise (see Diagram 7).

FI also introduced a maturity floor of 2.5 years under Pillar 2 for banks authorised to use the advanced IRB approach. This is another example of how FI, based on a broad risk perspective that also takes systemic risks into account, has introduced limitations to the banks’ internal models.

FI is naturally also continuing with the very fundamental aspect of its assessment of the banks’ credit risks, namely the ongoing supervision of the banks’ risk management, which analyses how the banks measure, assess and review their own risks.

Conclusion

In summary, FI makes the assessment that the risks in the commercial real estate market may be elevated. Over the past few years we have observed rising prices for both commercial and residential properties. We are also facing a unique combination of very low interest rates and strong growth, private consumption in particular, which generates high demand for business premises. However, it is important to be aware that the conditions the market is facing now can change quickly. The fact that the risk-free interest rates have gone down more than the yield requirements may be an indication that the real estate companies to some extent have taken this into consideration.

At the same time, the earnings and repayment capacity of real estate companies are good, and real estate companies have relatively low loan-to-value ratios despite the increase in debt. Banks have also changed their credit assessments compared to before the crisis of the 1990s, and these assessments are now to a greater extent based on the companies’ cash flows. Some banks have also reported that they have become more restrictive when lending to real estate companies.

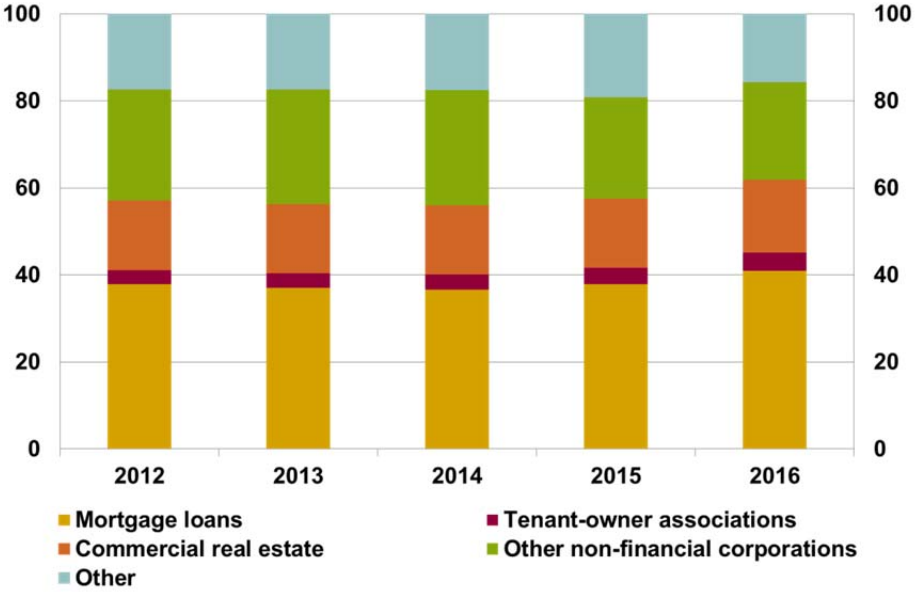
We currently make the assessment that the real estate sector is not a major threat to the stability of the financial system, but we have noted that risks are building up in the sector, which means that FI must be observant. We have increased our focus on this market and are monitoring its developments carefully in our ongoing supervision to identify any changes that could result in greater risks for financial stability.

With regard to households, FI makes the assessment that the macroeconomic risks associated with high debt continue to be elevated. Both house prices and household debt have been rising for a long time. The amortisation requirement has had somewhat of a slow-down effect on new mortgagors, but the unique macroeconomic situation combined with high household debt continue to be a vulnerability.

Diagrams

Diagram 1: Distribution of the major banks' credit portfolios

(Per cent)

