

Svein Gjedrem: Housing finance in Norway

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), to the Norwegian Covered Bond Forum, Oslo, 27 January 2010.

The text below may differ slightly from the actual presentation. This lecture does not contain assessments of the economic situation or current interest rate setting.

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From state to private housing finance

After the Second World War, the credit market in Norway was regulated. Credit demand was high. The Norwegian state endeavoured to steer credit flows towards priority sectors and the state banks therefore played an important role as credit intermediaries.

There were considerable housing shortages after the war. For some population groups, living conditions were poor. In 1946, the Norwegian State Housing Bank was established to provide credit for new residential construction. This bank and Statens Landbruksbank (the state agricultural bank) dominated housing finance for new house purchases up to the 1980s. State bank mortgage rates were initially set based on political objectives, but were over the years gradually revised up and adjusted to market rates.

With the gradual deregulation of the credit market in the 1980s, state lending institutions assumed a lesser role in housing finance and the private market took over. Sales of existing homes increased. In 1992 private banks provided the majority of residential mortgages. Their share of housing finance was also high compared with other Nordic countries. In Denmark and Sweden, mortgage institutions were the primary source of residential mortgages. Even though their importance has been reduced in recent years, mortgage companies still provide most residential mortgages.

With the predominance of mortgage companies, fixed-rate mortgages have been a tradition in Denmark and Sweden. This has not been the case for Norway. Mortgages from the State Housing Bank were primarily adjustable-rate loans. After credit market liberalisation, adjustable-rate mortgages were also offered by banks. The supply of fixed-rate mortgages was limited. Fixed-rate loans are less common in Norway than in the other Nordic countries.

From the 1980s to the 1990s, the Norwegian economy moved from high to low inflation with, until recently, falling nominal long-term interest rates. Borrowers with fixed-rate mortgages fared poorly in this period, and even more poorly than maturity or mortgage insurance premiums alone would imply. But with a clear monetary policy objective to keep inflation low and stable – and with an independent central bank tasked with achieving this objective – the result would be different. The high inflation expectations that were built into long-term interest rates no longer exist and a further marked fall does not seem likely, nor for that matter does any substantial inflation-driven increase in long-term rates. Purchasing a home is a long-term investment. A fixed-rate mortgage reduces borrowers' uncertainty about expenses over the life of the loan.

Longer-term financing in banks

Banks play an important role in the economy. Their task is to convert short-term deposits into long-term loans. In times of crisis, fulfilment of this task is put to the test. A century ago, depositors could lose confidence in the banks and rush to withdraw their savings. However, deposits stabilised when guarantee schemes were established in the 1930s.

Loans to households make up a third of banks' assets. Residential mortgage loans are long-term loans. At the same time, funding for Norwegian banks has changed. Market funding has assumed a more important role. In recent years, both short-term market funding and funding

in foreign currency have grown in Norwegian banks. Banks have increasingly transformed short-term deposits from international money markets into long-term domestic lending. This is the main reason for the strain on liquidity experienced by Norwegian banks when foreign funding came to a halt in 2008. For Norwegian banks, the financial crisis has primarily been a liquidity crisis and not a solvency crisis.

The authorities all over the world are currently reviewing the regulation of banks' liquidity. The Basel Committee on Banking Supervision presented recommendations on quantitative liquidity requirements in December 2009. The UK, Switzerland and New Zealand have introduced, or are in the process of introducing, stricter rules. Norwegian banks must also expect the regulation of liquidity to be more stringent in the future. It will be more difficult to base housing finance on short-term funding. Issuing covered bonds may be an alternative. The collateral pool for covered bonds may comprise residential mortgages or mortgages for holiday homes with a loan-to-value ratio (LTV) of up to 75 per cent, commercial property mortgages with an LTV of up to 60 per cent or loans to public sector entities with an LTV ratio of up to 100 per cent. These instruments are highly collateralised, carrying lower risk premiums than ordinary bank bonds, and are well suited to pension fund investment and other investments with a long-term horizon.

According to the rules for the issue of covered bonds, the value of the cover pool is required at all times to exceed the value of the covered bonds. Both assets and liabilities are to be recorded at estimated market value. This implies that a mortgage company must add further collateral to the cover pool, for example in the form of government bonds, to replace any shortfall.

An efficient bond market can handle large trading volumes without substantially affecting prices. Such a market requires instruments that are easy to understand and clear regulation. Trading should be transparent. Ideally, there should be multiple independent bidders and askers and trading volumes should be high in primary and secondary markets.

Issues of covered bonds have picked up in Norway since the regulations relating to covered bonds entered into force on 1 June 2007, supported since autumn 2009 by the arrangement for the exchange of government bonds for covered bonds.

