Swedish banks: brighter prospects as housing crash fears recede

Sweden is emerging as a bright spot in European banking. In recent weeks, Scope has upgraded its issuer ratings on Swedbank and Svenska Handelsbanken and maintained its high rating on Nordea. As fears of a housing crash recede, prospects look brighter.

Scope's recent rating actions on Swedish banks are noteworthy, as the credit positives deriving from the banks' business profiles and forward prospects outweigh concerns about a hard landing in the country's over-heated housing market, which Scope considers unlikely.

Swedbank's Issuer Rating was upgraded on 24 May by one notch [to A+ Stable]; as was Svenska Handelsbanken's [AA- Stable]. In its 24 March rating update on Nordea, the Issuer Rating was maintained at AA-Stable.

Sweden's major banks are very profitable and returns and efficiency ratios are among the strongest in Europe. The banks currently enjoy very low credit costs. "While we do not necessarily expect the cost of risk to remain so favourable, the banks appear well positioned to deal with the normalisation of the credit cycle and higher resulting credit costs," said Jennifer Ray, executive director in the banks team at Scope Ratings.

The large Swedish banks currently maintain good access to senior unsecured funding and other market segments, particularly covered bonds. They also have robust liquidity reserves. But like other European banks, they are nominally exposed to a shift in wholesale market funding conditions and this remains a (somewhat latent) concern if the market suffers sustained credit-spread widening and constricted access windows.

Swedish banks' capital ratios are higher than those of most European peers. That will probably remain the case even after calculation changes proposed by the Swedish regulator. Because of proposed changes to the way mortgage risk-weight floors are calibrated, headline capital ratios will fall. Swedish mortgages are currently accounted for under Pillar 2 (guidance) but from 1 January 2019, it is expected that calculation will shift to a Pillar 1 (formal) requirement under the framework of Article 458 of the Capital Requirements Regulation. As risk-weights go up, reported capital ratios will go down.

"Regulatory adjustments that will reduce the headline capital ratios of Swedish banks are purely technical in nature, however, and reflect no change to the solvency position of the banks," said Ray. "They will be expected to maintain a similar level of nominal capital against the same basket of risks."

From the perspective of filling subordinated debt bail-in buffers, it is worth noting that Nordea issued Sweden's first senior non-preferred bond in mid-June 2018 – a EUR 1bn five-year issue that attracted heavy investor demand. Swedish SNP implementation is in process (scheduled to be applied from 29 December 2018) but Nordea pressed ahead using contractual format.

Table 1: Swedish Big Four Q1 2018

	Handelsbanken	Nordea Bank	SE-Banken	Swedbank
ROE	11.70%	10.00%	11.60%	15.40%
Cost/income ratio	48.60%	52.00%	50.00%	39.00%
CET1 ratio	21.60%	19.80%	19.00%	24.80%

Source: Bank reports

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Housing crash fears recede

There had been real concerns about the impact of a collapse in the Swedish housing market on the banks as recently as last year. Bearing in mind the bull market has continued for around two decades – price appreciation even continued during the financial crisis – there had been some anxiety about the part the banks were playing in perpetuating the cycle, with memories of Sweden's banking crisis of the 1990s still lingering.

Any direct comparisons are misplaced, however. Commercial property lay at the heart of the problem then, and a host of very specific circumstances played into that situation. The focus today is residential property, which introduces a different debt-service dynamic; home-owners will typically go to great lengths to remain current on mortgage payments.

"Although potential for further pricing weakness remains, we've taken a more measured view on the housing market, on the basis that a whole host of structural factors have supported the boom. We came to the view that while the major banks have been expanding their property portfolios, this has been against a backdrop of a growing economy and a rise in household wealth," said Ray.

Property prices have levelled out since last autumn, partially on the back a residential construction boom. Meanwhile, concerns by the Swedish regulator about high levels of household debt need to be viewed through the lens of affordability: in the context of low and negative interest rates, the average Swedish borrower is paying a mortgage rate in the region of just 1.5% to 2% and the banks stress-tests their customers to much higher levels.

