Lars Nyberg: Swedish housing financing and the EMU

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riskbank, at Economics Day held at HSB Bank, Stockholm, on 8 November 2000.

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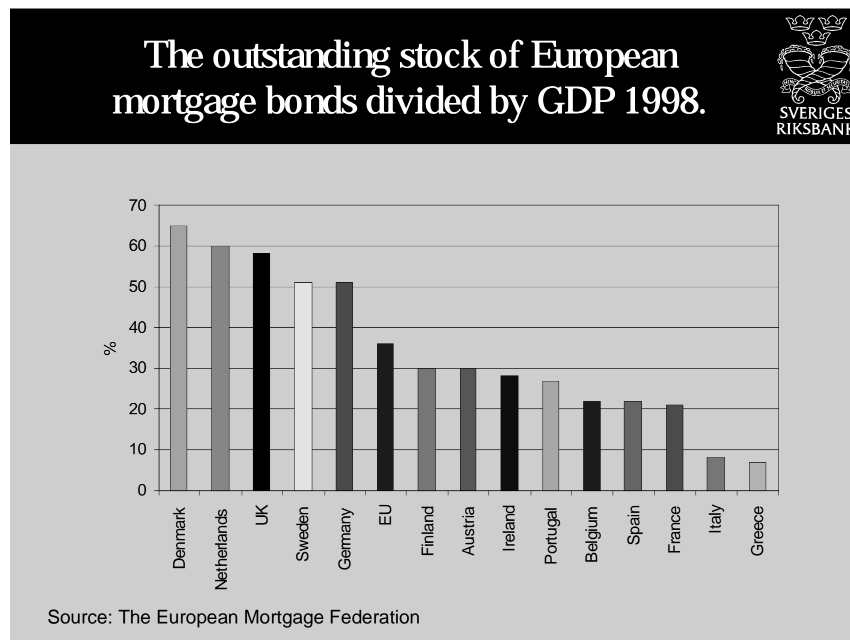
I would like to start by thanking you for inviting me to HSB Bank's Economics Day and giving me this opportunity to talk about Swedish housing financing from an EU perspective.

Introduction

One of the main purposes of the Single Market and the introduction of EMU is to create a more efficient market for goods and services, a market which is characterised by greater competition and better products at lower prices. On the mortgage market, this should mean that borrowers can expect a wider range of products, more choice of suppliers and lower interest rates.

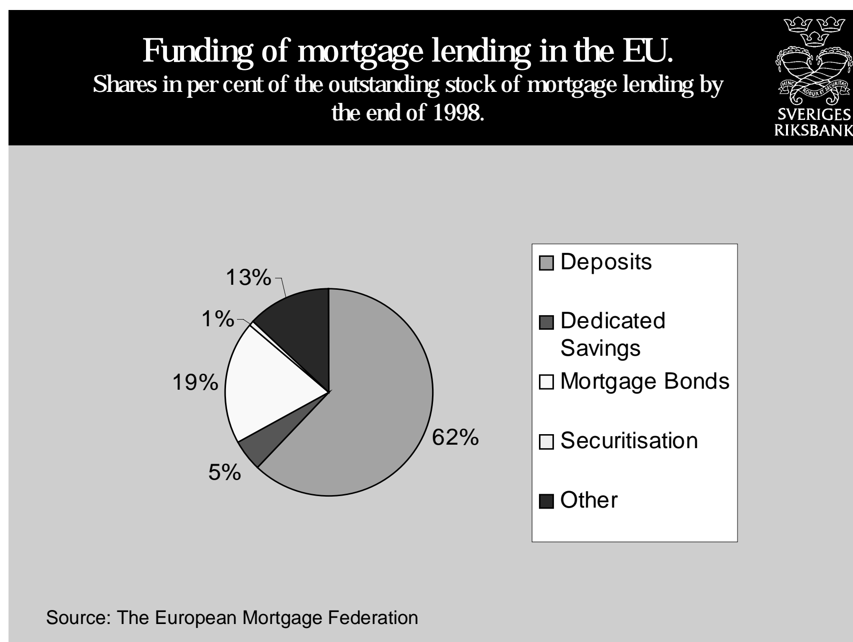
The national mortgage markets in Europe vary considerably, as does their significance to the country's economy. This is illustrated in the following diagram (Figure 1). In countries such as Germany, Denmark, Sweden, the Netherlands and the UK, the total outstanding stock of loans with property as collateral amounts to over 50% of GDP. In other countries, such as Greece and Italy, the corresponding figure is less than 10%. The differences are mainly due to factors such as different regulations, tax legislation and market structures in the different countries. As in Sweden, housing financing issues have often aroused considerable political interest, a fact which is reflected in all of the above factors.