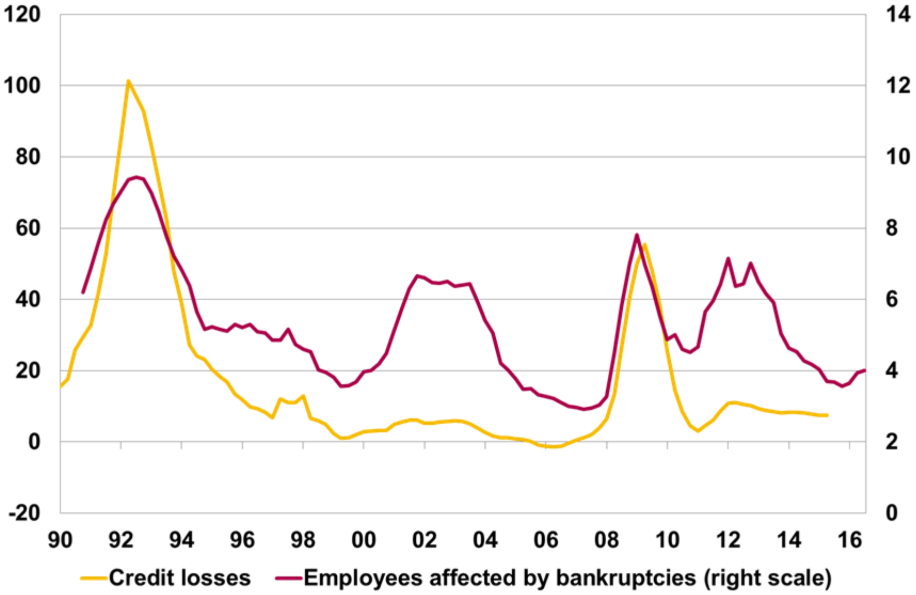


Note: Lending to tenant-owner associations is slightly underestimated since Nordea does not list tenant-owner associations separately in its credit portfolio.

Source: The banks' fact books.

Diagram 2: Credit losses and the number of employees affected by bankruptcies

(SEK billion and thousands, respectively)

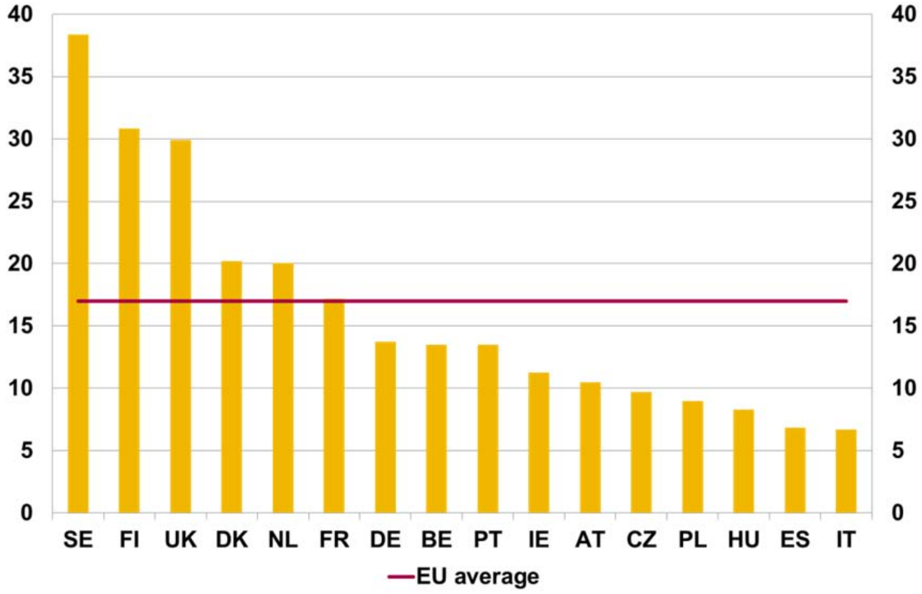


Note: Number of employees affected by bankruptcy refers only to limited liability companies. To even out the series, the diagram shows a four-quarter moving average.

Source: Statistics Sweden and UC.

Diagram 3: Estimated size of the commercial real estate market in EU countries

(Share of GDP in 2015)

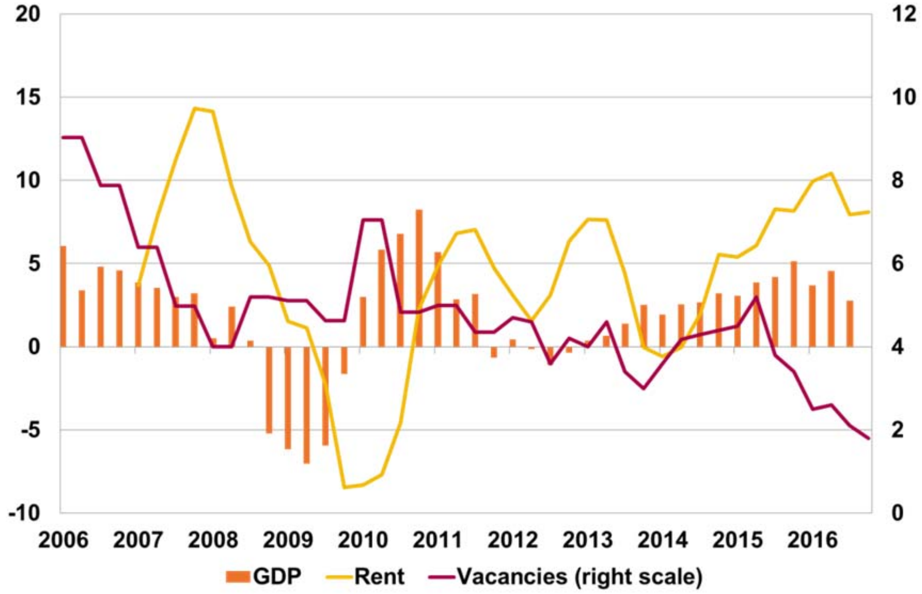


Note: The market's size is calculated by estimating the value of the commercial real estate market that is owned by professional real estate investors. The data is taken from "Real Estate Market Size 2015 - Annual Update on the Scale of the Professionally Managed Global Real Estate Investment Market" written by Teuben, B., McElreath, B., and Hariharan G.. G MSCI research report, June 2016.

