Swedish banking outlook

Strong recent earnings leave banks well placed to cope with volume, costs and provisioning pressures

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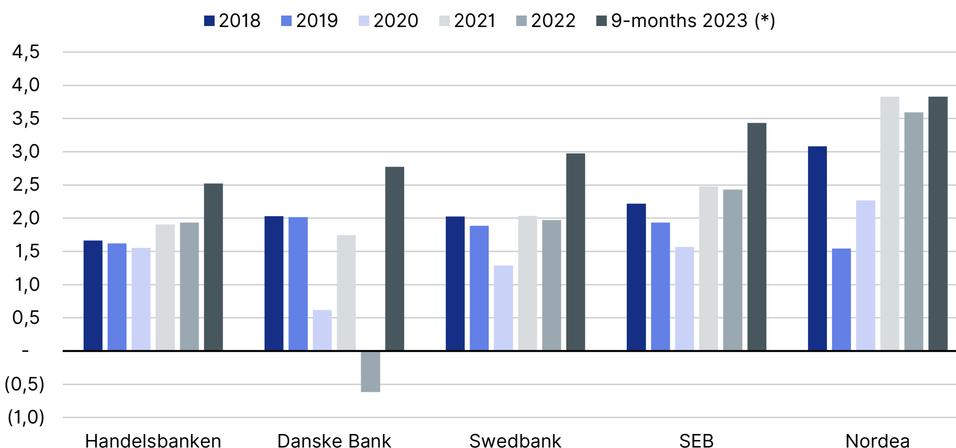
Earnings growth puts Swedish banks in a strong position to confront shrinking volumes, higher funding costs and the risk of higher provisions in the year ahead amid a gloomy economic outlook.

The prospect of record earnings in 2023 for Sweden's banks after robust Q3 results contrasts sharply with the likely build-up of provisions next year due to potential decline in Swedish household and corporate asset quality, notably in commercial real estate (CRE). Extra pressure will come from the increase in funding costs as deposits and debt issuance become more expensive.

Figure 1: On a roll: Swedish banks turn in strong results (net profit, EUR bn)



Source: Banks financial results, Scope Ratings. (*) Annualised.

Significant gains in net interest income and still contained credit impairments have underpinned recent earnings growth as operating costs have risen largely in line with inflation. The credit risk profile of banks is stable as they have comfortable capital buffers (CET 1 ratio between 16.3% - 19.4%), a balanced portfolio of mortgages and corporate loans and a diversified and cost-efficient funding structure, principally from deposits and covered bonds.

Trends for Swedish banks		
Profitability	Positive, higher net interest margins for longer	↗
Asset quality	Mildly negative, concentration risk from CRE	↘
Funding	Mildly negative, deposits base shrinking	↘
Capital	Stable, organic capital generation remains sound	→

Loan volumes set for decline as broader economy struggles

Corporate lending set to shrink

Sweden's weak growth and investment outlook is set to constrain corporate loan demand. The financial pressures stemming from the rise in interest rates and high inflation, as well as the economic slowdown, are reducing the needs for funding. We expect the Swedish economy to contract 0.7% this year after strong growth of 5.4% in 2021 and 2.6% in 2022. In addition, the corporate sector is facing further pressure from the weak krona. Registered bankruptcies are rising while the CRE sector is undergoing significant restructuring and deleveraging.

High interest rates curbs demand for new home loans

Households are rethinking how much debt they should be shouldering. The increase in interest rates is limiting demand for mortgages, the main growth driver of retail banking in Sweden. The average mortgage rate for outstanding loans continues to increase, up at more than 3.7% in September 2023 from around 1.5% at the beginning of 2022.

Expectations for 2024 are mixed. The outlook for bank profitability and capital remains favourable, but asset quality will decline, and retail funding will likely contract.

Swedish banks face a challenging macro-economic scenario in 2024

Still gloomy growth outlook for Sweden in 2024

Figure 2: Scope ratings forecast of key macroeconomic indicators

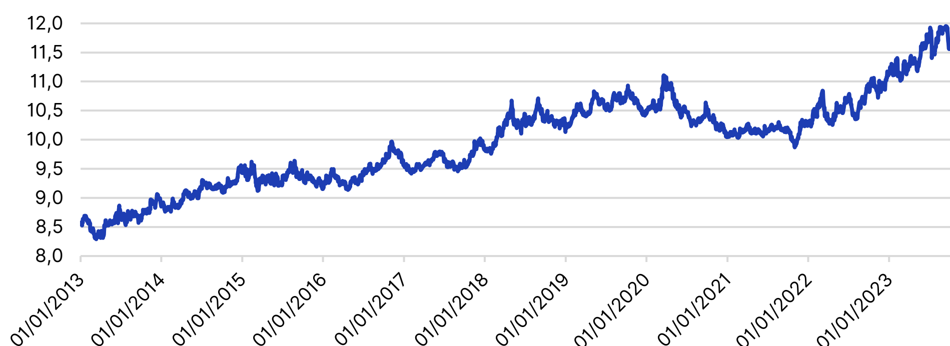
	GDP growth (%)		Inflation (%)	
	2023F	2024F	2023F	2024F
Denmark	1.3	1.0	3.8	2.8
Finland	0.0	0.4	5.0	2.3
Sweden	-0.7	0.2	8.7	4.0
EU area	1.0	1.3	5.6	2.9