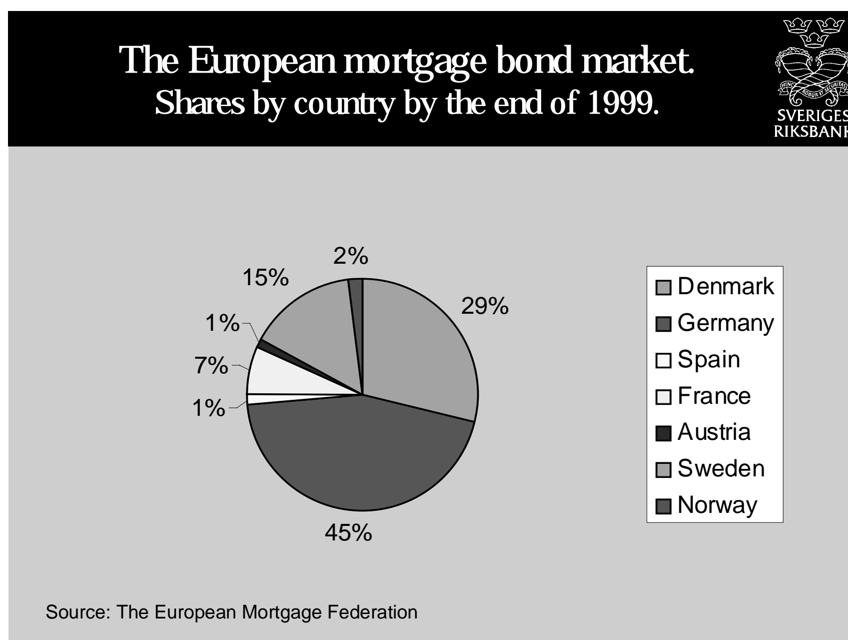


In the EU, the value of the outstanding stock of loans with property as collateral was estimated at around SEK4,500 billion at the end of 1999.[1] This stock of loans in Europe is mainly financed through

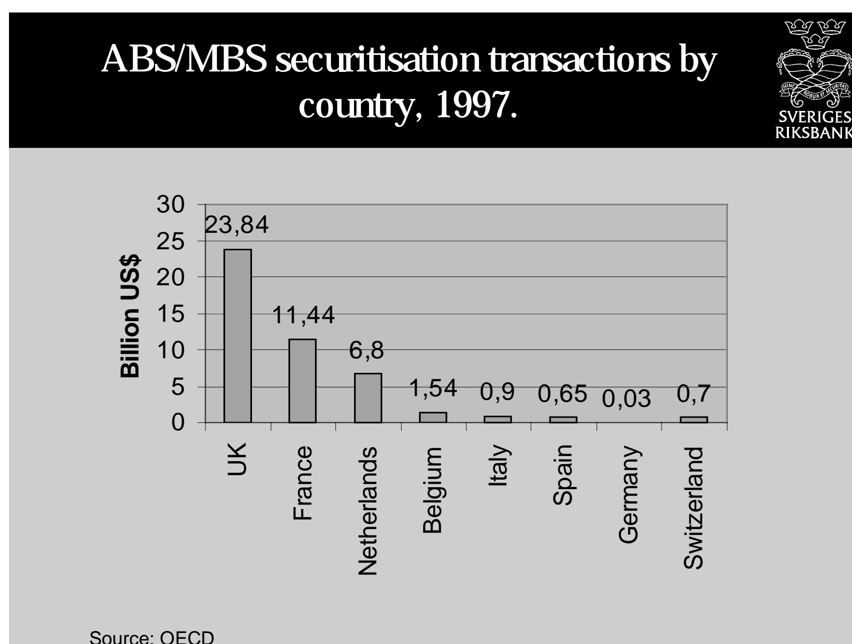
[1] According to the European Mortgage Federation

various forms of borrowing, around 62% (Figure 2). The second largest source of financing, approximately 19%, is through bonds, while a relatively new type of financing in the form of securitisation comprises around 1% of the outstanding stock of loans with property as collateral. The United Kingdom is the country in Europe where securitisation is most frequently used, followed by France, the Netherlands and Belgium (Figure 3). The market for securitised assets is still rather undeveloped in the other European countries.





