Talreferat

FINANSINSPEKTIONEN

FI dnr 22-1364

Finansinspektionen
Box 7821
103 97 Stockholm
Tel +46 8 408 980 00
finansinspektionen@fi.se
www.fi.se

Commercial real estate debt, non-banks, and the stability of the financial system

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Speaker: Karin Lundberg, Executive Director Banking
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Lending to commercial real estate companies and financial stability

The current macro-economic environment, characterised by high inflation, rising interest rates, and concerns about an economic downturn, presents challenges in one way or another for virtually every part of society. Among those particularly affected are households and commercial real estate companies.

Vulnerabilities have been building up in the financial system over a number of years. We are now in a situation where these may start to materialise. Finansinspektionen has employed a number of structural measures from our toolbox, with chiefly two aims: (1) to dampen the build-up of risks, and (2) to increase the resilience among banks as well as households. (An example of the former would be the amortisation requirements for residential mortgages. An example of the latter would be the higher capital requirement for bank lending to the commercial real estate sector.) Thanks to such measures, the impact of the ongoing macro-economic adjustment on the Swedish economy and on financial stability will be smaller than it would otherwise be.

There is a silver lining to the high-interest macro environment. The build-up of risks in the economy was fuelled by extremely low interest rates and extremely low risk premia, for an extended period of time. In the longer

term, a return of interest rates and risk premia to more normal levels, combined with our measures, makes it possible to dampen or reverse the excessive levels of risk taking that we have seen in recent years. This is intrinsically good for financial stability.

However, in the short and medium term, this transition may prove to be a rocky road, not least for CRE companies. The rising interest rates are arguably the biggest threat to the CRE sector at the moment. Its companies are highly indebted. We have warned about the high leverage for several years, during which the sector's leverage has continued to rise unabated – nominally, as a percentage of GDP, and in relation to operating cash flows. Much of this increase has come in the form of market financing.

On the surface, the starting point actually seems quite favourable. Looking at the sector as a whole, cash flows from the real estate business are strong and the capacity to bear higher financing costs right now is relatively good. But we are entering a period of slower growth or even a recession. A not unlikely scenario is one where this translates into lower demand for premises, higher vacancies and lower market rents, while financing costs remain high. If you add on top of that the possibility of structural changes to demand (from, say, more people working from home), and significant parts of the CRE sector would probably find themselves squeezed.

In other words, a new time of reckoning may be coming, when the resilience of the sector's companies will be tested. Financing costs for CRE companies have gradually become more expensive during the year (even if the last few weeks have seen occasional periods where yields on traded debt securities have gone down).

Granted, much of the debt is still on fixed interest rates and spreads, and there is a degree of interest rate hedging providing protection for the time being. But over time, as debts and hedges mature and there is a need for refinancing, it will have a very tangible effect on company Profit & Loss statements. Exactly how big that effect will be and exactly how quickly it will feed through is perhaps more difficult to say, but we do know that roughly 15 per cent of the debt of the large listed companies will mature within one year, with roughly another 15 per cent maturing in 1-2 years.

In our latest financial stability report we assessed the CRE companies' vulnerability due to high debt levels to be high and rising. We have performed stress tests where we look at the sensitivity of CRE companies to

changes in Net Operating Income and interest rates. In the latest test from 2021, we found that the share of bank loans to CRE firms with elevated credit risk would rise from below 9 per cent to more than 23 per cent if there were a shift in interest rates of 3 percentage points. Now, this calculation does not take into account that the impact would be gradual due to interest rate hedging, but it gives an idea of the magnitude when the effect has fed through. In comparison, the test indicated that a Net Operating Income drop of 25 per cent would have a much smaller impact on the CRE companies.

For larger Swedish CRE companies, the debt capital market has been a relatively cheap source of financing for the last eight years or so. At present, that is no longer the case, so companies are turning away from the debt market due to pricing.

Moreover, the Swedish corporate debt market does not always function optimally, making it susceptible to disturbances in times of heightened financial uncertainty. Indeed, the market for CRE corporate debt has exhibited several periods of low liquidity in recent years, when companies have found it challenging to issue new debt securities. This pattern has continued during 2022. Therefore, Finansinspektionen assesses that the refinancing risk of commercial real estate firms is higher than at the beginning of the year.

CRE companies' increased reliance on market debt in recent years represents a growing flowback risk for the banks. When the primary market for commercial paper and bonds is unattractive or illiquid, companies will turn to the banks. CRE companies with maturing market debt have credit facilities they can draw on to some extent, and the banks also have the capacity to further increase the credit supply for relationship clients. However, it is uncertain to what extent they would be willing to do this, especially for new clients. The situation is indeed a delicate one. If banks were forthcoming with credit in such a situation, distressed selling of assets could potentially be limited and the necessary adjustment process in the market could be smoother as a result. On the other hand, such "bridge financing" would obviously mean even more risk taking on part of the banks.