Source: Scope Ratings

Sweden's inflation is highest in Nordic region

Following the recession in 2023, we expect the economic environment to remain tough for Swedish banks, with GDP near zero next year, inflation among the highest in the Nordic region and the krona likely to remain volatile. Most of the domestic economy is composed by consumer-oriented companies that face tightening financing conditions and a slowdown in consumption.

Figure 3: Swedish krona weakness is another economic headwind (SEK/EUR, spot rates)



Source: Macrobond

Commercial real estate is a weak spot

Households' disposable income has eroded as living costs have risen. Swedish households have reduced consumption as well as their rate of savings. The net savings rate has fallen to near 12% from a peak of 16% in 2019, putting it more in line with the EU average.

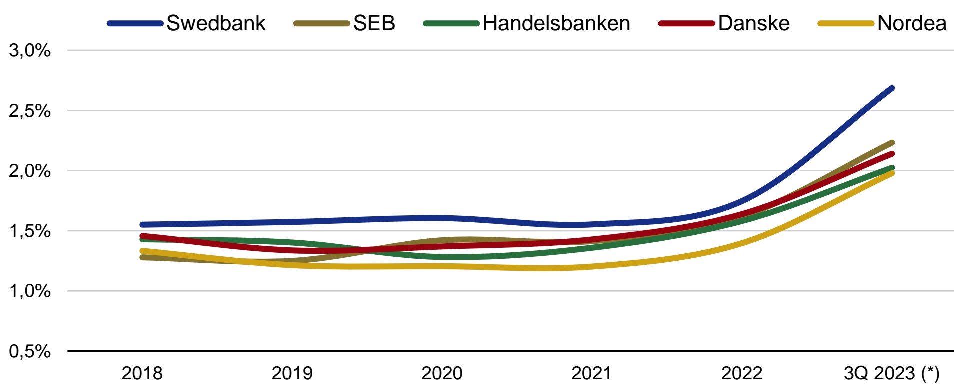
For companies, the material change in refinancing conditions, with a more costly access to capital-market funding is a game changer – particularly for the important commercial real estate (CRE) and property management sectors. Here, falling property prices and the increase in interest rates make refinancing difficult, a situation made worse by firms' high leverage and reliance on short-term borrowing, requiring significant corporate deleveraging and balance-sheet restructuring.

Banks' net interest margin to remain wider for longer

Net interest margins rose fast in 2023

Net interest margins are increasing fast and remain the main driver of the strong improvement in the banks' bottom-line results. Net interest margins for the largest banks are increasing to levels not seen for a decade, as low interest rates had kept margins at historically low levels. Now that market conditions have changed, the average rate on outstanding mortgages has risen to more than 3.7% in Q3 2023 from around 1.5% a year earlier, and in the case of corporates, to 4.7% from 1.4%, allowing banks to significantly improve their margins.

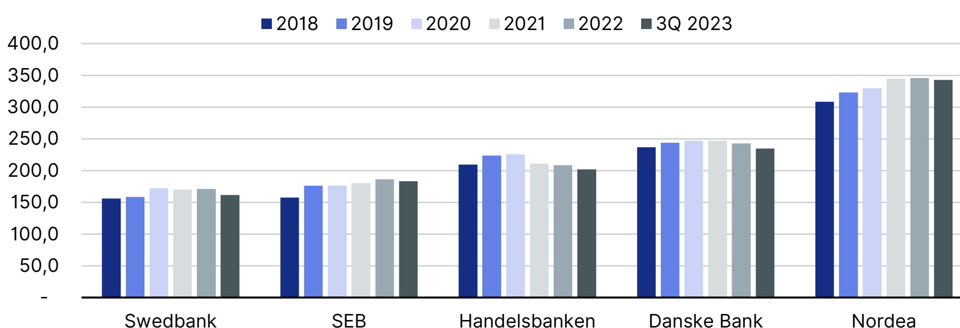
Figure 4: Net interest margin is growing fast



Source: banks financial data, Scope Ratings. (*) Annualised.