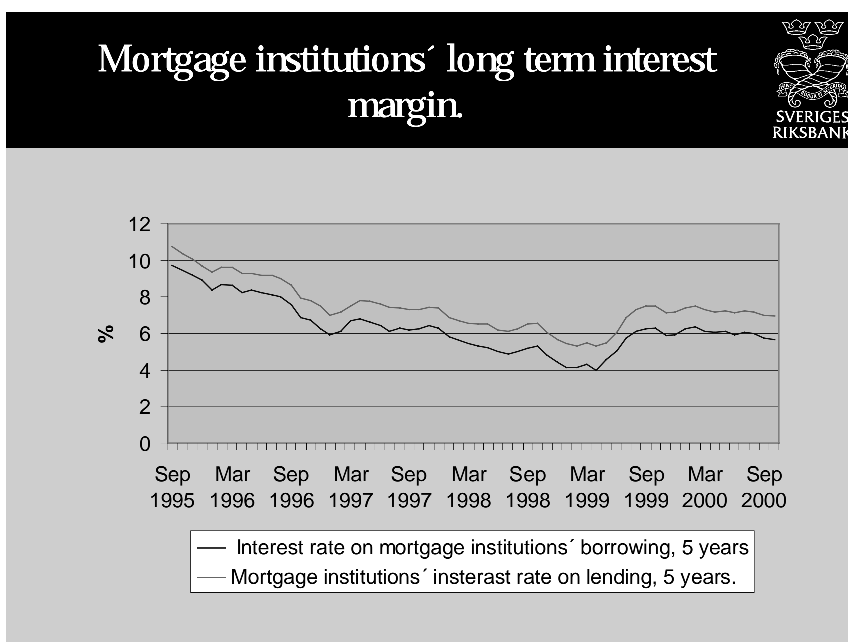
The European market for housing bonds is currently dominated by three countries - Germany, Denmark and Sweden. Together, these countries account for around 89% of this market (Figure 4).



Competition for customers

Although mortgages are a relatively straightforward and standardised financial product that should be well suited to sell abroad, international mortgage sales have been limited to date. One probable reason is that the mortgage market mainly targets private clients, which are hard to reach without using a local distribution network. In this respect, the Internet should be able to lead to greater transparency and competition, both by the credit issuers themselves supplying information and credit services over the Internet and by Internet-based brokerage sites finding the cheapest mortgages for borrowers.

While Internet-based mortgage services are still a relatively new phenomenon, they are likely to increase competition on the mortgage market. However, if we look at the spread between the cost of borrowing and the lending rate for mortgage institutions, there is no indication that the interest margin for mortgage institutions has fallen as a result of increased competition (Figure 5).



The new Internet-based players on the mortgage market are made up of those who mediate loans via the Internet and those who issue credit over the Internet. Players such as Blockbid, Bolånebörsen, Comboloan and E-loan search for and mediate the cheapest mortgages for borrowers. Europeloan, on the other hand, is an Internet-based credit issuer that has operated in Sweden since February 1999. The company, which also operates in Belgium and Germany, finances mortgages through securitisation.

