ARTICLE - Financial sector linkages with the commercial property sector

Property companies are the banks' largest group of borrowers among non-financial corporations. They have also increased their borrowing the most of all companies in Sweden in recent years. Much of this borrowing comes from the Swedish banking system but, in recent years, it is borrowing via the capital markets that has grown the fastest. This has led to asset managers, such as funds in Sweden and abroad, as well as insurance and pension companies, becoming more exposed to the property sector. This development means that property companies are now more interconnected with the entire financial sector than before.

The large loans make property companies vulnerable to shocks such as changing financing conditions or a downturn in the economy. Now that property companies have to cope with higher interest rates and lower economic growth, the risks that have built up in the property sector are more likely to materialise.

As the property sector has historically created or strengthened financial crises both in Sweden and in other countries, it is important to understand how problems in the property sector can spread. The focus of this article is on how problems can spread to the financial sector.

Risks in the property sector have been increasing for a long time

To finance their operations, property companies use equity and loans. The strong economic growth of the last ten years, combined with low and falling interest rates, has meant that Swedish property companies have increased their borrowing rapidly. Between 2012 and 2021, their borrowing has grown from just over SEK 1,300 billion to SEK 2,300 billion, which today corresponds to 42 per cent of Sweden's GDP.[115] Property companies are the largest borrowers among all non-financial corporations. Among the banks, property companies account for 43 per cent and, on the capital market, for 42 per cent of the volume of loans to companies.[116]

[115] This article refers throughout to property companies operating in the commercial property sector. This means companies owning property with the primary purpose of letting it. Properties owned by enterprises whose main purpose is manufacturing, for example, are therefore not included. The commercial property sector includes offices, retail properties, rented residential units, hotels, logistics and industrial properties.

[116] The capital market refers to commercial paper and bonds issued by Swedish companies in all currencies.

Despite the increase in debts among property companies, the average loan-to-value ratio has decreased slightly and is now around 50 per cent. This is due to the fact that property values have also risen rapidly over this period.[117] On the other hand, property companies have increased their loans relative to their operating profits.

The risks associated with the property sector's large loans are something that Swedish authorities such as the Riksbank and Finansinspektionen, as well as international organisations such as the IMF, OECD and ESRB, have drawn attention to on several occasions.[118] In particular, the large loans have made property companies increasingly sensitive to changing economic conditions, such as limited access to loans, less favourable financing conditions or weaker economic activity.

The high level of borrowing in the property sector may have consequences for financial stability and the real economy. If property companies find it more difficult to borrow, they may be forced to make adjustments, such as reducing their investments in existing or new properties. This could lead to a reduction in construction activity and thus to lower demand for labour, which could exacerbate a downturn in the economy.[119] At the same time, reduced access to credit combined with poorer financing conditions, such as higher borrowing costs, may force property companies to make large write-downs on property values and conduct fire sales of properties. This could have an impact on the financial system, for example through large loan loss provisions by the banks and large negative value changes for bondholders. In the worst case, higher borrowing costs could lead to property companies defaulting on their payments. This would result in even higher loan loss provisions and value changes.

Property companies have been borrowing more and more outside the banking system

In the past, property companies have mainly obtained funding by taking loans from major Swedish banks, although foreign banks have also acted as lenders. The global financial crisis of 2008-2009 meant that foreign banks in particular, but to some extent also the major Swedish banks, became more cautious in their lending to property companies, among others.

The generally low level of interest rates helped to increase demand for riskier assets such as corporate bonds, as investors sought to maintain the yield on their fixed income assets. In addition, the financial crisis led to a gradual increase in capital requirements for the banks, which contributed to their lending rates not falling as much as other interest rates. All in all, this contributed to capital market financing becoming

[117] The value of the properties is based on market valuations, while the liabilities are nominal and thus, aside from amortisation, will stay the same regardless of what happens to market valuations.