To facilitate banks' access to borrowing from Norges Bank during the period of financial turbulence, collateral requirements for loans were temporarily eased. In October 2009, it was announced that the temporary rules for collateral requirements would be changed. Acceptance of new securities eligible under the temporary rules was discontinued in October. Securities already approved under the temporary rules would be eligible as collateral until maturity, or at the latest until 15 February 2012.

Changes in the so-called bank quota were also announced. Under the current rules, up to 35 per cent of a bank's borrowing facility can be based on collateral in bonds issued by other Norwegian banks. Debt instruments issued by foreign banks will be included in the bank quota as from 1 December 2010. Securities issued by banks will no longer be eligible as collateral for loans as from 15 February 2012.

Covered bonds will still be eligible as collateral, including, until further notice, bonds to which no credit rating has been assigned and bonds issued by a bank's own mortgage company. This is expected to contribute to the development of the Norwegian covered bond market.

The housing market – a source of disturbances in the economy

Banks have had strong incentives to extend credit for house purchases. Even during the banking crisis around 1990, Norwegian banks' losses on residential mortgages were low. This is reflected in the low risk weights for residential mortgages in banks' risk models. For an individual bank, residential mortgages are low-risk loans. However, market fluctuations, accompanied by shifts in saving behaviour, are nonetheless a source of business cycle

fluctuations and substantial losses when banks have to write off loans to firms selling goods and services to households.

With low risk weights for residential mortgages, banks can lend extensively, operating with a substantially reduced equity ratio. As a result, banks are more vulnerable to disturbances in funding markets. Thus, low risk weights for residential mortgages also lead to higher liquidity risk in our banking system.

A high level of tax incentives for house ownership and a large volume of adjustable-rate mortgages contribute to wide fluctuations in activity and prices in the Norwegian housing market.¹ The rise in house prices over the past two decades has also been very strong compared with countries where housing bubbles have burst.

We have been through the longest period of uninterrupted house price inflation. In real terms, house prices in Norway have tripled since the trough in 1992. House prices fell in 2007 and 2008, but have picked up again and have, in nominal terms, surpassed the summer 2007 peak.

Norwegian household debt is high compared with households in other countries. The number of residential mortgages with a high loan-to-value ratio, i.e. above 80 per cent, has also increased.

Periods of sharply rising house prices have historically been followed by periods of declining prices. House prices can fall considerably over only a few years. Loan-to-value ratios will then increase. Mortgage companies should therefore take housing market fluctuations into account when issuing covered bonds.

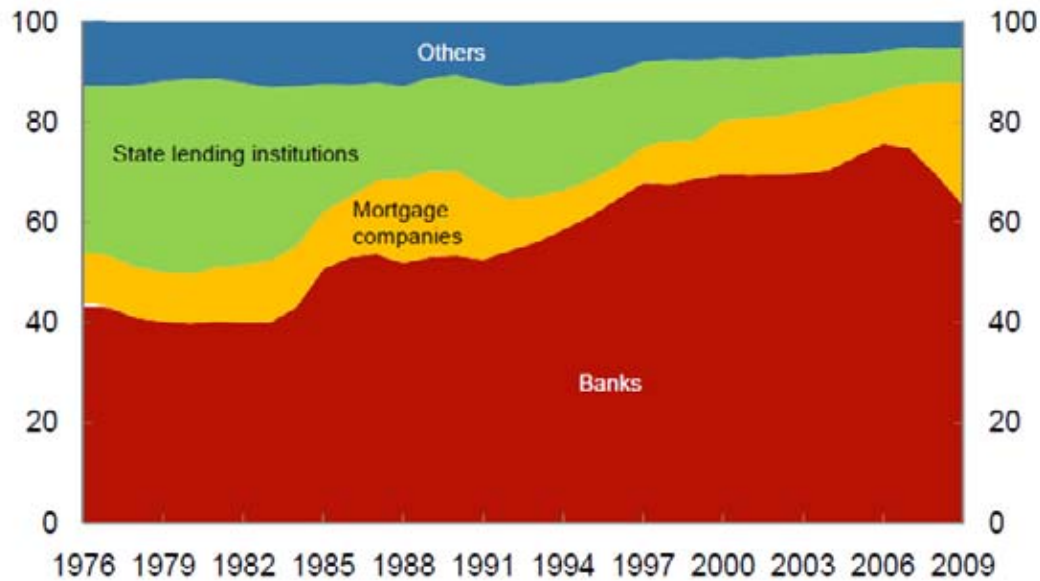
Conclusion

I think it is fair to say that housing finance in Norway is in its infancy. There is a large proportion of adjustable-rate loans. Fixed-rate loans offered in Norway are less customer-friendly than, for example, in Denmark, where it is less expensive to cancel a fixed-rate mortgage and where there is a secondary market, providing risk diversification. Mortgage companies have a limited role in housing finance. Loan-to-value ratios are in some cases alarmingly high. And last, but not least, banks finance their housing loans by means of short-term asset swaps in foreign markets. This is not a sustainable solution. I hope that this forum can contribute towards the development of a better foundation for housing finance in Norway.