"The worst thing that could happen is a sudden sharp in rise in interest rates that would hurt affordability and make it more difficult for households to service their debt. That would also affect some of the property companies to which banks may be exposed. However, we sense the larger banks have become more cautious over time and are certainly more focused on cashflow and valuations in making lending decisions," Ray said.

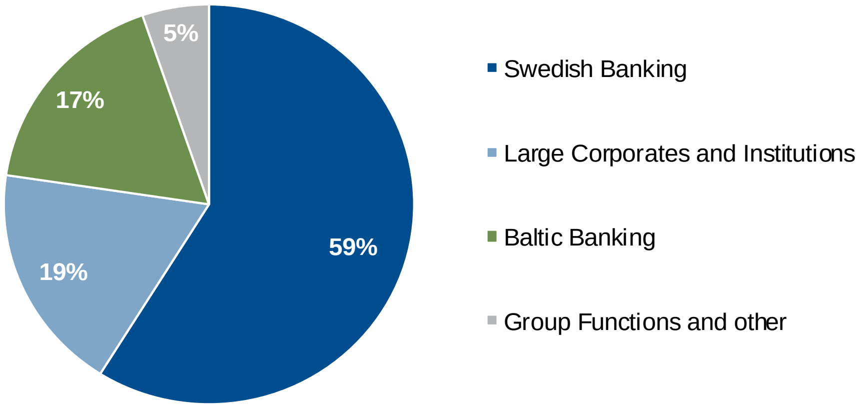
Swedbank

Swedbank's upgrade was predicated on its solid market position in Sweden, the much-improved performance of its foreign activities since the financial crisis, cost discipline, and a strong digital offering. Against a more stable housing backdrop, Scope is more reassured that Swedbank's strong credit fundamentals are likely to hold up.

"Swedbank's underlying efficiency ratio has been sub-40% in the past two years, although significant digital investments may push that number up. Swedbank's bank's digital investment plans are expensive but it's precisely because the bank is efficient and profitable that management can afford to commit investment," said Ray.

Swedbank has 10% of its loan book and generates 20% of its pre-tax profits from the Baltic countries. During the financial crisis, this exposure created some significant problems, but management has reduced its risk profile since then. Nordea and DNB pooled their operations in the Baltics in 2016 under the Luminor Bank brand to create a more competitive offering but Swedbank is still dominant in those markets.

Figure 1: Swedbank: revenues split by division (2017)



Source: Company data, Scope Ratings

Nordea

Scope's ratings on Nordea Bank are driven by the bank's long track record of strong operating profitability, low levels of non-performing assets and credit losses, and geographic diversification, which cushion it from localised downturns in the countries where it operates.

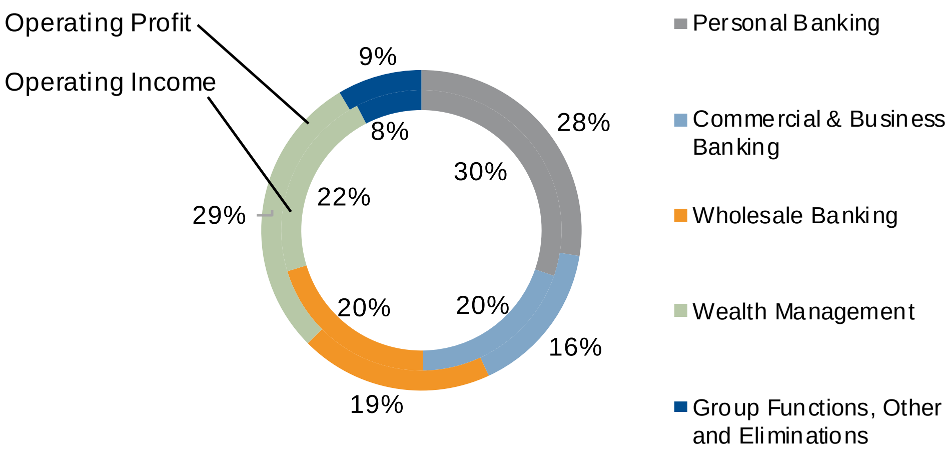
Nordea's forthcoming HQ shift from Stockholm to Helsinki is likely to be a one-off. "I don't see other Swedish banks deciding to do that. It clearly suits Nordea to be primarily supervised by ECB under the construct of the Banking Union. There were suggestions that the bank may have opted for the move seeking softer capital requirements. But it is by no means clear either that they were trying to do this or that the capital burden will in fact be reduced," said Ray.