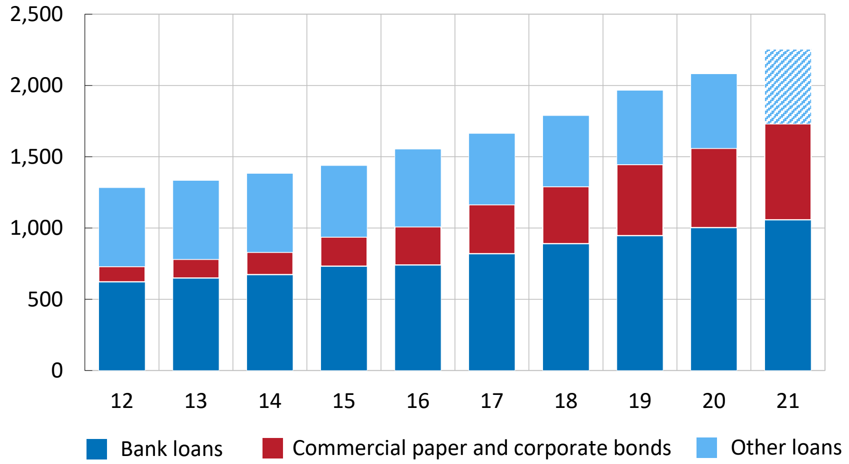
[118] See, for example, the article "Commercial property and financial stability" in *Financial Stability Report*, 2017:2, Sveriges Riksbank, "The Commercial Real Estate Market and Financial Stability", 2019, Finansinspektionen, "Sweden: Article IV Consultation – Staff Report", 2021, IMF, "Report on vulnerabilities in the EU commercial real estate sector", 2018, ESRB, and "The Swedish Corporate Bond Market and Bondholder Rights", 2022, OECD.

[119] Moreover, during financial crises, highly indebted companies tend to be more inclined to reduce their investment and labour demand than less indebted companies. See, for example, Myers (1977), Kiyotaki and Moore (1997) and Brunnermeier and Krishnamurthy (2020).

relatively more advantageous and to property companies increasingly choosing to finance their operations via the capital market. Before the financial crisis, capital market financing represented less than one per cent of total loans of listed property companies. Between 2012 and 2021, this type of financing increased from 10 per cent to 30 per cent of property companies' loans. This corresponds to an increase from just under SEK 100 billion to almost SEK 700 billion (see red area in chart 23).

Chart 23. Loan financing of property companies

SEK billion



Note. Includes loans from Swedish MFIs, outstanding corporate paper and bonds in all currencies, nominal amounts and other loans. Other loans includes loans on the balance sheets of property companies that cannot be attributed to Swedish bank loans, commercial paper or bonds. That is, for example, direct loans, owner loans and loans from foreign banks. Other loans are calculated on the basis of Statistics Sweden's Structural Business Statistics as total short- and long-term liabilities minus Swedish bank loans, commercial paper, bonds, intra-group loans, tax liabilities and trade credits. Other loans 2021 (the striped part of the bar), is an estimate as data for that year was not available when this report was published.

Sources: Statistics Sweden (SVDB) and the Riksbank (KRITA).

Increased financing of property companies through the capital market can help to promote growth in the wider economy.[120] It has also helped to extend the loan-to-maturity of some property companies.[121] More sources of funding also means that credit risk is spread across more lenders, both Swedish and foreign, who together may be better able to manage loan losses than if all loans were held by the banks.

[120] See L. Gambacorta, J. Yang, and K. Tsatsaronis, *Financial structure and growth*, BIS Quarterly Review, March 2014, pp. 21-35; S. Langfield and M. Pagano, *Bank bias in Europe: Effects on systemic risk and growth*, Economic Policy, Vol. 31, No 85, January 2016, pp. 51-106.