¹ See Van den Noord, Paul (2005): "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie Internationale* 101, pp.29–45. This paper shows that house price volatility is higher in countries where tax regimes favour owner-occupied housing. See also IMF (2004): *World Economic Outlook*, September, p.81, where house price volatility is higher in countries where adjustable-rate mortgages are common.

Lending by lender sector. Norway

As a percentage of total lending. 1976 – 2009¹⁾



1) Statistical break in 1985. Figures for 1976-1984 for state lending institutions include Norges Bank

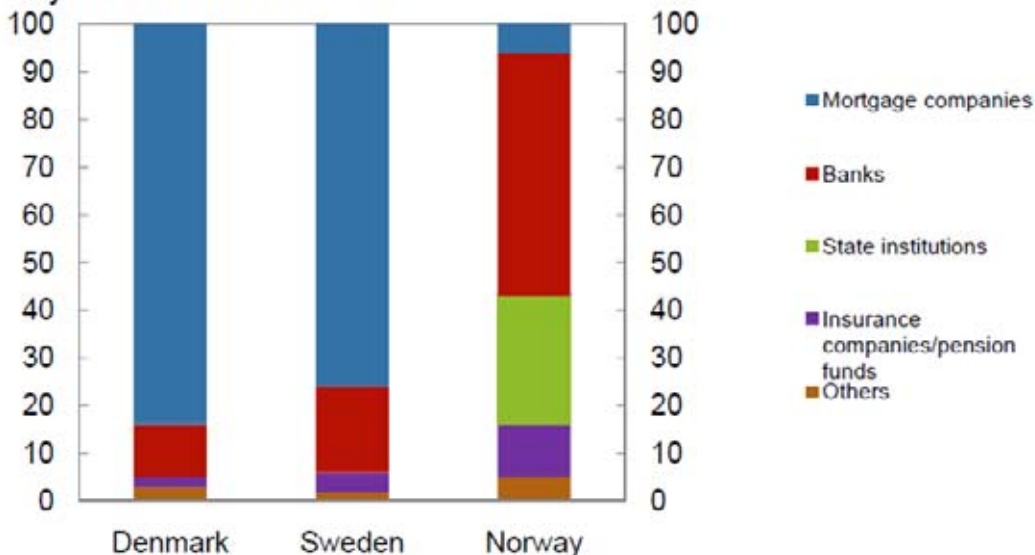
Sources: NOU (Official Norwegian Report) 1989:1, Statistics Norway and Norges Bank

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Housing finance in selected countries in the 1990s

By lender sector. Per cent¹⁾



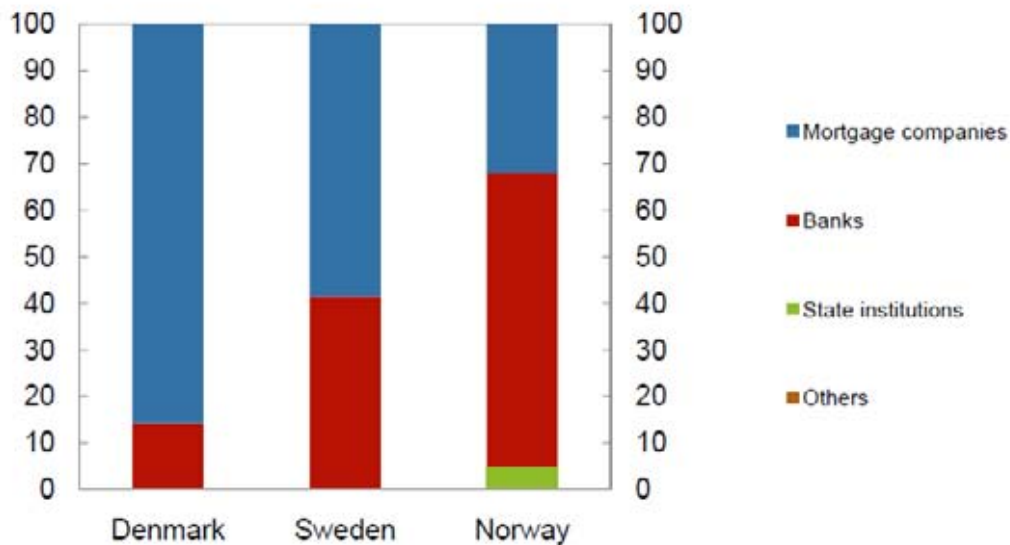
1) 1992 for Denmark and Norway and 1989/1990 for Sweden. Residential mortgage loans from state lending institutions are not specified for Denmark and Sweden

