Eva Srejber: Future issues for the housing market in Sweden against the background of Basel II

Speech by Ms Eva Srejber, Second Deputy Governor of the Sveriges Riksbank, at the annual meeting of the Swedish Association of Municipal Housing Companies (SABO), Taeby, 8 January 2002.

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Introduction

I should like to begin by thanking you for the invitation to come here and the opportunity to discuss this evening's theme of future issues for the housing market.

At the beginning of May 2001 I gave a talk to SABO Byggnadsförsäkrings AB on the property market and economic trends in Sweden. I then took up the question of why and how the Riksbank monitors the property market. The focus for this evening will be on what the future may hold for the property market and granting of credit for the purchase of property and housing. My talk should therefore be seen (and heard) as a complement to, or continuation of, my earlier talk.

My talk this evening will primarily deal with our view of the housing market and the role it plays with regard to financial stability and potential growth. I will then go on to describe the credit granting process and current changes that will affect this process. I will conclude with a look towards future developments.

The role of the housing market for financial stability and potential growth

Let me begin, however, with brief description of the housing market from the Riksbank's perspective. Those who wish to go into this subject in more depth can read our most recent Financial Stability Report. As we know, the property sector consists of two parts: the housing market and the commercial property market. The Riksbank studies the property sector for two main reasons. One reason is that property companies comprise the largest individual borrowers from the banking groups - approximately 15 per cent of the banks' lending is to property companies. Properties are also the dominant form of collateral for loans. Loans with property as collateral comprise almost 50 per cent of the bank's lending against collateral. The health of the companies in the property sector therefore has repercussions for financial stability.

The growth rate for credit has remained at an average level of just over 6 per cent a year for the past four years, which exceeds annual GDP growth by a few percentage points. It could be considered cause for concern to have a higher growth in credit than in fundamentals, i.e. GDP, and it is easy to recall developments at the beginning of the 1990s, but since then there has been a change in the focus of monetary policy and fiscal policy towards macroeconomic stability. At the same time, the effects of earlier as well as new structural reforms, such as the tax reform, the pension reform and deregulation, have also contributed to the Swedish economy becoming less sensitive to disturbances now than it was in the 1980s. In addition, the experiences of the financial crisis have also led to a change in behaviour in the financial sector. The financial situation appears stable and the banks' increase in lending is not so high that it can be interpreted as greater risk-taking in the financial sector.

Approximately SEK 420 billion of the total lending by mortgage institutions comprises loans to purchase apartment blocks. This is a large percentage, almost 40 per cent of the total lending by these institutions. However, the figures on lending during the 1990s show that both the percentage and the volume of lending in this area is declining. Statistics provided by the mortgage institutions with regard to gross flows of loans for various purposes with apartment blocks as collateral confirm this picture. In 1991 new building was the reason for most of the lending, while renovation and extensions accounted for only a minor part. During 2001, on the other hand, new building accounted for a small part, renovation and extensions for even less, while the largest percentage was for other purposes.

Why is this? Naturally, it is related to the way the sub-markets function. The market for single-family dwellings functions well with buyers and sellers agreeing on a market price when houses are sold. Once a single-family dwelling has been built, the market functions well without any major disturbances from restrictions or regulations.

The market for apartment blocks, on the other hand, is more complex, as it is affected by a number of different regulations and restrictions. This has led, for instance, to the relationship between rents and prices in this market not being stable. Normally, there should be a connection between the development of prices and rents for apartment blocks, as the future cash flows that constitute the basis for the valuation of the property are primarily governed by rent income. However, the statistics regarding prices and rents for apartment blocks show that the rise in prices of apartment blocks has been clearly higher than the rises in rents since 1995. A similar development took place between 1987 and 1990, although the price rise was much more rapid then. The price increase at the end of the 1980s was driven by expectations of future price rises. Regulations in the form of the utility value system and central rent negotiations provide modest changes in rent every year. The changes in rents do not vary substantially in connection with economic activity and demand. These regulations may have a stabilising effect on the property sector in that they stabilise income flows, given that the vacancy rate for housing is low and does not vary. Stable income flows are a good thing from the lender’s perspective.