[121] Longer loan-to-maturities reduce refinancing risk, provided that maturities are also spread over time. The average (volume-weighted) original maturity of bank loans is just over 4 years. For bonds issued in SEK and foreign currencies, the average loan-to-maturity is 5 and 9 years respectively (bonds with 'perpetual' maturity are excluded). Overall, the average loan-to-maturity among European property companies is longer than that of Swedish property companies, for both bank loans and bond loans.

Increased funding via the capital market means greater interconnections

As a result of the increasing borrowing by property companies through Swedish banks, but especially through the capital market, new and stronger links have emerged between property companies and the financial sector. This means that shocks can spread more easily to and within the financial system.[122]

Banks increasingly exposed to property companies

The major property companies have accounted for the largest increase in capital market borrowing. Despite the fact that these larger players have chosen to increase their lending mainly through the capital market, the banks' concentration risk towards the property sector has continued to increase. Between 2012 and 2022, the banks' exposures to property companies have grown from just over 30 to 44 per cent of their total exposures to non-financial corporations.[123] Swedish banks have a significantly higher concentration risk towards property companies compared to banks in other countries. On average, commercial property exposures account for 25 per cent of total corporate exposures among banks in the EU.[124] However, it is not only the increased concentration risk towards larger property companies that is creating greater risks for the banks. Smaller property companies have been increasingly able to borrow from the banks, as the major property companies have increasingly been able to meet their borrowing needs via the capital market.

Smaller property companies may be associated, to a greater degree than larger ones, with a credit risk that is higher and more difficult to assess. For example, this may be because they could be more vulnerable to shocks, as they often do not have the same ability to adjust their operations or funding situation in a deteriorating economic or financial situation. However, it is also because smaller property companies are often not as transparent, for example because larger property companies are more likely to be listed on the stock exchange and therefore regularly publish quarterly reports. In addition, the higher credit risk for the banks may be due to the fact that smaller property companies generally have higher loan-to-value ratios.[125] Consequently, the banks' more extensive lending to smaller property companies may have increased their credit risk a bit more in recent years.

If, in a situation of financial turmoil, capital market participants reduce their investments in the bonds of property companies, some companies will find it difficult to refinance themselves through the capital market. In such a situation, they will most

[122] Swedish banks refers to Swedish monetary financial institutions.

[123] However, the banks' off-balance sheet exposures to major property companies have increased mainly as a result of credit facilities granted to these companies to manage their refinancing risk in the capital market.

[124] See Risk Dashboard Quarter 1 2022, European Banking Authority (EBA).

[125] The median loan-to-value ratio of small and medium-sized property companies is just over 60 per cent, while the corresponding figure for major property companies is 50 per cent. However, one explanation for the difference may be that small and medium-sized property companies are more likely to include properties on their balance sheet at book value rather than market value, as they do not generally follow the IFRS 13 accounting standard, unlike major property companies.

likely have to refinance themselves through the banking system instead – primarily by drawing on their agreed liquidity and credit facilities. Such tendencies have been observed since the spring of 2022 until now, but this also happened at the start of the pandemic.[126] The credit risk associated with these loans is then shifted from capital market participants to banks. At the end of the first quarter of 2022, property companies had about SEK 190 billion in outstanding credit facilities with the banks. This meant that such facilities could cover the maturities of the outstanding volume of commercial paper and bonds that are expected to take place by March 2024.[127]

If the banks have the scope and willingness to grant loans equivalent to the outstanding commercial paper and bonds of the property companies, their exposures to major property companies would increase rapidly. The banks may have an incentive to grant additional loans to avoid major problems for the property companies. Failure to grant additional loans could lead to higher loan losses on existing bank loans. If capital market participants, including the property companies themselves, assume that the banks will always be willing and able to take over these exposures, the concentration risks of the banks towards the commercial property sector will, so far, have been underestimated.

Funds have become more dependent on developments in the property sector

Property companies' funding via the capital market has mainly increased as regards corporate bonds, although the volume of commercial paper has also increased. This is partly because many investors have increased their exposure to these investments. But it is also because entirely new investors are now exposed to property companies.