Source: NOU (Official Norwegian Report) 1995: 11

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Housing finance in selected countries. 2009

By lender sector. Percent¹⁾



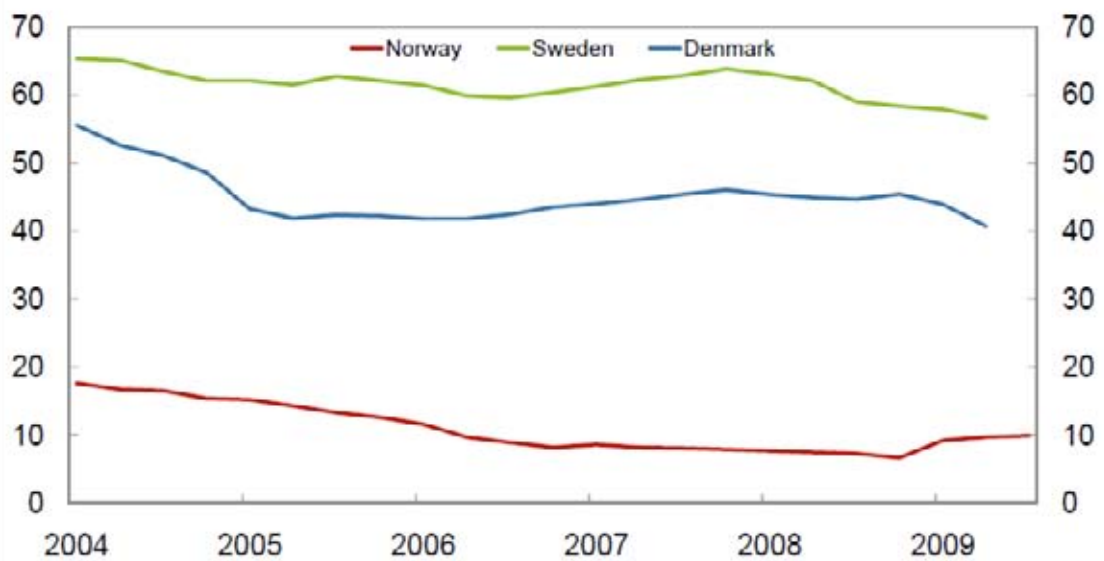
1) Residential mortgage loans from state lending institutions are not specified for Sweden

Source: Danmarks Nationalbank, Sveriges Riksbank, Statistics Norway and Norges Bank

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Fixed-rate loans as a percentage of total household lending¹⁾

2004 Q1– 2009 Q2



1) Figures for Denmark refer to residential mortgages only

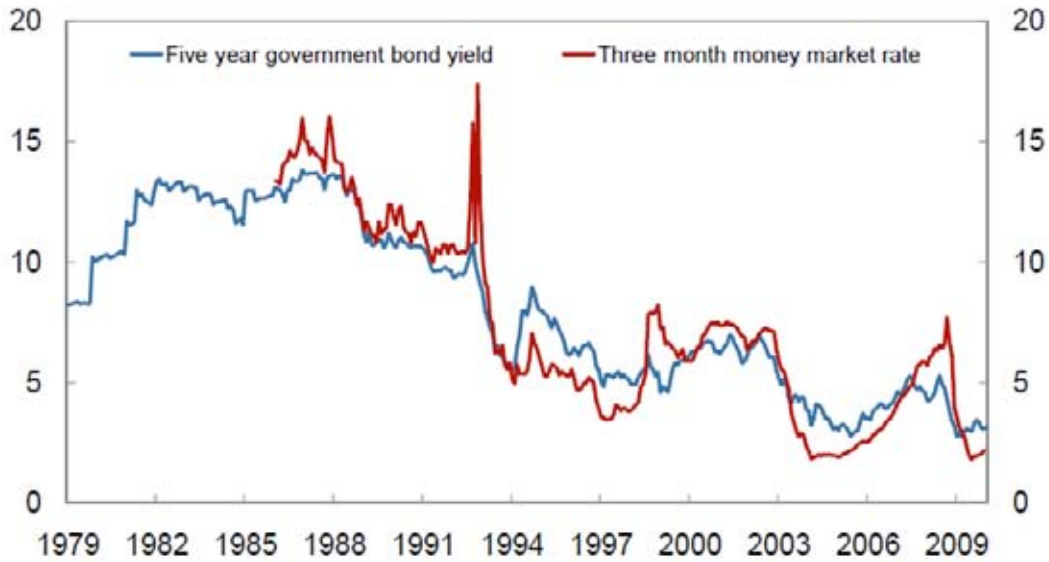
Sources: Danmarks Nationalbank, Sveriges Riksbank, Statistics Norway and Norges Bank

