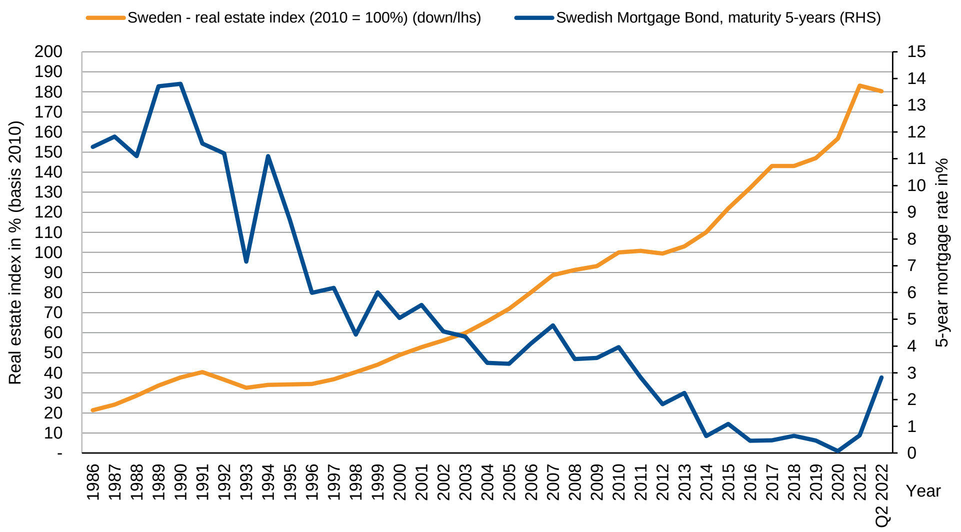
Correction in Swedish residential property but mortgage market to remain resilient

With mortgage rates rising to levels not seen since 2011, we expect a slowdown in the number of property transactions and a correction in prices this year, following the record increase in 2021 (see Figure 1). But mortgage loan losses will remain low. A sound regulatory framework for mortgage lending coupled with a strong borrower database will continue to support sound credit underwriting and management.

Downside risks stem mainly from high consumer price inflation which combined with higher mortgage rates may impair property values and dent the affordability of lower-income households with low savings capacity.

Figure 1: Swedish residential property price index vs. five-year mortgage rate



*Note: The values for Q2 2022 are forecasted

Source: SCB Statistics Sweden

Significant property price inflation has helped to limit credit losses on Swedish mortgages because it has allowed more flexibility around refinancing solutions and offered better headroom in restructuring or recovery scenarios.

The Swedish mortgage market

Residential property prices in Sweden have risen significantly on the back of rapid credit expansion. The strength of the economy, decreasing mortgage rates and moderate population growth have all supported property prices as well as mortgage affordability. Disposable annual income per capita grew by an average of 2% per annum between 2001 to 2021 while the population grew by 0.8% per year over the same time horizon.

Mortgage lending has also been supported by a stable and sound regulatory framework and by good levels of obligor transparency, which have facilitated prudent credit underwriting and management. Low public indebtedness and the sovereign's sound capital market access (Sweden AAA/Stable – latest Scope review on Sweden) allow the government to intervene and protect private households from adverse economic events.

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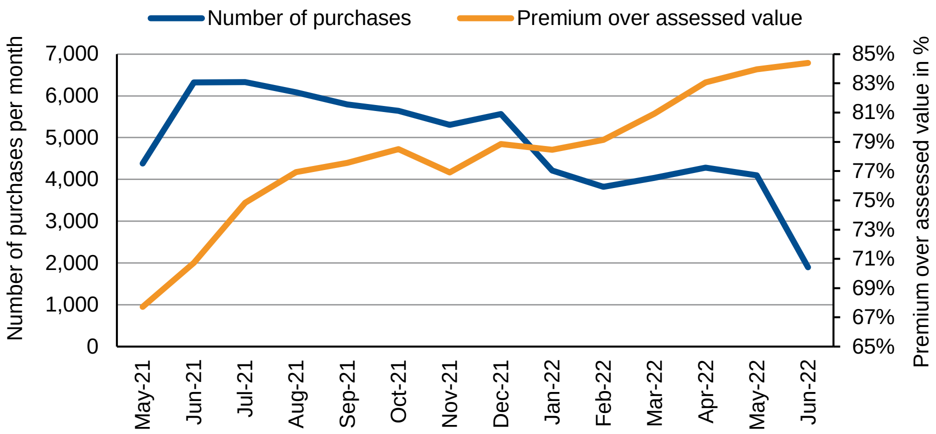
The beginning of the end?