In 2022, foreign investors owned 53 per cent of property companies' bonds (see chart 24). Foreign investors own 95 per cent of the bonds issued by property companies in foreign currencies and the majority of these are bonds issued in euros.[128] Foreign investors include, for example, funds registered in countries other than Sweden. In addition, Swedish funds, whose holdings in the bonds of property companies have grown rapidly, are now the second largest investor group with 21 per cent of these bonds. Swedish insurance and pension companies account for 12 per cent. Swedish monetary financial institutions, which hold and quote prices for corporate bonds to facilitate trading in those instruments, have gradually reduced their holdings since 2009. They now own just under 3 per cent of property company bonds. This is probably because the capital requirements introduced after the financial crisis have made it more expensive to hold such assets on the balance sheet. The Riksbank owns 1 per cent of the bonds, which is a consequence of the purchases initiated in connection

[126] If this were to continue for a longer period, it would not be possible to rule out the possibility that the banks might have difficulty in providing loans in sufficient volumes, for example because of restrictions related to individual companies or an unwillingness to increase exposure to the property sector.

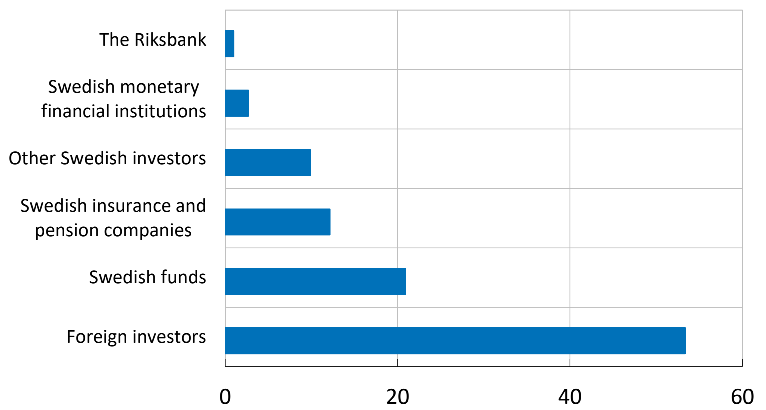
[127] These facilities include all commercial property companies with which the banks have agreements. This may include companies that have facilities but do not have outstanding commercial paper or bonds.

[128] Of their foreign currency capital market funding, 73 per cent is issued in euros, 14 per cent in Norwegian kroner, 5 per cent in US dollars, 4 per cent in Swiss francs and 5 per cent in other currencies such as British pounds, Japanese yen, Hong Kong dollars and Australian dollars.

with the pandemic to mitigate the effects of the pandemic on the Swedish economy and thus contribute to a functioning credit supply.

Chart 24. Owners of corporate bonds of property companies

Per cent



Note. Refers to outstanding corporate bonds in all currencies issued by Swedish commercial property companies. Swedish MFIs refers to Swedish monetary financial institutions, which include the major banks in Sweden. Other Swedish investors refers to central government, regions and municipalities, social security funds (National Pension Insurance Funds), non-financial corporations (including other property companies), households, non-profit institutions serving households, and other financial intermediaries that are not monetary financial institutions. Data refer to the first quarter of 2022.

Source: The Riksbank.

The large exposure of funds and insurance and pension companies in particular to property companies means that they can be affected by problems arising in the property sector. For example, they may have to downgrade their holdings when the price of bonds falls as the market prices the deteriorating financial situation of property companies. It may also force these participants to sell bonds to avoid larger losses.[129] In addition, if credit ratings are downgraded so that companies or their bonds are no longer classed as investment grade, some investors may be forced to sell their bonds.[130]

Fire sales leading to sharply falling property values could contribute to lower bond values and thus large losses for bondholders. Taken together, this could lead to a sharp increase in the cost of issuing bonds, making it more difficult for companies to obtain funding in the bond market. This may be perceived by companies as a credit crunch.

