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Swedish Rental Housing System Could Be Reformed Following EU Complaint

The Swedish rental housing market is currently receiving unexpected attention from the European Commission. The Commission is considering a complaint made against the Swedish government alleging that the country's municipal housing companies (MHCs) are receiving unlawful state aid. If the Commission were to conclude that Sweden's municipal housing system is incompatible with EU rules governing state aid, major changes may be in store for the country's 300 MHCs and for the Swedish rental property market as a whole. Moreover, this particular case should also be of great interest across Europe as it shows that EU competition and state aid rules are increasingly being applied to sectors that were previously perceived to be sheltered by national policy.

The dispute's origins date back to May 2005. This is when the European Property Federation (EPF; comprising national federations for private property owners), filed a complaint with the Commission on behalf of the Swedish Property Federation (Fastighetsägarna), arguing that Swedish municipal housing companies receive unlawful state aid from their owner municipalities. It is claimed that state aid in 2002 amounted to Swedish krona (SEK) 11.5 billion (€1.25 billion). In addition, the EPF objects to the Swedish rent-setting system where MHCs effectively set the benchmark for all rents in the market. Under this system, private landlords are restricted to setting their rents within a range of five percentage points above or below those for equivalent municipal apartments.

If the European Commission finds against the Swedish government, Standard & Poor's Ratings Services envisages that the decision will have far-reaching implications for the Swedish local government sector as a whole because most municipalities own housing companies. One likely result would be that rent-setting would have to become more market-based. This would place upward pressure on housing rents in regions where there is excess demand for housing. In addition, the MHCs' exclusive normative role in rent-setting would be expected to disappear.

Even so, we consider it highly unlikely that Swedish MHCs will be required to repay previous state aid flows, and as a result there does not appear to be any immediate credit concerns for the five MHCs rated by Standard & Poor's. These MHCs generally have strong credit profiles owing to their high quality portfolios, low vacancies, high surplus values (that is, market values that are much higher than book values), and moderate LTV ratios. Although their credit profiles will evolve with time, these credit strengths should continue to support them in the future.

The Pivotal Role Of MHCs In The Swedish Rental Market

The Swedish housing market is divided into three main categories: rental housing (40% of Swedish housing in 2004); cooperative housing (bostadsrätter; 18%); and owner-occupied housing (42%). About 300 MHCs are active on the rental housing market, holding an average market share of approximately 50%.

MHCs are the main vehicle for the implementation of Swedish welfare policy, which aims to provide quality housing for all citizens at reasonable prices. This system is different from those of many other European countries where the public sector provides social housing to low-income households in need.

To prevent rents from becoming unreasonably high and to protect the "right of possession for tenants" *(*besittningsskydd*)*, Sweden developed the "utility value system" *(*bruksvärdessystemet*)*. The utility value principle implies that rents for apartments that are considered to have an equivalent utility value (based on factors such as size and standard), should be more or less the same. The rents of MHCs' apartments establish the norm and private landlords must set their rents within certain specified limits of these norms.

Why EU State Aid Rules May Apply To Swedish MHCs

EU rules (Article 87 of the EC Treaty) state that "any aid granted by a member state or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between member states, be incompatible with the common market."

The interpretation of this Article has been developed through case law by the European Court of Justice. It should be noted, however, that public ownership of companies, in itself, is allowed by EU rules.

The market affected has to be considered a part of the EU's internal market, which aims to ensure the free movement of goods, services, capital, and people. Whereas housing markets were previously considered to be the domain of national policy, there are now indications that the Commission increasingly views housing as part of the EU capital market. A parallel case involving the housing market arose in the Netherlands in 2002. Although, there is no final ruling yet, we understand from a Commission letter dated 14 July 2005 that in the Commission's assessment the existing Dutch support measures are incompatible with the common market and is due to recommend specific changes to the Dutch government.

In assessing whether the support given by Swedish municipalities to their housing companies is unlawful, the following factors are of relevance:

First, not only direct grants, but also other types of support such as credit guarantees and provision of equity capital can be considered as unlawful state aid if provided on terms that are more favorable than those of the market. Consequently, the aid granted in the form of shareholders' equity, which constitutes the bulk of the alleged state aid in the Swedish MHC case, could be incompatible with EU rules.

Second, the state aid provided needs to distort, or threaten to distort, competition by favoring certain undertakings. Only the MHCs receive the alleged state aid, and not the private housing companies that compete on the same market.

Third, state aid has to affect trade between EU member states. Although the bulk of property owners on the Swedish rental housing market are Swedish, property owners from other member states are already present in this market (Denmark, Germany, and the U.K., for instance).

Standard & Poor's understands that some commentators have concluded that the criteria in Article 87 have been fulfilled. It is, however, up to the European Commission to decide on this matter.