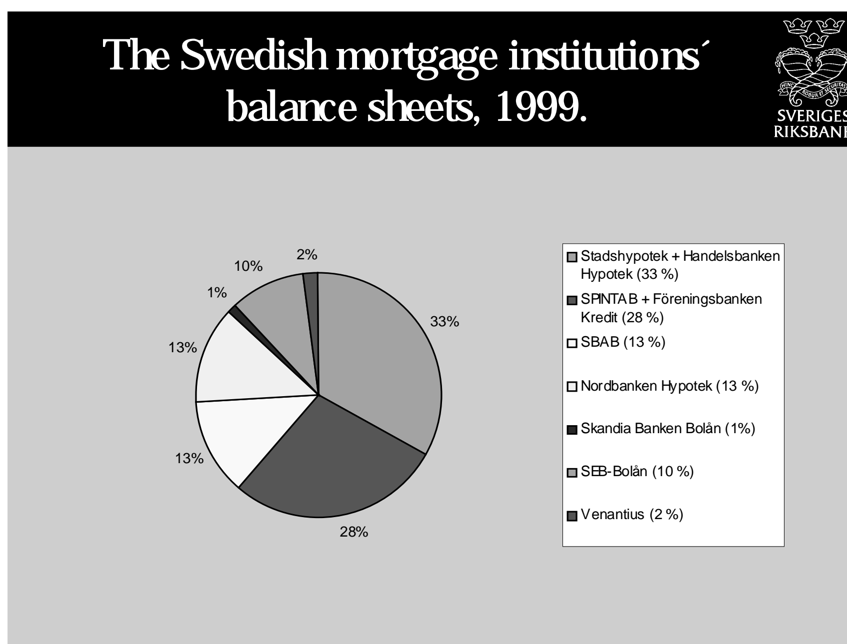
As more than 70% of the households have chosen floating interest rates on their new loans raised in the mortgage institutions during the last year, it could be suitable to look at the interest margin between short borrowing interest rates for mortgage institutions and floating interest rates on housing loans (Figure 6). This diagram suggests that the interest margin for mortgage institutions is now about 1.2% compared to about 1.5-1.7% during 1996.

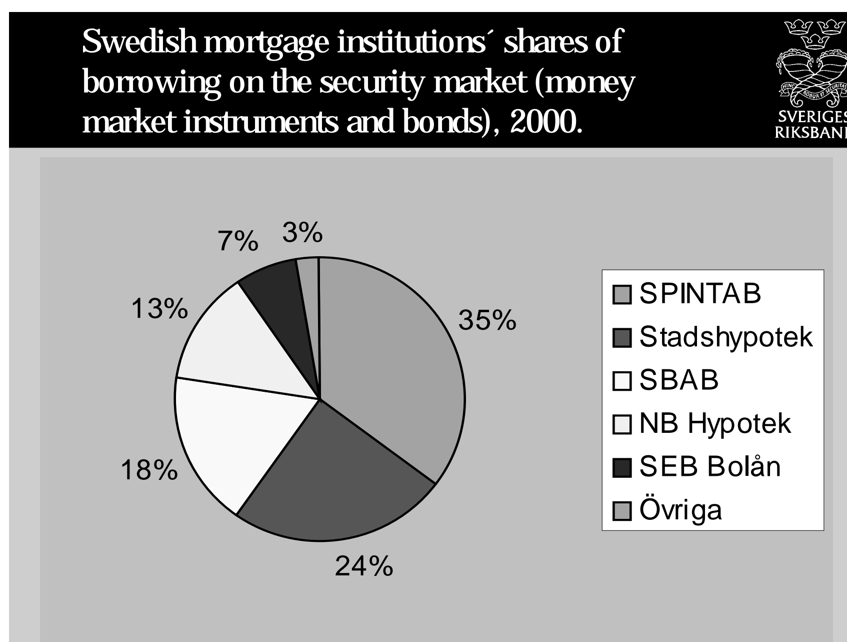
Lending by mortgage institutions to the household sector amounted to about SEK600 billion by the end of September 2000, compared to SEK581,6 billion at the beginning of the year. About 35% of the households' total borrowing raised in mortgage institutions are loans with floating interest rates, ie about SEK210 billion.

Another reason why cross-border activities have been limited so far is that the mortgage markets are governed by national regulations. A third reason is that cross-border activities are exposed to foreign exchange risk.

As long as Sweden is not a member of EMU, foreign players wishing to establish operations on the Swedish mortgage market will have to offer loans in Swedish kronor, since Swedish borrowers are unlikely to want to expose themselves to foreign exchange risks. However, if Sweden joins EMU, interest rates offered to borrowers in EMU-affiliated countries will be directly comparable. A common currency would make it easier for borrowers to assess which credit institution in the common currency area offers the best conditions. Swedish borrowers will be able to raise loans in euro without being exposed to foreign exchange risk, and access to potential lenders will increase.