The ECB is engaging in a very detailed examination of Nordea's portfolio and the group's capital requirements will be decided on this basis. "There are elements of bank capital requirements in Sweden that won't occur under ECB regulation. But Nordea is committed to having Double A type ratings, so it cannot hand back a huge chunk of capital and report what the market will see as weaker capital ratios."

One of the challenges facing Nordea – along with other European banks – is low interest rates, which have squeezed net interest margins; while inexpensive funding and competition continue to erode its return on assets. Like Swedbank, the group's results have also been affected by the front-loading of costs associated with its digital transformation programme. Nonetheless, the bank's efficiency ratios remain strong compared to many international peers.

Nordea operates a large-scale Swedish domestic operation but (largely because of its well-balanced international business model) is not as exposed as some of its peers to any downturn in the property market. Its customer footprint is more geared to corporate customers than that of other Swedish banks, although it has a diversified business profile. This includes the biggest asset management operation in the Nordic region, which is delivering strong results. Scope expects this division will continue to support revenues.

Figure 2: Nordea: divisional operating income and operating profit split (2017)



Source: Company data, Scope Ratings

Handelsbanken

Svenska Handelsbanken's upgrade reflects the bank's solid and well-diversified market position in Sweden, the healthy nature of its foreign activities and solid risk management. Scope expects Handelsbanken to preserve and strengthen its reassuring financial and prudential metrics.

Handelsbanken has not had a quarterly loss since 1992. The bank has taken a cautious approach to credit underpinned by a decentralised branch-oriented operating culture. Apparent attempts to alter its tried and tested *modus operandi* under the tenure of Frank Vang-Jensen (appointed president and group CEO in February 2015) lasted just 18 months before he was replaced by current CEO Anders Bouvin, who restored the status quo.

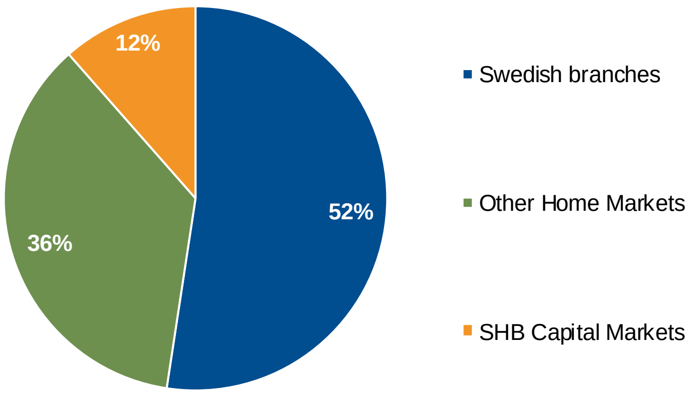
While the group is broadly domestically focused, Handelsbanken's expanding international branch network has pushed up the proportion of pre-tax profits from non-domestic operations. From a credit perspective, international operations provide useful diversification and act as a hedge against a potential downturn at home.

Overseas, Handelsbanken has a strategy of targeting high-end private customers and small businesses in mature markets – specifically the UK and the Netherlands – where it competes on customer service. The bank has 208 branches in the UK and has had some success in attracting custom away from UK banks.

Handelsbanken's GBP 50m loss on the collapse of UK facilities management and services company Carillion (the bank was an arranger on the company's GBP 790m revolving credit facility signed in November 2015) was untypical and certainly not representative of its conservative approach.

A key development in the UK is the setting up of a UK subsidiary to facilitate business continuity post-Brexit. Handelsbanken will not hit the level at which ring-fencing will capture its UK business but the UK subsidiary will likely satisfy the PRA, especially as the bank has sizable retail operations and GBP 13.2bn in deposits at the end of Q1 2018.

Figure 3: Handelsbanken: revenues split by division (2017)



Source: Company data, Scope Ratings

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