Moreover, banks already have a very large exposure to the CRE sector. In terms of risks to the stability of the Swedish banking sector and the Swedish financial system in general, the credit risk in the banks' existing and

potentially increasing CRE exposures is Finansinspektionen's prime concern.

These risks would rise further if financing costs were to increase more steeply and/or for a longer period of time, and it is plausible that credit losses could rise in such a scenario. It is therefore important for financial stability that the banks are well-capitalised, and that is why Finansinspektionen raised the capital and buffer requirements for the banks a few years ago.

In summary, the financial stability risks in the short and medium term continue to be elevated and have even increased slightly over the summer. Right now, banks generally have good asset quality in their credit portfolios and credit losses are low. But now the resilience of households and commercial real estate companies is being tested, and risks may start to materialise.

Non-bank financing

The increasing share of market financing among commercial real estate companies and the functioning of that market is a good illustration of my next topic for today. Which is:

What could be the consequences for financial stability if the credit supply of Swedish companies were to depend on market financing to a significantly larger extent than today?

The topic warrants attention from regulators and market players alike. As for Finansinspektionen, our analysis is ongoing. But today I want to highlight a few factors that we think would influence whether more market financing would be positive or negative for financial stability.

In recent years, we have seen an increasing number of initiatives, driven both by lenders and borrowers, moving credit risk from the banks' balance sheets to other types of market players. Indeed, this is what happens when borrowers replace bank debt by issuing bonds. But in many cases, it is the lenders that are driving these initiatives, for example through securitisations. After a cool-down during the pandemic, the number of initiatives within this area is now taking off again.

The European Commission works continuously to improve the functioning of the internal market, also within the credit area. Recent examples of new

regulation that aim to achieve this are found within in the areas of securitisations and Alternative Investment Funds.

The bond market in Sweden has been growing over the last years and is now clearly important for financial stability. Other types of market-based financing have also become more common, such as securitisations and Alternative Investment Funds investing in credit assets, both corporate and retail. So far, those types have moderate asset volumes and are currently not systemically important. However, if the transition from bank financing to market financing continues, this will probably be one of the most important financial stability topics that we need to address, as a regulator and supervisor. Under what circumstances can an increased share of market-based lending contribute positively to financial stability? In other words, what are the risks that we need to address, in order for this development to have a positive rather than a negative impact on financial stability?

Before deciding on a policy stance, we need to ask ourselves: What is the purpose of regulation in the first place? If the purpose is simply to protect depositors' money and prevent bank runs, it should – from a stability perspective – be enough to regulate only banks and credit institutions. But if the purpose is also to stabilize the credit supply, it is probably not enough to regulate only banks. In this case, the requirement to implement stabilizing features into their fundamental set-up would have to apply to other categories of players as well.

The functioning of the corporate bond market in Sweden is essential for achieving a stable credit supply. In the last few years, we have been discussing how we can promote better liquidity in the Swedish bond market also during periods of stress. Among other things, we have talked about the need for good liquidity management in investment funds investing in corporate bonds, and we have proposed the introduction of a corporate bond benchmark standard in Sweden.

Today however, I want to focus on a different, still small but growing, part of the nonbank-based credit market in Sweden: Namely when non-banks issue or invest in credit, both retail and corporate. This can be done in any number of ways: securitisations (traditional or synthetic), investment funds that acquire credit portfolios or even originate loans themselves, and financial institutions investing in corporate credits. These types of initiatives allow credits to households and to small and medium sized enterprises to be

financed or risk-covered by non-banks, whereas the bond market can only be accessed by larger corporates.

As you probably recognize, this topic is not new. Finansinspektionen has had reasons to discuss different initiatives within this area several times during the last few years. On several points we have clarified our stance publicly, after careful consideration in each case:

- Preconditions for a well-functioning mortgage fund market (2019)[1]
- Pillar 2 methodology for securitisations (2017, updated 2021)[2]
- Legal opinion on the definition of deposits from the public (2021)[3]

Many of the types of entities and instruments that I have mentioned are connected to or initiated by banks in some way or another, although this is not necessarily the case. Therefore, two basic concepts related to banks lie at the heart of our analyses: step-in risk and flowback risk.

Step-in risk is the risk that a bank considers itself compelled to “step in” to provide financial support to an entity despite having no legal obligation to do so. For example, an entity could be connected to a bank (formally or informally), but not consolidated. If such an entity were to experience difficulties or failure, the bank might deem it necessary to step in, in order to avoid or limit reputational damage to the bank itself.

Finansinspektionen defines flow-back risk as the risk that a bank will bring a loan back onto its own balance sheet during periods of stress, although it has no legal obligation to do so. For example, a bank may do this in order to protect itself from losses on other exposures to the same borrower that it has on its balance sheet; or it may do it to preserve a good relationship with that borrower.