Do these regulations cause any problems? I can see two main problems, which I shall discuss. The first is that price formation for rental properties in relation to tenant-owned properties is distorted, which means that the stock of tenant-owned apartments may come to comprise an overly large part of the total apartment stock. This could be negative for growth, as it could mean that, for instance, young people and other groups with a shortage of capital may experience difficulty in entering the housing market and moving to where the jobs are. Prices of apartment blocks are largely governed by prices for tenant-owned apartments, as apartment blocks are currently sold most often in connection with a changeover from rental property to tenant-owner associations. This means that as long as the utility value principles apply for apartment rents and prices for tenant-owned apartments remain high, the difference between the development in rents and prices will remain. As the utility value system limits the income a rental property can generate, the market value of rental property is also limited, and both the owner of the rental property and the future tenant owners profit if the property is transferred at a price somewhere between the market value for rental properties and the market value for tenant-owner apartments. Despite the fact that prices for tenant-owned apartments have fallen slightly, the difference between the price of apartment blocks sold to tenant-owner associations and the price of rental properties indicated by rent levels. One explanation could be that when property owners sell rental properties for conversion to tenant-owner associations, they take a larger part of the price difference between the two property types.

While the utility value principle has certainly contributed to an evening out of rent levels over the economic cycle, it has also contributed to making it more profitable to allow apartment blocks of rented apartments to be converted to tenant-owner apartments than to sell them to another owner and continue to run them as rental properties.

The second problem is that the regulation of rents, in connection with a number of other institutional factors, is holding back new production of rental properties where there is a demand for housing. The way prices on apartment blocks develop in future will depend on the supply and demand situation, as well as on regulations. The total growth in demand is steered mainly by population growth, while the distribution of demand around the country is steered by where growth occurs. In general, housing construction has been much lower during the 1990s than in previous decades. According to the National Board of Housing, Building and Planning’s most recent nation-wide forecast for the number of apartments in apartment blocks where construction has begun, just under 11,000 apartments had been started last year and just under 13,000 will be started this year, from a level of just over 9,000 in 2000. This can be compared with almost 42,000 new apartments in apartment blocks begun in 1990, immediately prior to the property crisis. Residential construction of apartments in apartment blocks in relation to the population increase has been lowest in Stockholm county, followed by Skåne county and Västra Götaland county.

One ray of hope is that the number of building permits granted for apartment blocks is continuing to increase, which indicated a continued increase in new production of apartment blocks. Factors such as regulated rents for rental properties, i.e. the utility value system, a lack of land with planning permission in growth regions, the construction of the municipal tax equalisation system, the imbalance between traffic situations and housing in growth regions and long planning processes probably all contribute to the relatively low level of residential construction, even in areas where demand is high. A further restriction is the lack of competition in the construction sector. This is demonstrated in the developments in prices and wages in the sector. Construction workers’ wages have increased more than those of industrial workers in recent years. Another example is that the costs of construction materials, which constitute approximately one-third of total construction costs, have shown price increases over and above other industrial products for some time now, with price rises even during periods of low demand. One important explanation for this is the fact that the construction trade is concentrated to a small number of large companies. In some markets, for instance, those for cement, reinforcement steel and plasterboard, one company accounts for more than 50 per cent of total sales. This can mean that utility value rents do not cover total production costs in growth regions where land and construction costs are relatively high.

It is evident that the total regulatory framework does not contribute sufficiently to ensuring that supply follows demand.

The low level of construction and the high level of immigration to metropolitan regions contribute to prices in the market for apartment blocks being relatively little affected by the current lower level of economic activity. Property companies' earning capacity should thus be relatively stable, which is positive from the point of view of both the company owners and creditors. However, the weak level of residential construction has led to sluggishness in the housing market. The fact that it is possible to move between residential areas and between regions stimulates mobility among the labour force and flexibility in the functioning of the labour market, which affects economic developments. A clear example of this is the Stockholm region, which has a housing shortage. This has probably led to a lower growth for the Stockholm region than would have otherwise been the case. As 25 per cent of Sweden's economy lies in Stockholm, this affects the entire country's growth potential. A housing sector that does not function properly will thus affect the country's potential growth, as it will become more difficult for labour to move to where the jobs are. For this reason, it is in my opinion important that a review is made of the total complex of regulations governing the functioning of the housing market, in order to allow it to function better. From the Riksbank's point of view, a higher potential growth means that demand in Sweden can be higher at the same time as price stability can be maintained.

The credit granting process

If the housing market can become more flexible, it will enable new construction where housing is most needed. These new investments will need to be financed. It is therefore important to be aware of the professionalisation of the credit granting process that has occurred within the financial institutions following the bank crisis. This is reinforced by the new capital adequacy rules that are being worked out. The modern credit granting process focuses more on the individual borrower's cash flows. This individualisation means that the interest paid will to a greater extent reflect the market's valuation of the profitability of the individual object, e.g. a particular property.