The Alleged State Aid On the High Side

If the Commission were to decide that unlawful state aid is being provided to MHCs, we nevertheless believe that its assessment of the amount of unlawful aid would be materially lower than the EPF's figures.

The EPF's complaint is based on standard calculations for all 300 MHCs in Sweden, based on the 2002 annual accounts compiled by Ernst & Young. Using these calculations, the EPF argues that MHCs received state aid totaling SEK11.5 billion (€1.25 billion) in 2002. More specifically, the EPF argues that three types of support were given; (1) direct grants (corresponding to an amount of SEK18 million, or €2 million), (2) credit guarantees were given for no fee, or with fees at below market rates (SEK2.1 billion, or €240 million), and (3) equity capital has been provided with insufficient requirements on the return (SEK9.3 billion, or €1.0 billion).

When estimating the possible amount of aid provided to MHCs, the calculations are very sensitive to the assumptions made (please see sidebar titled "Calculating Estimated State Aid In Terms Of Cost Of Equity" at end of article).

We have used an alternative approach for our calculations to those of Ernst & Young, who assembled the EPF figures, resulting in significantly different estimates of state aid in 2002 (see table 1). EPF argues that the state aid represented a very high share—between 22% and 45%—of total adjusted revenues for four of the five MHCs that we rate, namely Fastighets AB Förvaltaren (Förvaltaren; A/Stable/A-1), Uppsalahem AB (A/Stable/A-1), Stångåstaden AB (A+/Stable/A-1), and MKB Fastighets AB (A+/Stable/A-1). Standard & Poor's calculations, however, reveal considerably lower ratios, at between 0% and 8% for all four of these rated MHCs.

Table 1

Estimated State Aid Given To Rated Swedish MHCs In 2002

	Fastighets AB Förvaltaren	Mitthem AB	MKB Fastighets AB	Stångåstaden AB	Uppsalahem AB
Owner munipality	Sundbyberg	Sundsvall	Malmö	Linköping	Uppsala
Total adjusted revenues (mil. SEK)	798	266	1,161	1,055	728
*Ernst & Young's calculations**					
Direct grant	0.0	0.0	0.0	0.0	0.0
Support that reduces borrowing costs	2.6	1.1	6.8	7.2	5.1
Cost of shareholder's adjusted equity	377.0	26.3	362.3	385.1	236.7
Total	379.6	27.4	369.1	392.3	241.8
Reported income after financial items	22.3	25.6	110.3	101.1	18.8
Total alleged state aid	357.3	1.8	258.8	291.2	223.0
Total alleged state aid as % of total revenues	44.8	0.7	22.3	27.6	30.6

Table 1

Estimated State Aid Given To Rated Swedish MHCs In 2002 (cont.'d)

	Fastighets AB Förvaltaren	Mitthem AB	MKB Fastighets AB	Stångåstaden AB	Uppsalahem AB
*Standard & Poor's calculations for the cost of equity**					
Direct grant	0.0	0.0	0.0	0.0	0.0
Support that reduces borrowing costs	2.6	1.1	6.8	7.2	5.1
Cost of shareholder's adjusted equity¶	181.1	18.1	337.0	222.9	172.8
Total	183.7	19.2	343.8	230.1	177.9
Reported income after financial items	22.3	25.6	110.3	101.1	18.8
Depreciation and write-downs	98.9	20.3	174.6	120.1	136.2
Income after adding back depreciation and write-downs	121.2	45.9	284.9	221.2	155
Total calculated state aid	62.5	(26.7)	58.9	8.9	22.9
Total calculated state aid as % of total revenues	7.8	(10.0)	5.1	0.8	3.1

*Based on annual accounts for 2002. ¶Return requirement of 7% on the entire adjusted equity has been assumed. MHC—Municipal housing company. SEK—Swedish krona.

There are important differences in the level of estimated aid received by different MHCs, and the main explanation is that the calculated cost of adjusted equity increases with the estimated market value of the properties. Since MHCs, as regulated by Swedish law *(*lagen om allmännyttiga bostadsföretag), are not-for-profit organizations, the companies that own properties with the highest market values would in general receive the largest amount of supposed state aid. Even if MHCs comply with Swedish law in that their profit levels are limited by legislation, it should be noted that whenever there is a contradiction between national laws and EU legislation, EU legislation takes precedence.

Looking more closely at the specific companies, Förvaltaren, and to some extent MKB and Uppsalahem, are the companies that have state aid ratios of any significance. Förvaltaren operates in a suburb of Stockholm, Sundbyberg, a region where excess demand for housing is very strong. MKB and Uppsalahem operate in the cities of Malmö and Uppsala, which are also characterized by supply side constraints.

