Popular and controversial banking products for households in Norway

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1. Introduction

In the past three to four years, two new banking products have grown very popular among Norwegian households. These are credit lines secured on dwellings, which have more than quadrupled in two years, and structured investment products, most commonly known as guaranteed bonds or deposit investments with index-linked yield. Banks often offer loans to finance these investment products. However, hardly any investors made a profit on the investments when they were financed by loans. As a consequence, Kredittilsynet (the Financial Supervisory Authority of Norway) has introduced new and very strict rules for the sale and marketing of such products to households.

2. Credit lines secured on dwellings

Credit lines secured on dwellings are, as the name indicates, loans to customers who can offer good security in return. The loans are secured on dwellings, usually within a loan-to-value ratio of up to 80%. Banks promote these loans as equity release loans and an alternative to ordinary repayment loans secured on dwellings. Borrowers are able to draw on the credit line without having to apply each time ready funds are needed, and they pay interest only on the amount drawn at any time. These loans are far more flexible than ordinary repayment loans, and are growing far more popular. They can be used for both housing and other purposes, such as the refinancing of loans, buying a new car, going on holiday or other consumption purposes.

Sharp increase in credit lines secured on dwellings

Credit lines secured on dwellings have increased sharply since they were broadly introduced to the market in January 2006. Figures for June 2008 show that this trend continues. Banks' and mortgage companies' stock of such loans to households was NOK 271 billion at end-June[2], an increase from NOK 37 billion in January 2006.

The total stock of repayment loans secured on dwellings to households is still much larger than credit lines secured on dwellings, but the increase in repayment loans is much lower. The stock was NOK 1143 billion in June 2008, an increase of NOK 136 billion since January 2006. In the past two years, such loans have increased by around 9% compared with 370% for credit lines secured on dwellings. These figures clearly demonstrate which loan product is the more popular.

Graph 1 and Table 1 below illustrate that credit lines secured on dwellings are increasing at the expense of repayment loans (both with and without mortgage secured on a dwelling).

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1 Statistics Norway.

2 http://www.ssb.no/orbofbm_en/tab-080-en.html (Statistics Norway).

From the first quarter of 2006 to the second quarter of 2008 the share of credit lines secured on dwellings increased from 3% to 15%, while the share of repayment loans with mortgage on a dwelling has decreased from 73% to 65%. This confirms the impression given by the banks' marketing; most banks now focus on selling credit lines secured on dwellings rather than ordinary (repayment) mortgage loans.

Graph 1

Credit lines' and repayment loans' share of total loans to households.

Q1 2006 – Q2 2008

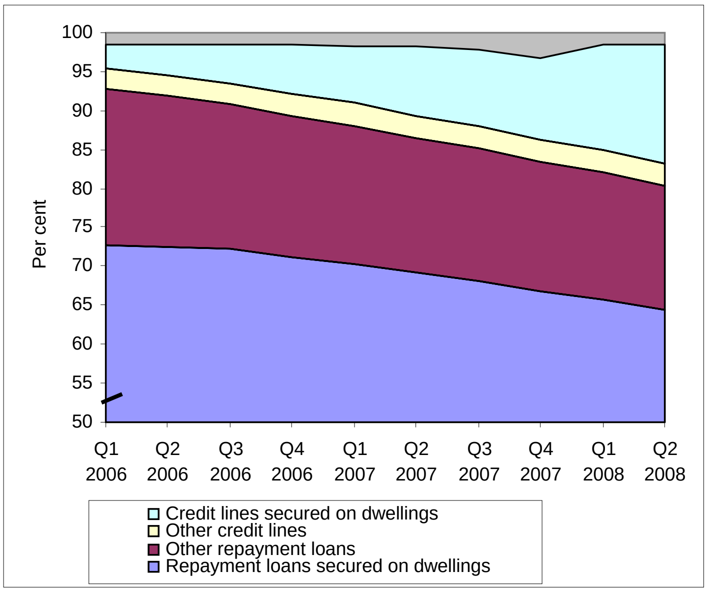

Table 1

Financial corporations' credit lines and repayment loans to households.

NOK billion. Q1 2006–Q2 2008

	Credit lines secured on dwellings	Repayment loans secured on dwellings	Other repayment loans	Other credit lines	Total loans to households
Q1 2006	44	1021	280	37	**1403**
Q2 2006	58	1050	279	38	**1447**
Q3 2006	73	1076	277	40	**1490**
Q4 2006	95	1095	281	44	**1540**
Q1 2007	116	1104	278	46	**1570**
Q2 2007	144	1123	278	46	**1620**
Q3 2007	162	1135	282	48	**1665**
Q4 2007	179	1145	284	49	**1712**
Q1 2008	235	1146	284	50	**1742**
Q2 2008	271	1143	284	52	**1777**

In light of the strong growth in equity release facilities, the Financial Supervisory Authority of Norway conducted a separate survey of banks' practice with regard to this product[3] in autumn 2007. This survey is quoted in "The Financial Market in Norway 2007 – Risk Outlook"[4]:

> The 15 most active banks reported qualitative and quantitative details of a selection of concrete equity release loans. Just over 46% of loans (ceiling granted) were within a 60% loan-to-value ratio, while 42% were between a 60 and 80% loan-to-value ratio. Almost all banks in the survey reported applying stricter loan-to-value criteria to equity release loans than to ordinary repayment loans. A majority allowed a loan-to-value ratio approaching 75–80% of property value. Internal guidelines for equity release facilities were reported to be the same as for ordinary repayment loans in a great majority of banks.