House prices remain above pre-pandemic levels but have corrected substantially

Moving forward into the rest of 2022, we expect a reduction in demand for both property and mortgage credit in Sweden. This is primarily due to the rising cost of living[1] and higher credit costs. House prices are above the levels seen before the pandemic but they have fallen substantially from the peak. Amortisation rules could further impair household income and stress affordability.

The number of property purchases has been declining since June 2021 (see Figure 2). The fact that purchases are closing at increasing premiums indicates that it is mainly wealthy individuals that are still active in the residential property market; financially weaker households are dropping out.

Figure 2: Number of real estate purchases and premium paid compared to assessed value*



*Note: The assessed value represents the 2021 real estate tax value, a conservative estimate of the property market value.

Source: SCB Statistics Sweden

Households attempt to reduce debt-service uncertainty

Apart from scaling back activity, households are also attempting to reduce uncertainty around debt service: mortgage duration is going up as households fix interest rates for longer periods of time.[2]

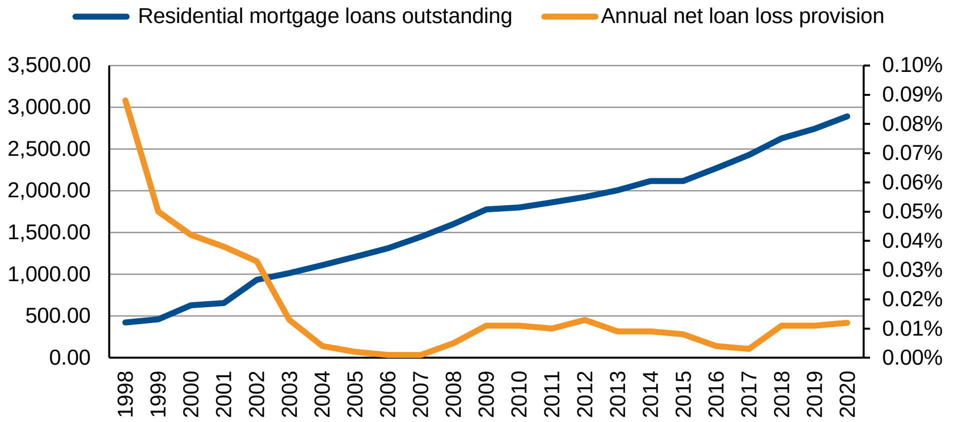
Mortgage market remains low-risk

We do not expect material problems for the country's mortgage market, even though residential property prices may see their first correction on an annual basis. The countrywide property price index is declining for the first time since 1993 (see Figure 1). Following exceptional growth in 2021, Q1 2022 yielded another 4.6% index increase but the market saw prices decline by about 5.8%[3] in Q2, resulting in a year-to-date index decline of 1.5% in 2022.

Over the last 20 years, residential mortgages have earned a reputation of being low-risk (see Figure 3). Cases of default have been rare and always been counterbalanced by sufficient levels of collateralisation that has provided flexibility for refinancing and recovery. The prudent regulatory lending framework and good levels of transparency have helped banks to lend to good obligors and prevent material levels of defaults and loan losses.

[1] Scope expects unemployment to decline to 7.1% in 2022 from 8.8% in 2021, while inflation is expected to increase significantly to 4.8% in 2022 up from 2.7% in 2021.
[2] https://www.fi.se/en/published/reports/swedish-mortgage-reports/the-swedish-mortgage-market-2022/
[3] https://www.businesstimes.com.sg/real-estate/swedish-home-prices-drop-the-most-since-the-financial-crisis

Figure 3: Residential mortgage loans vs mortgage net loan loss provisions



Source: Scope Ratings

The average Swedish mortgage shows comparably low credit metrics

The average Swedish mortgage currently has a low loan-to-value ratio of 64.5% while the average loan-to-income multiple is 4.4x[4]. Lenders generally focus on extending high LTV mortgages to young people, and high loan-to-income mortgages to high-income households. The metrics are relatively low when compared to recent evidence from European peers.