It should be noted that the calculated ratios only reflect estimated state aid for one specific year, which could be affected by one-off factors. To have more comparable figures, a longer time period would have to be considered.

Swedish Government Expected To Aim To Avoid Formal Inquiry

The Commission has already held informal discussions earlier this year with the Swedish government, concerning the allegation of unlawful state aid for MHCs.

The dialogue between the Commission and the Swedish government has taken a temporary pause following the general elections in September 2006, which led to a new center-right government replacing the previous Social Democrat government. The new Minister for Local Governments and Financial Markets has already indicated, however, that the new government would aim at avoiding the case being turned into a formal investigation. Given that the new government has a more liberal view on housing policy than the previous incumbent, the possibilities for resolving the situation without launching a formal investigation, are likely to have improved since the election. If no such solution is found, the Commission could decide to proceed to a formal investigation, resulting in it making a decision with which the Swedish government would have to comply.

Standard & Poor's expects that the Swedish government will come up with changes to the current system that are bold enough to satisfy the Commission and prevent a formal investigation being launched. It cannot be completely excluded, however, that the government might ask the European Court of Justice to clarify the case, if there is strong political pressure for taking such a course of action. To Standard & Poor's knowledge, there are no precedents regarding the housing market and it is therefore difficult to predict what stance the Court could take.

State Aid Likely To Be Gradually Abolished?

In the event that the Commission decides unlawful aid is being provided, in our opinion, the most likely scenario is that state aid will have to be more or less completely abolished, but that the Commission could allow a transition period for the changes to take place gradually. This implies that many of the MHCs and the bulk of their operations may face progressively increasing requirements on their rates of return, and eventually be expected to provide rates of return similar to those of their private housing company counterparts.

Social considerations could well be taken into account, implying that exceptions would be made for the MHCs that operate in municipalities with large depopulation problems or for low-income households in need. The latter is, however, very much dependent on whether Swedish politicians would want to identify and segregate this type of social housing, as is already the case in many other EU member states. To date, the Swedish housing system has been based on a social integration model that does not distinguish between middle and low income earners, and Standard & Poor's expects that this model is likely to be defended by parties across the political spectrum.

Although the Swedish rent-setting system is not strictly covered by EU state aid rules, there is a high probability that the government would choose to abolish the exclusive normative role of the MHCs. There has been a parallel case at the Swedish Court of Appeal *(Svea Hovrätt)* where the Court states that the normative rental-setting role by the MHCs could be violating the EU competition rules regarding abuse of dominant position (Article 82 of the EC Treaty). Standard & Poor's believes that the utility value, which has no discriminatory feature in itself, will be kept. Nevertheless, in the future when assessing the level of rents, the assessment of the benchmark rent would have to be made incorporating the rents of both municipal and private housing companies.

Possible Impact Of Reforms On MHCs' Credit Quality

If the Commission assesses that the Swedish rental housing system will have to be reformed, the magnitude of the impact will depend on the approach used by the Commission in assessing the market requirements of the cost of equity. Standard & Poor's expects that the Commission will make a realistic assessment.

In terms of impact, there are likely to be large regional differences; the MHCs that are expected to be the most affected are those that operate in attractive areas, often in larger cities, and particularly in the Stockholm region. Depending on the degree of calculated state aid, the MHCs affected will face more or less important challenges in the future. Since there is likely to be a transition period for implementation, MHCs will have some years to gradually adjust to the new requirements. To increase their profits, the MHCs will have to make efforts both on the income and the expenditure sides. Standard & Poor's assesses that there is scope for improving efficiency and rationalizing MHCs' costs, but that rent levels in markets with strong excess demand are more or less certain to have to be increased as well, becoming more market-based.

Taking a closer look at the rating implications for the MHCs that we rate, Mitthem AB (A/Stable/—) and possibly also Stångåstaden ought to be largely unaffected by the changes that could be in store. The other three, however, Förvaltaren, MKB, and Uppsalahem, are likely to be affected to varying degrees, as they operate in areas of high housing demand. Standard & Poor's assesses that the likelihood that any of the Swedish MHCs will face claims for repayment of previous state aid flows is extremely remote, and therefore there does not appear to be any real credit cliff.

On the one hand, profits will have to increase with time and this will put a pressure on the companies to undertake efforts in terms of rationalizing costs. On the other hand, the companies are also expected to be able to generate higher cash flow (through a gradual increase in rents), which would provide an additional buffer in times of need. The MHCs are also likely to be able to use at least part of this additional cash flow to self-finance profitable investments—as EU state aid rules would allow a public owner to invest capital in their companies as long as a private owner would have done the same, that is provided the capital is used for profitable investments (the Market Investor Principle).