To conclude, equity release loans are a good, safe and flexible banking product for people who can offer good security, and from the banks' perspective these loans have a very low loan loss potential.

This brings us to the rise and fall of the other, and more controversial, banking products introduced in Norway a few years ago.

3. Structured investments products

In recent years, banks have increased their sale of structured investment products, also called guaranteed savings, or simply, structured products. In addition to selling these products, banks also offer loans to finance the customers' investments to increase the gearing of the investment. A wide variety of products fall within the structured products category. Statistics Norway compiles statistics on two of the main products (from December 2002) as well as statistics on the loan financing of such products (from December 2005). The two products concerned are deposits with index-linked yield, and index-linked bonds.

In this context, structured investment products can be defined as investment products that consist of a savings or bond component and a derivative component. The deposit or bond forms the basis for a guaranteed return for the investor, whereas the derivative component is meant to generate returns beyond the guaranteed amount. The derivative component is preferably an option linked to indices related to stock markets, currency markets, raw materials markets, interest markets etc; so the total return on the investment is linked to the same indices and markets. The customer is usually guaranteed the nominal value of the investment and a yield linked to the index if the index investment generates a positive yield larger than the bank charges when the contract matures.

In the past two years several economists have questioned the yield from investments in structured products. They have warned households about investing in such products due to the high charges by banks and other investment advisers. Economists and consumer advisers have also criticised the investment advisers' role as both adviser and seller of these products. This dual role may result in a situation where the investment advisers do not offer their customers the best advice. The media and the Norwegian Consumer Council have also criticised some investment advisers for arranging sales meetings in service centres for the elderly. The elderly normally have an investment horizon that is relatively short, but the

[3] Home loan survey of equity release loans secured on dwellings.

[4] http://www.kredittilsynet.no/archive/f-avd_pdf/01/04/TheFi007.pdf.

nature of these meetings has put great pressure on elderly people to put money into these long-term investments.

In autumn 2007, Kredittilsynet conducted a survey of structured products among 15 banks. The survey covered return, sales and marketing of structured products, in-house training of advisers/sales personnel, revenues from the products, and advisers/sales personnel's compensation related to sales of structured products. One conclusion from this report was that "calculations based on returns reported by the banks showed that the majority of products held to maturity as of the third quarter 2007 did not produce returns in excess of a risk-free investment. This is true both of equity-financed and debt-financed investments covered by the survey"[5].

The survey also showed that about 55% of the structured products with 80% debt financing generated zero returns or less with a calculated average return on debt-financed products of about 2%. Product subscription costs reduce the return both on equity-financed and debt-financed investments. Assuming 4% subscription costs and a duration of four years, the average return on contributed equity is –3% with 80% debt financing.

On 1 February 2008, four of the 15 banks participating in the survey announced that they would no longer offer loan financing of structural savings products[6].

On 12 February 2008, Kredittilsynet announced changes in the legislation concerning the sale of guaranteed savings products as of 1 March. Among other things, the changes in the regulations implied that those who offer guaranteed savings products would be obliged to investigate whether the products are suitable for the customer. This includes collecting information on the customer's knowledge and experience of guaranteed savings products, and the customer's financial situation. In connection with the changes, Kredittilsynet also advised banks against offering loans to finance investments in guaranteed savings:

> The regulations will make the sale of structured products more difficult by posing a number of new requirements on the financial institutions. Kredittilsynet presupposes that the institutions should not sell structured products or other complex products to customers who cannot be regarded as professional investors. In addition, Kredittilsynet advises the financial institutions against offering loan financing when selling structured products. This is based on historically low returns on equity capital and the risk of significant losses for the customers on this form of financing.

The new regulations have led to a marked fall in investments in structured/guaranteed savings products and loans to finance such investments. We do not have any statistics on sales and redemptions, but the stock figures show a slight fall in the figures in the past two years and a sharp fall in the second quarter of 2008. For the proportion of the structured investments financed by loans, we face some statistical problems. Since Norwegian banks offer loans to finance investments in index-linked bonds from foreign banks within the same banking group, the loan financing shares may exceed 100%. However, the figures show signs of a decrease, and in the second quarter of 2008 the share was 77%.

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[5] Kredittilsynet, "The financial market in Norway 2007: Risk outlook.", Report, February 2008 http://www.kredittilsynet.no/archive/f-avd_pdf/01/04/TheFi007.pdf.

[6] http://www.hegnar.no/personlig_okonomi/article250303.ece (in Norwegian only).

Graph 2

Banks. "Guaranteed" index-linked bonds and deposits with index-linked yield (total) and loans to finance these products.