[129] In addition, funds may also need to sell bonds to meet large redemptions by unitholders. This could put downward pressure on the price of property companies' bonds.

[130] Many investors want to limit their credit risk and are therefore only allowed to buy investment grade assets.

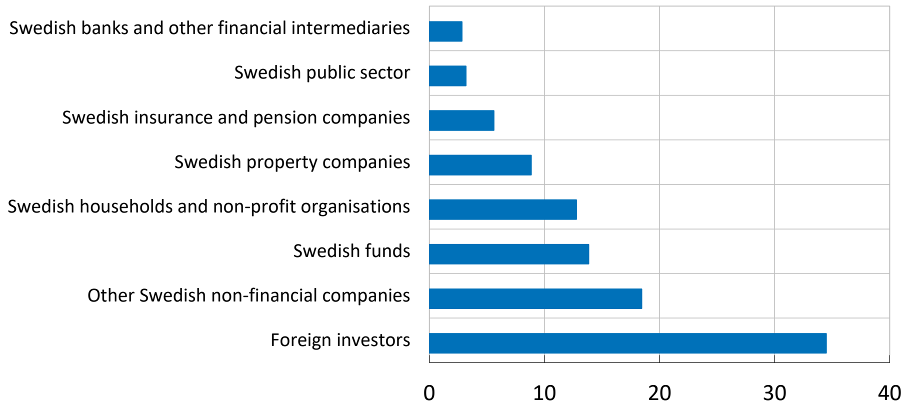
Insurance and pension companies have additional property exposures

Insurance and pension companies, as well as fund investors, are exposed to the property sector in other ways as well. For example, they own physical properties and shares in listed property companies.

The total exposure of Swedish and foreign funds to physical property in 2021 is estimated to be more than SEK 200 billion. The corresponding amount for insurance and pension companies is almost SEK 650 billion.[131] Swedish funds and insurance and pension companies together accounted for 20 per cent of ownership in listed property companies, corresponding to a holding of around SEK 450 billion in the first quarter of 2022. However, foreign owners, such as funds, constitute the largest category with 35 per cent of ownership in listed property companies (see chart 25). In addition, many insurance and pension companies own shares in non-listed property companies. For example, insurance companies had shareholdings in wholly-owned property companies worth SEK 100 billion at the end of the second quarter of 2022.[132] Overall, insurance companies' exposure to commercial property represents nine per cent of their total assets.[133]

Chart 25. Shareholders in listed property companies

Per cent



Note. Refers to listed ordinary and preferential shares in Swedish property companies as of the first quarter of 2022. The public sector includes social security funds (National Pension Insurance Funds).

Source: The Riksbank.

[131] Estimated by Pangea Research in January 2021.

[132] The data are not sufficiently detailed to show the holdings of insurance and pension companies in unlisted property companies that are not wholly owned. It is likely that their equity exposures to the property sector are larger than is reported here.

[133] EIOPA Insurance Statistics - Exposure data (2021 Q2). The corresponding figure for pension companies is missing.

The property companies own shares in each other

As shown in chart 25, property companies own just under ten per cent of the shares in listed property companies. This corresponds to shares worth approximately SEK 70 billion. In addition, it is common for property companies to jointly own shares in an unlisted joint venture where the joint venture itself owns property.

Cross-ownership among property companies can help an owner to obtain cash flows from other property companies that are not exposed to the same risks. However, cross-ownership also entails increased risks of conflicts of interest, reduced competition and reduced transparency in the property market, which the Riksbank has highlighted in the past.[134] Moreover, in the event of a crisis, cross-ownership may make it more difficult for property companies to secure financing through their shareholders. This is because the owner may have to prioritise when providing support to the different property companies. This may lead to higher demands on other existing shareholders or to the arrival of new shareholders who are better placed to meet the financial needs of the company.[135] A lack of capital injections from shareholders may result in lenders having to provide additional financing.