We expect this trend to continue in Q4 and stabilise in H1 2024, as the central bank pauses the current cycle of rate increases given our baseline scenario for a stabilisation of inflation in 2024. Assets will continue to reprice but at a slower pace than previous quarters, as the Riksbank estimates that around 70% of the total expected increase in mortgage rates in Sweden households has materialised. It is worth noting that around 60% of lending to households in Sweden involves fixed interest-rate periods of less than a year, exposing borrowers to significant stress in current market conditions.

Figure 5: Lending books are decreasing (total loans in EUR bn)



Source: banks financial data, Scope Ratings.

As expected, the loan books of most of the largest Swedish banks have contracted compared with YE 2022, mostly due to a reduction in mortgage volumes, which will offset the banks' ability to continue improving net interest margins. Banks will likely maintain pricing discipline and focus on maintaining margins rather than compete on price for greater volume and market share.

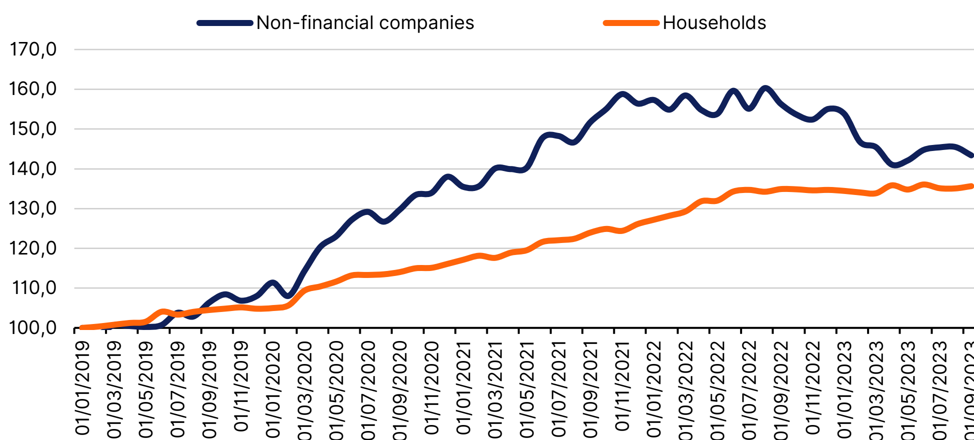
Bank lending is on the slide

Funding through deposits is becoming more expensive

In terms of funding structure, Swedish banks are typically well positioned, with funding mostly composed of a stable and large base of deposits and covered bonds. However, the trend of steady and cheap deposit funding has reversed. The deposits base has been shrinking since late 2022, driven mostly by falling corporate deposits.

Retail deposits relatively stable; corporate deposits falling fast

Figure 6: Deposits growth (*) decreasing fast, constant base 100=2019



Source: Riksbank, FSR 2023:2, Scope Ratings. (*) Deposits from Swedish households and non-financial corporations in MFIs.

Retail deposits have proved more stable, with depositors more inclined to move their liquidity primarily from sight to term accounts, reflecting the greater remuneration on the latter.

Sharp slowdown in deposit growth

For companies, the reduction in deposits reflects the shifting preferences between holding greater liquidity buffers – built up as a response to Covid when liquidity was cheap – and deleveraging, which is now in favour as interest rates have risen steeply.

That said, we note that the interest rates pass-through to deposits remains lower than in previous interest rate hiking cycles (47% for retail and 50% for companies in Sweden in 2022, compared to 53%, 66% respectively in 2010-2011), which should change in the H1 2024 as banks will start remunerating retail deposits better to stabilise their deposits base.

Concentration risk in CRE and property management sector remains high

The CRE and property management sector has represented an historically high concentration risk for Swedish banks, with exposure levels that range from 13% of total loan portfolios at Nordea to as high as 32% at Handelsbanken. At an aggregate level, the exposure amounts to an estimated EUR 200bn, mostly concentrated in Swedish counterparties.

Most banks' CRE concentration is above 100% of their CET 1

Swedish bank's exposure to CRE and Property Management remains significant (Q3 2023)