The Swedish mortgage sector is currently dominated by five companies, one of which - SBAB - is state-owned (Figures 7 and 8). These five companies cover around 97% of the market. Since mortgages are a highly standardised product, the price, ie the rate of interest, will be a decisive factor in the competition for customers. As competition on the mortgage market increases, the cost of refinancing will become the decisive factor for mortgage institutions' possibilities to pursue a profitable business. I will therefore devote the rest of this speech to the question of refinancing.





Traditional mortgage financing

Swedish mortgage institutions finance their operations mainly by issuing bonds and certificates. The entire balance sheet of the mortgage institution serves as security for borrowing, and consequently each loan is not directly linked to a specific amount of collateral.

The advantage of the Swedish model is that borrowing can be undertaken without any fixed link to specific loans. This means that large loans can be put onto the market, which makes it easier to uphold regular trade and strong liquidity. This has been the case with the Swedish benchmark bonds. Thanks to significant lending volumes and strong price formation on domestic loans, the mortgage institutions have also been able to compete successfully on the international bond market.

Borrowing against the entire balance sheet as security requires significant risk capital or some form of guarantees from the owners. All mortgage institutions, with the exception of SEB Bolån which does not does undertake borrowing transactions in foreign currency, have a capital cover considerably above the statutory minimum of 8% (Figure 9).

Swedish mortgage institutions´capital ratios, 1999.

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	Total	Tier 1
NB-Hypotek	10	8,8
SBAB	9,4	6,5
SEB Bolån	8,8	4,8
Spintab	13,5	10,0
Stadshypotek	12,6	12,6

Source: Mortgage institutions´ annual reports.

The Swedish mortgage institutions are currently estimated to borrow around 20% of their capital from abroad. The major part of this is borrowed from investors in the USA and Japan. Borrowing in the euro area accounts for approximately 20% of borrowing abroad. It is difficult to see that the option of borrowing in euro would increase central European investors' interest in Swedish housing bonds. As long as Sweden is not a member of EMU and as long as Swedish borrowers want to borrow in Swedish kronor, the foreign exchange risk will remain.

Increasing competition on the mortgage market will entail a greater need for new forms of financing that are more economical with the institution's risk capital. Two financing forms being used increasingly by foreign mortgage institutions are gilt-edged bonds and securitisation.

Gilt-edged bonds

In Denmark and Germany, mortgages are primarily financed through specially regulated secure bonds. These secure bonds are mainly housing bonds with clearly defined collateral. Security for this type of bond is regulated by law and the bonds are subject to strict supervision by authorities.

The German and Danish secure bonds have been given special treatment in EU directives. Under this special treatment, member states can exempt insurance companies and fund companies from the normal requirements for spreading risk for these bonds and a lower risk weighting can be applied when calculating capital adequacy requirements.

The government has instigated an investigation into whether gilt-edged bonds could be introduced in Sweden. In brief, the proposal means that a priority right would apply for this type of bond, that clear limits would be defined for the collateral ratio (max 75% for residential property) and that collateral

would be identified in a special register controlled by the Swedish Financial Supervisory Authority. The proposal is currently being examined by the Ministry of Finance.

The main argument in favour of allowing Swedish mortgage institutions to issue gilt-edged bonds is that such bonds are issued by European competitors and are already established on the market. Gilt-edged bonds would thereby be easier to sell to investors, would involve higher liquidity and give lower interest rates than traditional Swedish housing bonds. This would facilitate the mortgage institutions' financing and would hopefully result in lower interest rates for consumers.

However, the Riksbank is critical towards the proposal on account of the doubtful role that the national supervisory authority would assume by taking responsibility for ensuing that the total collateral for the loan is intact. The supervision of Finansinspektionen may create the impression that the government is assuming special responsibility for the security of the bonds, and this is not the intention.

Special legislation on gilt-edged bonds is likely to entail a return to tighter market regulation as mortgage institutions would be granted a special status on the capital market. What economic reason motivates to show favour to a certain group of borrowers?