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Five-year government bond yield and three-month money market rate

January 1979 – January 2010

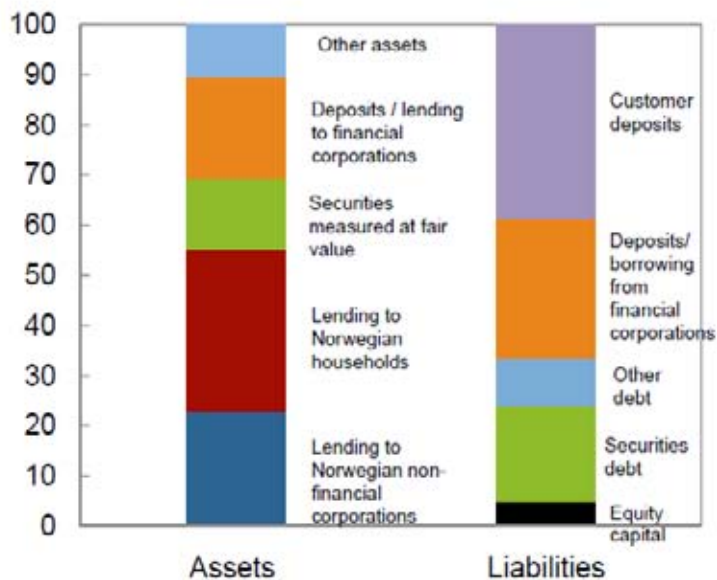


Source: Thomson Reuters

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Banks' assets and funding

2009 Q2. Per cent



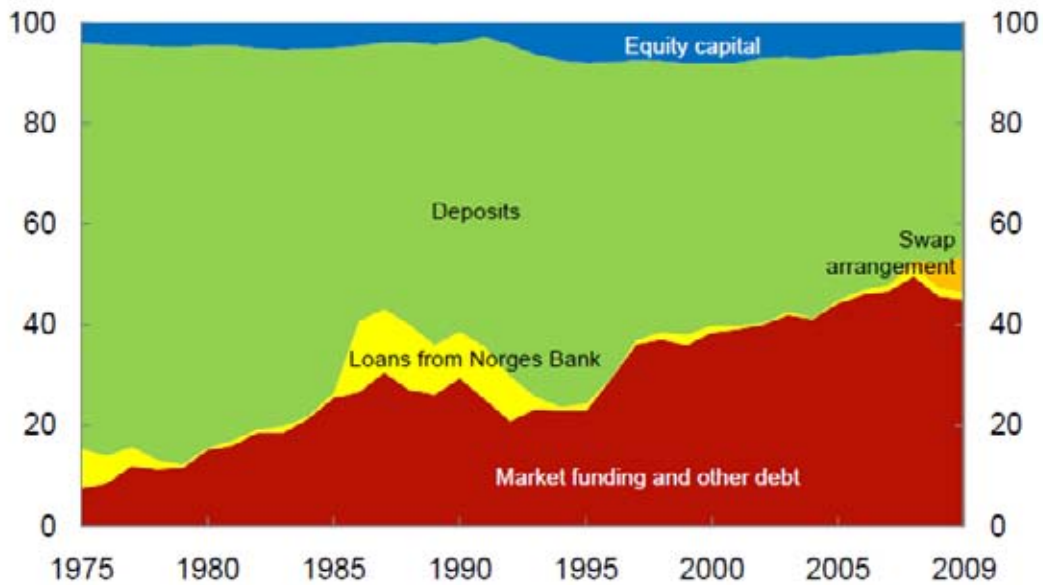
Sources: Statistics Norway and Norges Bank

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Sources of bank funding in Norway¹⁾