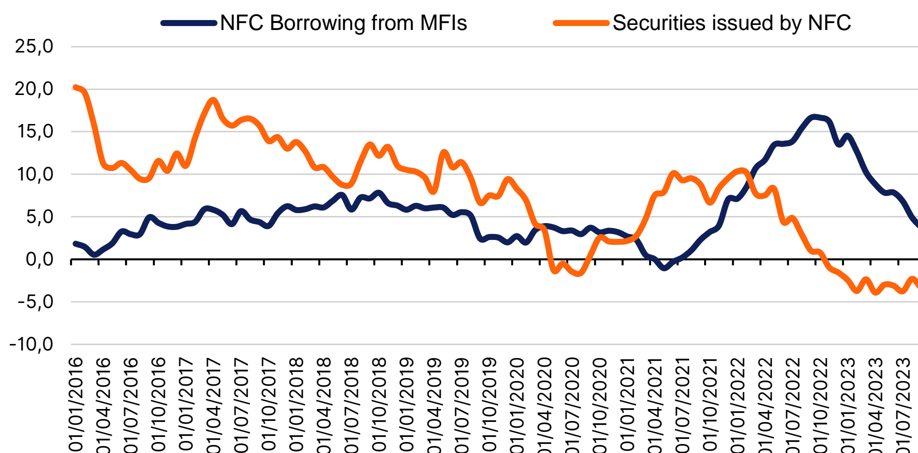
Key metrics	Handelsbanken	Nordea	Danske	SEB	Swedbank
Total exposure (EUR bn)	65.1	45.0	36.9	31.4	26.1
As % of total loans	32.3%	13.1%	15.7%	17.2%	16.1%
Sweden exposure only					
In EUR bn	28.8	18.0	7.4	23.3	19.6
As % of total Swedish exposure	20.5%	23.4%	Not available	14.3%	21.1%
As % of CET 1	**198%**	**78%**	**36%**	**177%**	**145%**

Source: Banks financial data, Scope Ratings.

Banks' CRE exposure remains steady despite sector troubles

CRE and property management companies in Sweden rely on capital markets and banks as their main sources of funding. As refinancing costs have risen steeply, debt issuance has declined consistently since early 2023. Banks are becoming more cautious about exposure in CRE, as prospects for further growth in the sector are diminishing. However, exposure to the sector is here to stay – it is hard for the banks to quickly reduce it – visible in little change in total CRE exposure during the first nine months of 2023.

Figure 7: Turning down: non-financial corporate (NFC) borrowing and debt issued (annual % change)



Source: Riksbank, FSR 2023:2, Scope Ratings.

Authorities act to contain concentration risk

Asset quality should deteriorate and materialise in higher stage 3 loans, as we have seen an increase in sector-specific stage 2 loans for the construction sector, rising to 12% (as of sector-specific loans) in H1 2023 compared with 8.0% in the same period last year, and for the property sector, up to 10% compared with 2.7%.

Sweden's banking regulator is actively monitoring concentration risk. The Swedish FSA has added a risk-weight floor for this specific exposure. The measure consists of a 35% risk weight for Swedish corporate exposures secured by commercial properties and 25% risk weight for corporate exposures secured by residential properties. This was initially implemented through Pillar 2 but has more recently moved to Pillar 1 requirements.

We take comfort from Swedish banks' large capital base and buffer to requirements, that should allow them to absorb additional credit losses in case of significant deterioration of this economic sector, as refinancing or deleveraging do not provide a viable solution.

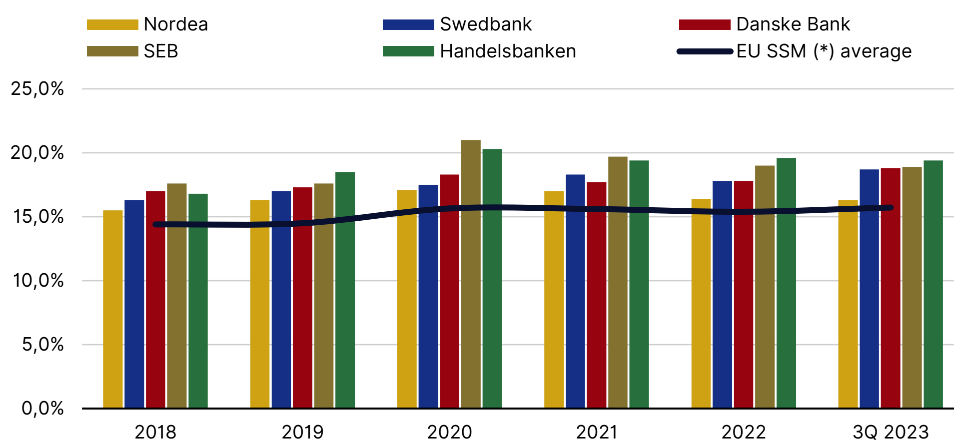
Comfortable capital ratios and buffer to requirements

Capital levels largely above upper bound compared with EU average

Swedish banks' capital levels remain solid. CET1 ratios improved to 18.4% at end-Q3 2023 from an average 18% in 2022, with buffers to requirements between 300bp and 400bp due to their relatively low risk-weighted asset intensity as well as a historically high base of core capital.

We expect some reduction on CET1 by year-end 2024, through high dividend payouts and share buybacks, as banks target a more efficient management of buffers. Current capital levels are well above management's targets, hence little risk of regulatory pressure to increase them in 2024.

Figure 8: CET 1 capital ratios remain solid



Source: EBA, Banks data, Scope Ratings. (*) EU average of banks participating in the SSM, data not available for Q3 2023, last data point Q2 2023.

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