It is not obvious that gilt-edged bonds would contribute to reducing the mortgage institutions' total financing costs. Gilt-edged bonds can only be issued against security up to a certain limit of the collateral value. It is likely that the remaining stock of non-secured loans will become more expensive to finance. The use of gilt-edged bonds may lead to lower financing costs for the issuing mortgage institutions if these institutions do not have to bear the cost of the special supervision that gilt-edged bonds require.

In my opinion, the increasing competition will promote new forms of funding that make more efficient use of equity.

Securitisation

One financing form that permits the efficient use of equity is securitisation. Securitisation involves a given loan stock with accompanying collateral being taken off the balance sheet of the mortgage institution and sold to a separate company specially created for this purpose (known as a special purpose vehicle). This separate company is then financed through issuing bonds on the market. The special purpose vehicle has a clearly defined risk scenario and does not pursue any business activities other than acting as holder of the specified loans. Consequently, the company is not subject to the capital adequacy regulations that apply for mortgage institutions.

Securitisation has several advantages, the main one being that it enables mortgage institutions to reduce their share of equity and thereby their total financing cost, since equity is a more expensive source of financing than loan financing. Furthermore, mortgage institutions can streamline their operations by selling claims and by specialising in issuing loans. Securitisation can also increase the stability of the financial system as credit risks can be transferred from institutions subject to regulation to players that are less sensitive to heavy credit losses.

Securitisation using a special purpose vehicle located in Sweden is permitted, but in practice it is unprofitable since, under the current regulations, the special purpose vehicle will be subject to the same capital adequacy regulations as the mortgage institutions. A proposal to improve the conditions for securitisation in Sweden is currently being prepared by the Ministry of Finance. The Budget Bill for 2001 states that the government intends to put forward a bill on improved conditions for securitisation during autumn 2000.

To date, three Swedish mortgage institutions, SBAB, SEB-Bolån and Bokredit have undertaken securitisation via special purpose vehicles abroad. On five occasions between 1990 and 1994, SEB securitised mortgage loans totalling SEK 12 billion, and in June 2000, the same bank securitised mortgage loans worth approximately SEK 8.5 billion. SBAB securitised mortgages worth approximately SEK 1 billion in February 2000 and loans worth approximately SEK 8 billion in October 2000. Bokredit, owned by Den Danske Bank, has securitised a stock of mortgage loans to a

value of SEK 1.3 billion. A new Internet-based issuer of mortgage loans is Europeloan, which started up operations in Sweden in February 1999. Europeloan is financing their internet based mortgage lending by securitisation of the loans abroad, up to now around SEK 0,5 billion.

Objections that have been expressed against securitisation include the fact that up until now it has been relatively complicated and costly to set up special purpose vehicles, and it has not been possible to invest the bonds at such favourable interest rates as their rating would imply. Possible reasons are that the market is underdeveloped and the issues have been few, which has meant that liquidity in the bonds has been low.

Securitisation of mortgages is common in the USA, where around half of the total outstanding loans stock of secured loans is securitised. In Europe, housing financing has mainly taken other forms. If competition in the mortgage market increases as a result of EMU, it is likely that the need to finance mortgage loans as economically as possible will also increase. Taking this into account, it is not unreasonable to believe that securitisation will become a more attractive option.

Increased competition can thus lead to a growing market for securitisation. Alternatively, the opposite may apply, ie that improved opportunities for securitisation will increase competition. This is what happened in Australia, where the mortgage market was deregulated during the 1990s. Legislation facilitating securitisation reduced the previously high market entry barriers, paved the way for new players and reduced costs for borrowers by as much as a couple of percentage points.

Conclusion

Overall, most factors point to an increase in competition on the mortgage market. New forms of financing, new technology and possible EMU participation will contribute to reducing costs for new players trying to enter the mortgage market. Since mortgages are standardised products, lenders will compete on price, ie the rate of interest on the loan. The financing issue will therefore be a decisive one for issuers of mortgages.

Traditionally, mortgage institutions have financed their operations by borrowing using their entire balance sheet as collateral. This method of financing is relatively expensive for mortgage institutions and as competition on the mortgage market increases, so will the need for cheaper methods of financing.

Securitisation and gilt-edged bonds have been discussed as possible methods for mortgage institutions to reduce their financing costs. Of these two financing methods, securitisation stands out as having the greatest potential for reducing financing costs, since securitisation makes the most efficient use of equity.