As a percentage of total assets. 1975 – 2008 and 2009 Q3



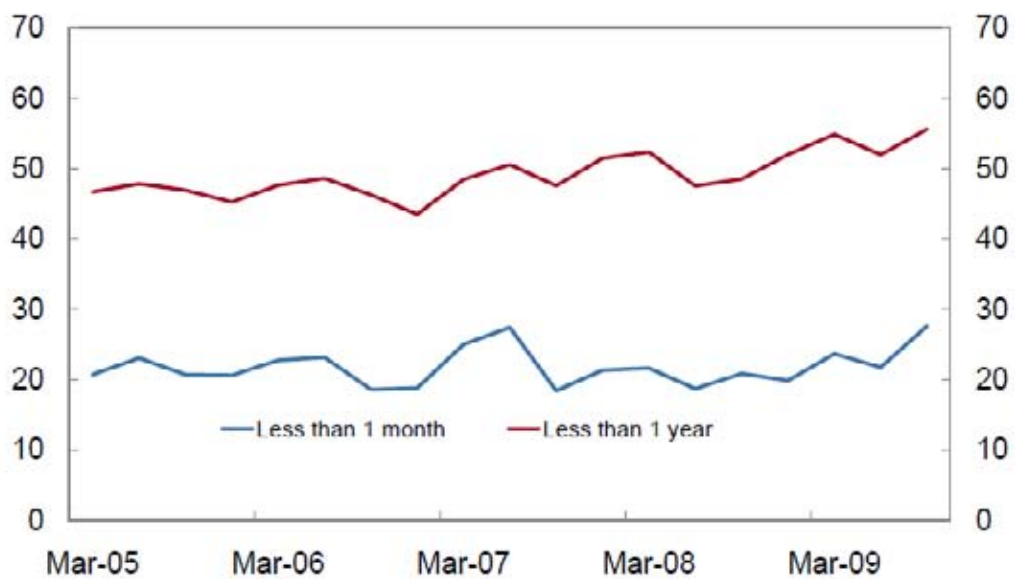
Sources: Klovland (2007), Matre (1992), Statistics Norway and Norges Bank

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Banks' market funding by residual maturity

Per cent. 2005 Q1 – 2009 Q3



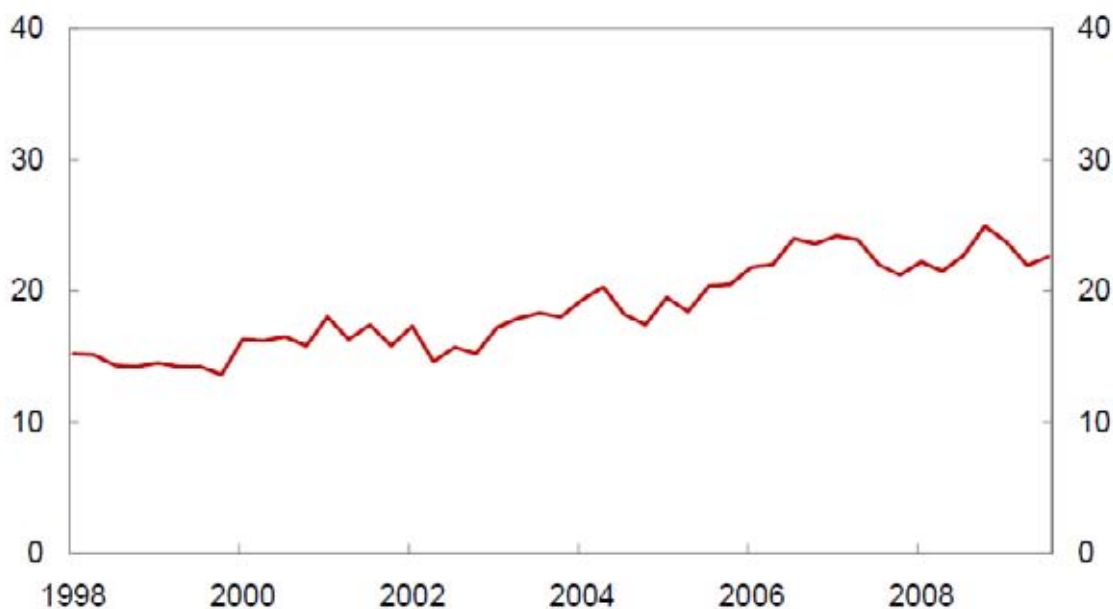
Source: Norges Bank

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Banks' foreign currency funding

As a percentage of total assets. 1998 Q1 – 2009 Q3



Source: Norges Bank

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An efficient bond market is characterised by:

- instruments that are easy to understand
- clear regulation
- transparency in trading
- multiple independent bidders and askers
- high trading volumes in primary and secondary markets