Source: Morgan Stanley Capital International (MSCI).

Diagram 4: Office rental growth and degree of vacancies in Stockholm CBD together with GDP growth

(Annual change in per cent and per cent)



Note: CBD refers to "Central Business District".

Source: Strateg and Statistics Sweden.

Diagram 5: Granted building permission

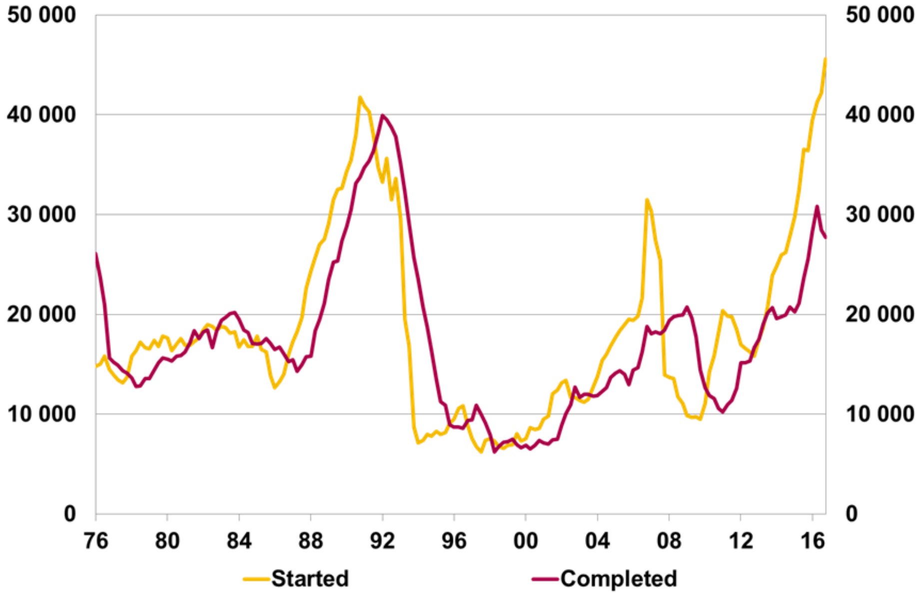
(Thousands of sqm)

Note: Commercial real estate includes offices, stores, hotels, restaurants, industrial property and warehouses.

Source: Statistics Sweden.

Diagram 6: Apartments in apartment buildings

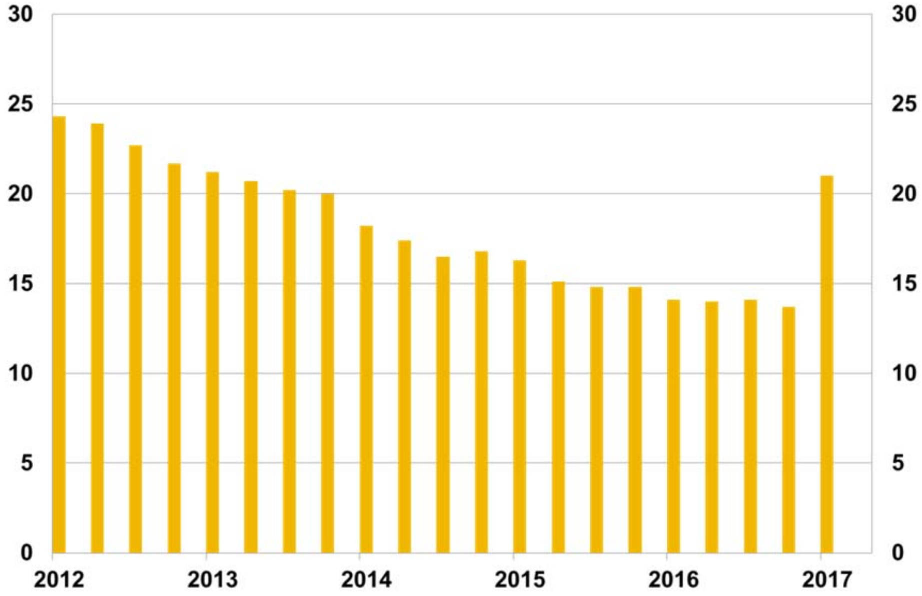
(Number)



Source: Statistics Sweden.

Diagram 7: Average risk weights for lending to real estate companies

(Per cent)



Source: Handelsbanken Fact Books 2013-2017.