Property companies' market funding highlights the importance of good capital market resilience

The changing macroeconomic environment is increasing the likelihood of risks in the property sector materialising. If this were to happen, the problems could spread to a larger part of the financial system. This could have more far-reaching consequences than in the past, as the banks' exposure to the sector has increased at the same time as more participants outside the banking system, including through the capital markets, have increased their exposure to the property sector. This would be particularly true if the loss-bearing capacity of the participants in the capital market were too low.

However, there are also other vulnerabilities linked to the funding of property companies that could contribute to increased instability. These include the lack of transparency and insufficient liquidity in the corporate bond market, as the Riksbank has previously pointed out.[136] The vulnerabilities in the corporate bond market became evident during the onset of the pandemic when the corporate bond market stopped functioning for a while. This created considerable uncertainty and made it difficult to value such assets. In turn, this led to difficulties in selling the assets and to the temporary closure of several funds investing in corporate bonds.

Foreign investors have been shown to act relatively quickly in past crises and periods of high uncertainty. For example, this happened during the 2008-2009 financial crisis and during the onset of the pandemic when they wanted to reduce their exposure to

[134] See *Financial Stability Report 2021:2*, Sveriges Riksbank.

[135] Property companies can also suspend dividend payments to avoid a reduction in equity.

[136] See "Towards a better functioning corporate bond market", *Riksbank Studies*, December 2021, Sveriges Riksbank.

Swedish companies and therefore sold corporate bonds.[137] This may be due, for example, to the fact that they feel they have less knowledge of the Swedish market and the true creditworthiness of companies.[138] However, it could also be because they do not want to be exposed to the Swedish krona in a crisis situation.[139] The fact that a larger proportion of bond investors are now made up of foreign players increases the need to safeguard the stability of the financial system. Doing this makes it possible to prevent periods of high uncertainty from adversely affecting the bond market.

As property companies have increasingly chosen to fund their operations in the corporate bond market, a well-functioning corporate bond market has become increasingly important for their credit supply. If disruptions occur which, in turn, lead to a more permanent restriction of credit availability, property companies may be unable to refinance existing loans or to take out new ones. Consequently, they may have to reduce their investments or sell assets. This, in turn, may lead to loan losses for more creditors, thereby contributing to a general credit crunch and, by extension, to financial stability concerns.

Greater interconnectedness increases risks to financial stability

Overall, the large loans of property companies are creating risks to financial stability. Now that property companies have to cope with higher interest rates and lower economic growth, the risks that have built up in the property sector are more likely to materialise (see section "Vulnerabilities and risks in the corporate sector").

As a result of the increasing borrowing by property companies through Swedish banks, but especially through the capital market, new and stronger links have emerged between property companies and the financial sector. This means that any shocks can more easily spread to and within the financial system. It is therefore important that banks and other agents in the financial sector have good resilience to deal with, rather than strengthen, such shocks.[140] It also makes it important for authorities to address shortcomings and vulnerabilities in the various funding markets for property companies, in particular the corporate bond market (see section "Summary of the stability assessment"). This should be done in a way that creates the right incentives for lenders and investors to price and share risk efficiently.

[137] When one or more participants are forced into these types of fire sale, it can put other participants in financial difficulty. In the worst case, they too will be forced to make sales, further depressing asset values. If many players have the same types of exposure, for example securities linked to commercial property, problems for one player can quickly spread to others.

[138] See Becker et al. (2020) "Kan obligationsmarknaden dämpa kreditcykeln? [Can the bond market slow down the credit cycle?]", *FI Analysis* 23, October 2020, Finansinspektionen.

[139] The reduced exposures can also be explained by investors acting to reduce the risk of losses rapidly as a precaution or to meet their investment mandates.

[140] The need for good resilience among capital market participants has been highlighted by the ESRB and the FSB, among others. See *ESRB Report on Vulnerabilities in Commercial Real Estate Sector in EU*, November 2018, ESRB, and *Enhancing the Resilience of Non-Bank Financial Intermediation Progress report*, November 2021, FSB.