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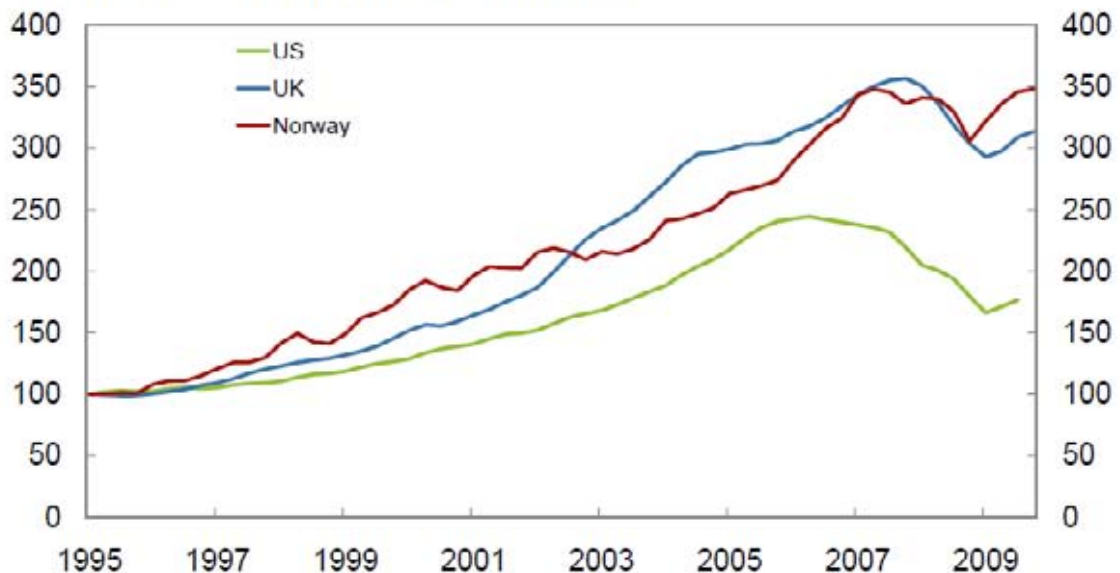
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Proposed changes in the collateral requirements for loans from Norges Bank

- No new securities under the temporary rules are approved as collateral as from 22 October 2009
- Securities already approved under the temporary rules may be pledged as collateral until maturity, at the latest until 15 February 2012
- Debt instruments issued by foreign banks will be included in the bank quota as from 1 December 2010
- Securities issued by banks will no longer be eligible as collateral for loans from 15 February 2012
- Norges Bank will continue to accept covered bonds (OMF) as collateral for loans

House prices in selected countries

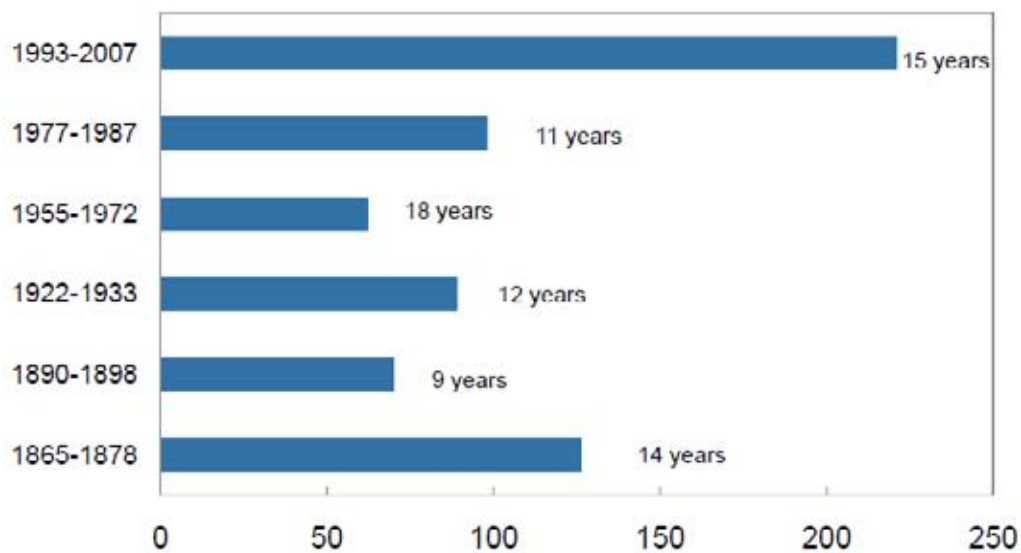
Index. 1995 Q1 =100. 1995 Q1 - 2009 Q4



Sources: Thomson Reuters, Standard & Poor's, Case-Shiller, Association of Norwegian Real Estate Agents, ECON Pöyry, Finn.no, Association of Real Estate Agency Firms and Norges Bank