The new rules that the Swedish housing market appears destined to operate under would clearly bring wide-ranging changes. This would put pressure on the overall MHC sector, including the companies that Standard & Poor's rates. The MHCs that we rate, however, have a strong stand-alone credit profile. Moreover, the ratings will also continue to factor in the strong credit quality of their owner municipalities. The MHCs have a dominant market position, low vacancies, a high quality property portfolio with large surplus values, moderate leverage with respect to market values, and some fiscal flexibility on the cost side (see table 2). Although their credit profiles are likely to evolve with time, these strengths should continue to support the companies in the future.

Table 2

Key Business And Financial Indicators For Rated Swedish MHCs

	Fastighets AB Förvaltaren	Mitthem AB	MKB Fastighets AB	Stångåstaden AB	Uppsalahem AB
Issuer credit rating (MHC)*	A/Stable/A-1	A/Stable/—	A+/Stable/A-1	A+/Stable/A-1	A/Stable/A-1
Owner	City of Sundbyberg	City of Sundsvall	City of Malmö	City of Linköping	City of Uppsala
Issuer credit rating (owner)*	AA-/Stable/A-1+	AA-/Stable/—	NR	NR	AA/Stable/A-1+
Business statistics					
Local housing market	Significant shortage of rental dwellings	Limited shortage of rental dwellings	Shortage of rental dwellings	Shortage of rental dwellings	Shortage of rental dwellings
Market position (share of rental market)	Very dominant (65%)	Dominant (36%)	Dominant (29%)	Very dominant (60%)	Very dominant (60%)
Housing as % of revenues	71	87	89	87	>90
Housing vacancy rate (%)	0.0	0.4	0.4	0.9	0.1
Average housing rent (SEK/square meter)	881	820	816	776	881
Rental differentiation	Little rental differentiation	Some rental differentiation	Fairly large rental differentiation	Some rental differentiation	Some rental differentiation
Rental increase potential	High	Low	Medium	Medium	Medium

Table 2

Key Business And Financial Indicators For Rated Swedish MHCs (cont.'d)

	Fastighets AB Förvaltaren	Mitthem AB	MKB Fastighets AB	Stångåstaden AB	Uppsalahem AB
Portfolio	High quality properties, strong concentration in some districts	High quality properties, well diversified	High quality properties, well diversified	High quality properties, well diversified	High quality properties, well diversified
Financial statistics					
EBITDA interest coverage (x)	1.8	2.2	5.0	2.5	2.6
Debt/total capital (%)¶	83	77	60	63	78

*Ratings at Dec. 4, 2006. ¶Sector average for debt-to-total capital ratio is 80%. MHC—Muncipal housing company. >—Greater than. NR—Not rated.

Sidebar: Calculating Estimated State Aid In Terms Of Cost Of Equity

Ernst & Young's and Standard & Poor's differing methodologies for calculating estimated state aid are discussed below.

Ernst & Young has calculated the cost of adjusted equity based on a market-value-adjusted balance sheet (see "Public Support to Municipal Housing Companies," published by Ernst and Young in September 2004). As MHCs report their assets at depreciated book values, Ernst & Young's main assumption is that the market value of a MHC's properties is 133% of the tax value. (This is a reasonable basic assumption provided that the legal framework stipulates that the tax value should correspond to 75% of the market value.) Ernst & Young further assumes that the return requirement for the equity portion up to the tax value of the property portfolio value should be 5.3% (corresponding to the National Board of Housing, Building and Planning's subsidy interest rate at the time, *Boverkets subventionsränta*). In addition, Ernst and Young assumes that the adjusted equity portion exceeding the tax value is 9.3% (incorporating a risk premium of four percentage points). Subsequently, to arrive at the alleged state aid figures, Ernst & Young deducts actual reported income before taxes from the calculated required return amounts.

Standard & Poor's calculations are based on the following assumptions. First, our calculations are based on reported market values as assessed by independent appraisers for the respective companies (with the exception of Mitthem, for which Ernst & Young's assumptions are used as there is no reported market value). Second, when calculating adjusted equity, we have deducted deferred income taxes, that is, future tax payments relating to the surplus value of the properties, which would materialize once sold. We do not, however, adjust for transaction costs, as these are more difficult to assess. Third, Standard & Poor's has applied a return requirement of 7% for the entire adjusted equity, which would reflect a reasonable return requirement from an investor at the time. Currently, it would be much lower, as yields have converged. Fourth, as a market-value-based balance sheet estimate has been used, depreciation and write-downs should be added back to reported income. Conversely, one could argue that the valuation gains and losses (net of deferred tax) in the financial year should be added to reported income (in line with IFRS accounting), as these indirect gains are also accretive to equity investors. This component, however, is much more volatile than rental-based income returns.