Does the banks' setting of interest rates vary between different borrowers and credit objects? How is credit granted today? How do the banks assess a loan application? I shall not explain these processes in detail, but outline the most important elements. Credit granting is part of the banks' core business. It involves mediating savings to borrowers. As managers of our savings, the banks have always needed to be able to assess, measure and manage the risks inherent in these operations. The four major banks regularly monitored by the Riksbank have similar procedures with regard to granting corporate loans. The bank assesses the risk in a particular loan on the basis of two aspects: the customer's ability to repay and the collateral that can be offered. The customer's ability to repay is the more important of these two aspects. For obvious reasons, loans without collateral are assessed more stringently. The fact that the banks now focus more on the ability to repay than on the value of the collateral is a lesson learned from the bank crisis in the 1990s.

Before a loan is granted, it is necessary to assess the risk of default in the form of a suspension of payments or bankruptcy. This means that the banks consider stable cash flows to be more interesting than whether a project can provide a higher yield than expected. On the basis of the bank's assessment, the borrower is assigned a risk classification. This classification contains both quantitative and qualitative factors and the risk grade is reviewed annually. The quantitative analysis is based on the company's profit and loss statements and balance sheets, while the qualitative analysis is based, for instance, on the company's competitiveness and the quality of its management. When making the decision to grant a loan, the assessment of the customer's ability to repay is supplemented with information on the specific loan, for instance, the amount of the loan and the collateral the borrower can offer against the loan. The most common form of collateral is mortgage deeds, but other types of collateral do exist. In addition to these internal assessments, the banks may supplement their analysis with external credit assessments. There are some independent external credit assessment companies in the market. These use various means to estimate, for instance, the likelihood of bankruptcy in almost all Swedish companies.

The risk involved in a loan can also be affected by the terms of the loan agreement signed by the bank and the customer. This is because the loan agreement can contain certain clauses entailing specific measures to be triggered in the event of various credit events. Examples of such events could be that the company's solvency falls below a particular predetermined level or that the owner conditions change. If one of these events occurs, it may comprise grounds for renegotiating the loan agreement.

The starting point for the banks' pricing is an overall assessment of the customer. This means that pricing is not solely dependent on the bank's risk classification of the loan, but also on the other income the customer may be expected to provide. What the banks lose on the swings, they may regain on the roundabouts. The banks' pricing can take into account risk classes and collateral, but there is not always a direct connection between prices and risk classes. However, developments in regulations and on the capital market favour a stronger connection between interest rates on loans and risk classification of the borrower.

The banks' credit assessment procedure is not a static process. The major Swedish banks currently have well-functioning organisations, methods and systems for assessing loans and managing credit risk. Developments in financial theory and rapid advances in IT over the past decade have created new and improved conditions in this field, and the banks have made good use of this.

As a borrower it is important to be aware that the individualisation in the modern credit granting process has also been taken up in the shaping of the new capital adequacy rules, where it will be possible to price loans more fairly.

Why do we have capital adequacy rules? As the banks play such a central role in the payment system, and the costs of disturbances in the system and in the credit market would be very large and have to be borne not only by the borrowers and lenders, but by society as a whole, the banks have long been subject to scrutiny and oversight with regard to their risk-taking. Since 1988 we have had an international agreement, the Basel Accord on capital adequacy rules. This involves, in simple terms, regulations as to how much capital a bank must hold with regard to different borrower groups for each hundred krona it lends out. It is much more costly for the banks to finance themselves by holding their own capital than through borrowing, just as for other companies. A higher capital adequacy requirement for taking bigger risks will thus lead to the banks being forced to charge more for lending money to higher risk borrowers. This is a regulatory system that is used by 120 countries and it contributes to financial stability around the world.

However, the current capital adequacy rules from 1988 are divided into 4 fairly rough risk classes, which do not very well reflect the risk with various borrowers. For instance, the risk classification means that all companies are in the same risk class, despite the fact that they can differ markedly from one another. There has therefore been intensive work on further developing these rules by the Basel Committee, in which both the Riksbank and Finansinspektionen (the Swedish financial supervisory authority) participate.

The idea with the new rules is that the risk weighting will better reflect the actual credit risk. This means that the banks will become more thorough in assessing the relationship between the risk in the credit and its yield. An increased risk will therefore be marked in the banks' pricing of loans, i.e. the interest rate. There are both advantages and disadvantages with the proposed capital adequacy rules. The proposed rules mean that the banks must hold more capital if the risks in their given loans increase. If they do not have more capital than the rules require, they must either acquire more capital or reduce the risks in their lending. In this type of situation, the bank may choose not to renew loans, which could have extremely negative consequences for the borrowers. The new rules thus risk reinforcing the sequence of events. However, there are many positive consequences; a more sound and individual risk assessment, which will better protect savings and reduce the risk that taxpayers, through the central government, will have to step in, opportunities for cheaper loans to borrowers who constitute a low risk but also increased interest rate costs for companies that are high risk. A fairer pricing of loans, in other words.