In the memorandum where we lay down the preconditions for a well-functioning mortgage fund market, we point to the advantages that non-bank-based funding for retail mortgages could bring for financial stability. The credit supply could be made less dependent on a small number of systemically important banks. If credit and financing risks can be allocated

[1] FI’s memorandum ”FI’s View on Preconditions for Mortgage-Based Business Activities”, published 25 January 2019.
[2] FI’s memorandum ”Updated Pillar 2 method for assessing flowback risk associated with securitisation”, published 13 July 2021.
[3] FI’s statement ”Ställningstagande: Obligationsfinansierad kreditgivning”, published 18 February 2021.

to a larger number of professional and long-term players, for example life insurers, the ability to absorb losses could improve, the liquidity risks could decrease, and the overall resilience of the system could therefore improve. To some extent, decoupling mortgage financing from other activities in systemically important banks could also lead to lower contagion risk in the system. The same line of reasoning is valid also for other types of credit, besides retail mortgages. For example, a more diversified market for corporate credit – not least for CRE companies – could be beneficial for financial stability.

But in the same memo we also underline that if these benefits are to be realised, the set-up must be done right. If it is not, the stability risks could actually increase. The step-in risks and flow-back risks for the banking system must be contained. This means that new vehicles must be set up in a way that minimizes the actual and perceived connections to any banks involved, and therefore the reputational risk to those banks. Reputational risk here pertains to the reputation among both investors and borrowers.

In the memorandum we also state that for mortgage funds, the maturity of the fund shares must be no less than ten years. This is meant to limit the re-financing risk of the fund to an acceptable level and ensure that the investors are long-term. Finally, we gave a legal opinion that said, simply explained, that consolidation into the banking group would be required if a mortgage fund were owned by a bank. If an entity is consolidated, it is subject to full capital and liquidity requirements at the group level.

In 2017, we introduced a Pillar 2 capital assessment methodology for flow-back risk stemming from securitisations. Securitisations can be difficult to refinance, for example when the market is unstable, or when investor demand is weak. Empirical evidence indicates that the Swedish credit capital market does not yet have sufficient depth to be fully resilient in stressed times. When credits can no longer be financed via securitisation, and the borrower has a financing need, exposures can flow back to the bank's balance sheet – for the various reasons that I mentioned before. As a consequence, there can be a sudden deterioration in the bank's capital ratios, since the loans that flow back require capital. To contain this flow-back risk to a manageable level, Finansinspektionen requires banks to keep Pillar 2 capital for flow-back risks stemming from securitisations above certain levels. This allows the use of securitisations as a complementary risk and capital planning tool for banks. But at the same time, it limits the potential

capital release from those securitisations to a level where the potential flow-back does not pose too large a risk for financial stability.

The third publication I wanted to bring to your attention is a legal opinion that Finansinspektionen issued last year. It is a legal opinion on the definition on deposits from the public, which is fundamental for whether or not a company is required to be licensed as a credit institution. As you understand, it is extremely important to get this right. First and foremost, as a credit institution you are required to comply with the capital and liquidity requirements. But not only that. My Danish colleagues recently did the numbers and concluded that EU regulations of approximately 15,000 pages kick in when you are licenced as a credit institution or bank. In the legal opinion that Finansinspektionen issued, we clarified that bonds issued in order to finance lending are to be considered as deposits and if these bonds are ever owned or can be owned by members of the general public, in other words if the securities are freely transferrable, it is considered taking deposits from the public.

This opinion did not make much of a splash, most likely because it did not change a lot in the Swedish market in its current structure. A few financial institutions made some adjustments in their bond issuance practices that made sure that the securities can never be owned by members of the general public, and that was it.

But the reason I wanted to point your attention to this is that it is important to avoid uncertainty when it comes to such a fundamental question as whether or not an entity is a credit institution and has to comply with 15,000 pages of rules. It may not be a very large issue today, but it could quickly become one if the rules are not clear.

The European Banking Authority issued an opinion on a related topic in 2020 in which they pointed to several interpretation difficulties and urged the European Commission to clarify the notion of ‘credit institution’ set out in EU law. I would like to repeat this request. It simply does not make sense to harmonise banking regulation down to the last detail if you do not agree on which entities the regulation should apply to.

The same goes for the issue of consolidation. The directive on alternative investment funds is now being reviewed. This is a positive and it will harmonise and clarify the playing field. But under which conditions an Alternative Investment Fund is required to be consolidated into a banking

group and thereby by subject to capital requirements on group level is still not harmonised. This makes a huge difference for the business case, as everyone understands. And if the volumes in these funds become significant, it could also make a huge difference for financial stability.

To sum up: a credit supply that is less dependent on the banking system, where financing and credit risk taking are provided by a larger set of market players, can contribute positively to the stability of the financial system. Especially if these market players are long-term and prepared to absorb credit losses during a down-turn. However, if these new credit vehicles are only independent of the banking system on the surface but are in practice very much a part of the banking system, and if that exposes the banking system to significant step-in and flow-back risks, then such a development could in fact increase stability risks. Then we could end up in a situation where banks appear to have reduced their risk exposures and may choose to carry significantly less loss-absorbing capital, but in reality still face a similar exposure as today. The risk exposures are then only dressed in different clothing.