Safety-focused regulatory mortgage lending framework

Sweden's regulatory mortgage lending framework enhances the safety net by capping household credit per income and increasing amortisation requirements depending on household leverage and property loan-to-value. Overall, we consider Swedish mortgage lending regulations to be robust and focused on keeping household indebtedness manageable. This also partially controls mortgage expansion. Analysis by the Swedish supervisor shows that an increase in mortgage rates to 7%, a level last seen in 1995, would bring only about 11% of all 2021 mortgage loan obligors into financial difficulty.

Regulations require:

- an affordability test, which takes into account the household's cost of living at stressed interest levels; and
- minimum mortgage amortisation if the loan-to-value (LTV) is above 50%[5], or the borrower's loan-to-income ratio (LTI) is above 450%.

Regulatory amortisation attempts to keep private household debt manageable

Minimum mortgage amortisation measures are designed to slow the market and keep private household debt manageable. If the amortisation requirement kicks in, it will reduce household debt capacity. However, we may see exemptions from this requirement, should there be evidence that mortgages default on a large scale. Measures similar to the ones taken during the pandemic should prevent additional liquidity stresses being added in the current uncertain economic environment.

[4] Income in this measure refers to net-household income.

[5] Amortisation for Swedish borrowers is generally deferred when the LTV is below 50%, when mortgages then become interest-only. Depending on the LTV and LTI, the borrower must amortise up to 3% of the mortgage per year.

Market infrastructure enhances transparency

Other strengths of the Swedish mortgage market include high obligor transparency and sound market infrastructure. Shared information-gathering about obligors' credit quality and property values, and a centralised foreclosure agency allow every lender to efficiently select the mortgage clients they want.

Standardised data formats and sharing of data costs allow a highly automated time and cost-efficient lending process for all mortgage originators in Sweden.

Credit bureau score

The UC score has countrywide coverage across all private obligors

Among available credit bureau scores, the UC score probably has the widest coverage across obligors in Sweden. Every borrower is required to have a UC score, which feeds into the risk assessment of most lenders. The score has a very wide definition, as it reflects the probability of an individual or entity not honouring a financial claim, and it signals financial difficulty early. The large number of cases on which the metric is trained results in a very high accuracy ratio: at least 93.8% since 2005.

That said, the wide definition makes the score less accurate for predicting mortgage defaults, leaving mortgage lenders either excessively prudent or with a false sense of confidence around the definition buffer. Additionally, as it is an external score, lenders might recognise methodology changes only relatively late.

Centralised valuation agency

UC AB also provides property valuations for almost all Swedish residential properties. The valuations are statistical but they have the benefit of being widely accepted in the mortgage underwriting business and have great coverage. Broker or other types of valuations are usually only considered if the statistical valuation is too conservative, since property specifics cannot be included in the statistical assessments.

Statistical valuations are broadly in line with actual property transaction prices

Statistical valuations are broadly in line with actual property transaction prices, with acceptable deviations. On 60% of all statistical valuations between 2020 to 2021, the deviation around the actual transaction price was +/-5%, increasing to 86%, in the range of +/-10%.

Of course, the statistical nature of these valuations makes it relatively hard to have changing economic conditions properly reflected and quickly. But as lenders generally ask for substantial equity contributions, there is some buffer available. Additionally, lenders can demand additional valuations in case of doubt.

Centralised collection agency

All major retail lenders have outsourced standard recovery and foreclosure. Kronofogdemyndigheten, the State-owned debt collection agency, is the market standard and high usage levels create sound cost efficiencies.

The centralised set-up has efficiency benefits in benign economic conditions. But a systemic shock that results in a lot of default cases could create capacity constraints and may reverse those benefits and lead to sub-optimal recovery results.

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