Unlike shares, where it may be considered exciting to take risks and hope for a high return, boring loans are cheap loans for borrowers. By this I do not mean that loans for apartment blocks are boring, but they are normally considered stable and durable. Characteristic for loans is a small expected profit, but with the low risk of very large losses. Loans that cost a low interest rate are therefore slightly boring loans with stable cash flows that generate stable interest payments and regular repayments, in other words, low risk.

So how will the new capital adequacy rules affect loans and credit granting to public utilities companies? A first reflection is that the banks will study credit objects and the companies concerned in a more individual manner than before. A second thought is that the banks, when pricing loans, will look at the cash flow from the loan, which in this case can be equated with the company's cash flow. In most cases, your companies have a large value in their properties as collateral and this will continue to be a positive thing for you, but as I said earlier, the banks today focus firstly on the customer's ability to repay and then on the collateral offered.

What is important to a company that has loans?

- Meticulous balance sheets and profit and loss accounts for the present time and going back a number of years.
- Low vacancy rates in the housing stock and rents that are paid on time.
- The banks will not merely evaluate the size of the cash flows, but also their stability.
- Orderly and well cared for property stock, i.e. property management is important.

It is therefore important to have good knowledge of the bank's actions and method of working. The difference in interest rate between borrowers of varying risk classes will be greater in future than it is today. It will therefore be important for companies applying for loans to present themselves as attractive borrowers to the bank or the capital market. If they want a low interest rate on their loans as a result of their negotiations with the bank, it is important to be able to demonstrate a company that has been stable and well managed for a number of years. The proposed changes in the capital adequacy rules will apply with effect from 2005, but developments in the capital market could very well lead to the banks' credit granting being adapted gradually to the new rules in advance of their introduction. It is therefore important for capital-intensive operations to prepare now for a more individualised credit assessment in future. The opportunities for finding competitive financing on the loan market at a low interest rate will be available to those who can convince lenders that their operations will generate stable future income. Higher risks, e.g. in the form of varying income flows will cost more.

Looking towards the future

I can see two important issues for the industry to consider for the future. The first is the financing of the new construction that is needed, where the effects of the modern credit granting process and the new capital adequacy rules will affect SABO's operations. It will be a sensitive issue for housing companies in municipalities with high vacancy rates and declining populations, particularly in the light of your own report issued just before Christmas. Previously, municipalities and municipal operations with municipal guarantees have been able to obtain loans on improved terms. In addition to the property as collateral, a municipal housing company has been able to use the municipality's guarantee as collateral. In future, it is not so certain that this will lead to improved loan terms to the same extent as now. For one thing, the municipality's credit rating could fall because it takes on another large credit commitment, which would lead to higher loan costs for both the municipality and the housing company. For another thing, there are some credit providers who have already ceased granting loans to municipalities with a poor ability to repay. This situation will probably be accentuated by the advent of the new capital adequacy rules, with more individual assessments of each borrower. Given this, it will be even more important to consider the four points I mentioned earlier.

The other important issue is to implement a review of housing policy, as it is important to obtain the construction needed in the regions where jobs are available. This will enable Sweden's economy to develop well. One example of possible changes is the introduction of market-adapted utility value rents or the complete disappearance of the utility value system.

It is possible that more market-adapted rents would contribute to increased production of new properties as a result of increased demand, unlike the current utility value regulated rents where increases in demand do not result in sufficiently large new production of apartment blocks of rental apartments in growth areas. It is often said that a changed, market-adapted system would lead to higher rents, but the question is whether this scenario would not only apply to the more attractive residential areas of the metropolitan regions and university towns. There are currently approximately

22,000 apartments vacant throughout the country and scenarios indicate that the vacancy rates in certain areas may increase further. What would market rents involve for areas in Sundsvall, Karlskoga, Boden or Bergsjön in Gothenburg? Would the rents in a market-adapted system be reduced in these areas to be able to compete with the single-family dwelling market? Yes, that is possible, but the question is whether the vacancies would be filled in all of the "emigration" regions? It would probably only apply to regions within commuting distance of jobs. However, if market rents and other changes in the regulations may mean that housing is built where it is needed, which will enable the labour market to function better, this could in any case improve Sweden's potential growth.

There are indeed a number of important future scenarios that need to be considered by both the housing companies themselves and the banks as lenders.