December 2002 – May 2008

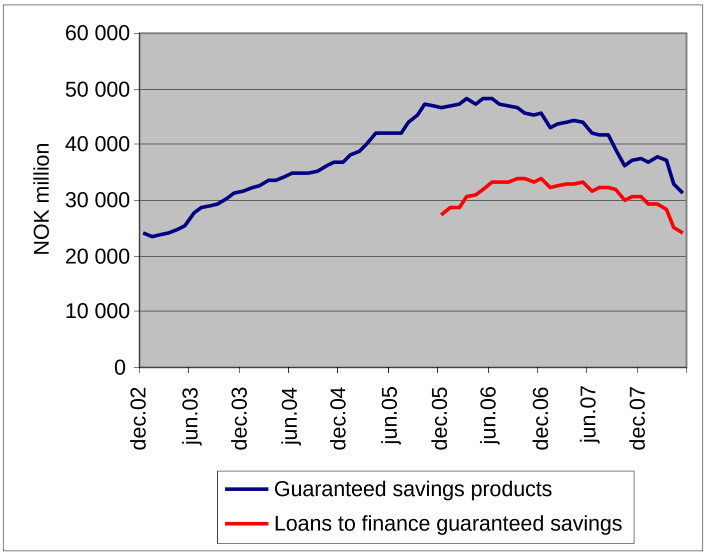

Table 2

Banks' "guaranteed" index-linked bonds and deposits with index-linked yield, loans to finance these products, and loan financing shares

Q4 2005–Q2 2008. NOK million

Month	Deposits with index-linked yield	Index-linked bonds	Total	Loans to finance			Loan financing share. Per cent		
				Deposits with index-linked yield	Index-linked bonds	Total	Deposits with index-linked yield	Index-linked bonds[1]	Total
Q4 2005	25570	21104	46674	12124	15264	27388	47	72	59
Q1 2006	27475	20877	48352	13718	16812	30530	50	81	63
Q2 2006	30398	17959	48357	16407	16974	33381	54	95	69
Q3 2006	30733	15759	46492	17186	16653	33839	56	106	73
Q4 2006	32483	13205	45688	18054	15969	34023	56	121	74
Q1 2007	31317	12741	44058	17410	15512	32922	56	122	75
Q2 2007	30965	11212	42177	17475	14313	31788	56	128	75
Q3 2007	30033	8986	39019	18303	13725	32028	61	153	82
Q4 2007	29968	7412	37380	19477	11107	30584	65	150	82
Q1 2008	29776	7256	37032	18547	9682	28229	62	133	76
Q2 2008	24416	6158	30574	15349	8287	23636	63	135	77

[1] Only Norwegian banks are included in the statistics. The part of loan financed index-linked bonds exceeds 100%. This is due to the fact that foreign-owned (subsidiary or branch) banks in Norway give loans to finance index-linked bonds offered by other parts of the corporation.

In a press release issued on 12 February 2008, the Director General of Kredittilsynet said that "The new regulations mean in practice a complete stop to the purchase of structured products financed by loans. The regulations will also mean that banks and other financial institutions will normally not be selling such products to normal savers, who cannot be regarded as ***professionals*** in this context."

Many people have interpreted the use of the word "professional" as a ban on the sale of these products to households, while others say that many people in the household sector can be regarded as professionals. As a result, many banks continue to sell these products to households, even though some of the larger banks no longer offer loans to finance them. After a long period of negative media focus, including stories about people who were "trapped" into investing in such products, the managing director of the Norwegian Financial Services Association (FNH), an institution that represents commercial banks, mortgage companies and insurance companies in Norway, wrote an article in Norway's largest newspaper Aftenposten[7] to justify some of these investment products. He reminded readers that while households traditionally only invested in bank deposits, they started investing in mutual funds in the 1990s and many lost their money when the stock exchange indices fell markedly. These new structured investment products are meant to give investors the safety offered by bank deposits and an opportunity to take part in a possible upswing in the stock markets. But everybody knows that there is no such thing as a free lunch; it is only natural that the upside will be limited as long as the investor is guaranteed to get back his/her investment. In a newspaper article in Norway's largest financial newspaper (Dagens Næringsliv) on 4 July, commenting on Statistics Norway's statistics on structured savings products (figures for May 2008),[8] a representative from Norway's largest bank stated that they no longer offer these investment products. In the same article the director of the Norwegian Consumer Council predicted that loan financing of these products would stop.

4. Conclusion

Structured products may be good investment products for some investors, while other investors should stick to bank deposits, securities funds or other markets. In my opinion, banks should be allowed to sell these products to households, but must follow the strict rules laid down by the MiFID etc. Furthermore, extreme caution should be exercised with regard to loan financing, and it is important to take the bank charges into consideration. The products themselves are interesting, but have a bad reputation due to high charges, irresponsible advisers/sellers and gearing. This means that the banks must do a better job of explaining the advantages of these products if they are going to offer them in the future.

Finally, credit lines secured on dwellings have been a major success for the banks as well as the customers, while we may draw the conclusion that we have witnessed the rise and fall of structured investment products in Norway.

7 Aftenposten, 3 July 2008, Kommentarer p 3.

8 http://www.ssb.no/english/subjects/10/13/10/orbofbm_en/ Marked fall in guaranteed savings.