Periods of rise in real house prices in Norway

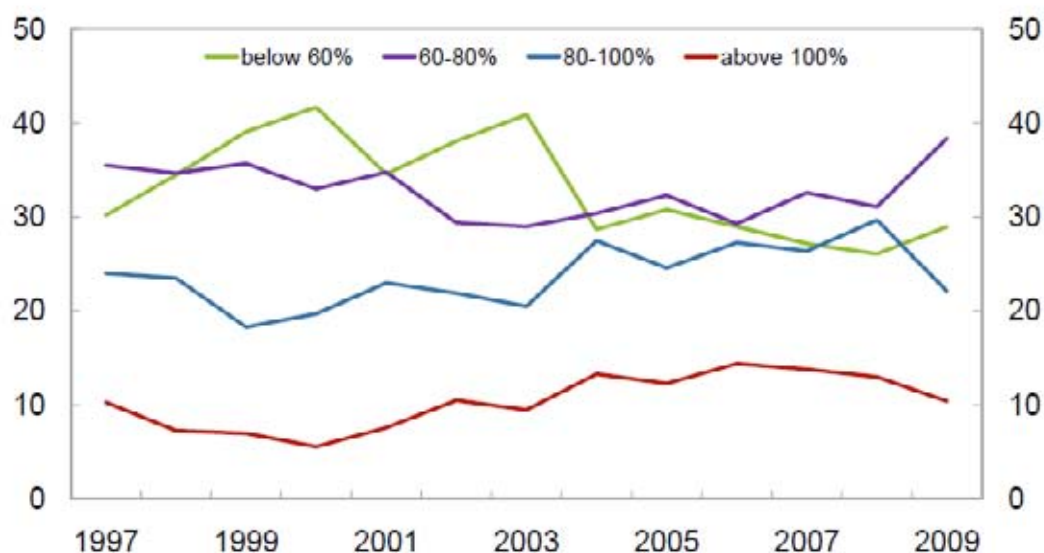
Number of years and total rise in per cent. 1819-2008



Sources: Statistics Norway and Norges Bank

Residential mortgages by loan-to-value ratio. Norway

As a percentage of total residential mortgages¹⁾. 1997-2009

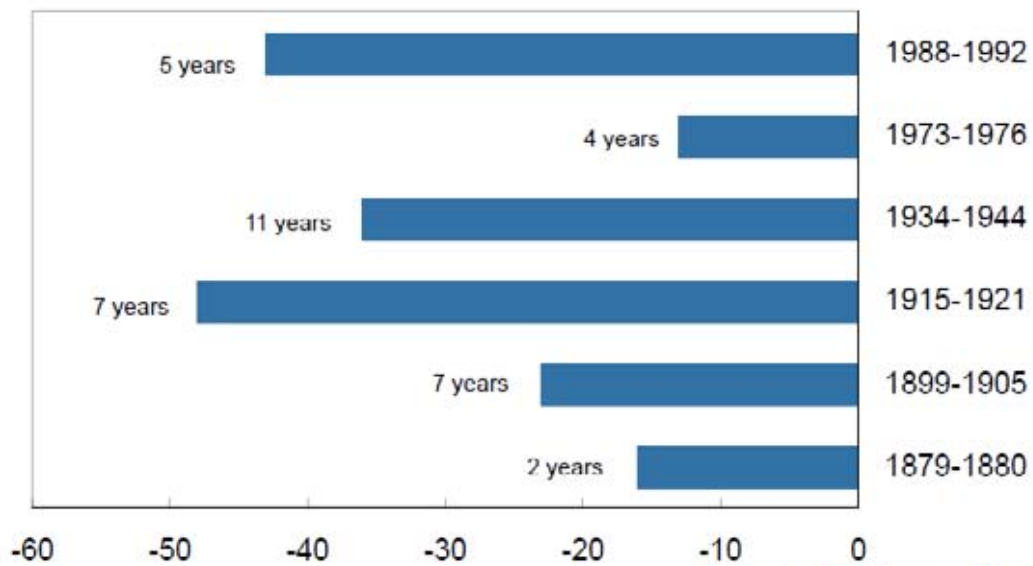


1) Total residential mortgage loans in the survey. The figures for 2009 are based on the spring 2009 residential mortgage loan survey, which contains fewer observations than previous surveys.

Source: Finanstilsynet's (Financial Supervisory Authority of Norway) residential mortgage loan survey

Periods of decline in real house prices in Norway

Number of years and total decline in per cent. 1819-2008



Sources: Statistics Norway and Norges Bank