Swedish country note

Niklas Nordman[1]

The Swedish market for housing finance[2]

Defining characteristics

Swedish mortgages are almost exclusively held on the balance sheets of lenders. The reason for this is the lower costs associated with traditional funding instruments in Sweden. Even if the legal framework is in place, credit institutions seem to show a lack of interest in issuing eg covered bonds in the domestic market.

The Swedish market for housing finance also appears to be regional to character and there are no clear signs of any changes in this structure. The Nordic countries are too heterogeneous to be treated as one market; mortgage products and lending conditions also display large differences.

Nevertheless, since mortgage institutions and banks in the Swedish market belong to internationally active banking groups, and since the share of funding raised abroad has increased, the international links have become more important.

Main developments

House prices have increased by more than 80% in nominal terms over the past decade. At the same time, household debt has experienced growth of the same magnitude, with the most rapid increase in borrowing from mortgage institutions.[3] This development has resulted in higher debt-to-income ratios, although lower and more stable nominal interest rates have translated into historically low debt service ratios.

The supply of new housing has developed slowly since 1993 (Figure 1). The level of new housing starts in Sweden has been low compared to international standards over the period. In city centre areas, where house prices have increased at a faster rate than the national average, it has even been hard to obtain building permits.

The degree of sophistication in risk management has improved; at the time of the banking crisis at the beginning of the 1990s, mortgage loans were granted based on assessed property values, while the ability of customers to pay is more important today. Access to high-quality registers of households supports efficiency in the risk management process. In line with elevated house prices and rising debt, the required economic status of borrowers has gradually risen.

The competition in the financial industry has increased over the last couple of years, at terms of both the number of new entrants and standard requirements for granting credit. However, the Swedish banking system today may be regarded as relatively concentrated compared to the situation 10 years ago.

There is a limited range of different maturities and underlying contract types available to mortgage borrowers; mortgage loans are to a large extent arranged at variable rates and there are in practice few products for long fixed rate mortgage loans (ie fixed rates beyond five years). In terms of

---

1 Sveriges Riksbank, Financial Stability Department.

2 Updated by Camilla Hellgren and Pontus Åberg.

3 The term mortgage lending refers to any kind of lending to households for housing purposes, both secured and unsecured. Commercial real estate lending is not considered in this context. Mortgage lenders are defined as all types of credit institutions providing mortgage loans and not just mortgage institutions. Due to a lack of more detailed information, however, the bulk of information applies to mortgage institutions specifically.

innovations, the menu of financial products has been almost unchanged over the last decade. In practice, all prepayment risk is borne by the borrower while the credit risk is with the lender, and this structure has not changed over the years.

Finally, the level of government influence on the Swedish housing market has gradually been reduced over the last 10 years in line with new housing policies. The government has also limited its influence in the Swedish banking sector over the last decade by gradually reducing its ownership in what today is the Nordea banking group.

Policy issues

The perception is that the housing finance system may have influenced developments in household indebtedness and house price inflation. From a financial stability point of view it is therefore important to identify elements in the housing finance market that might induce overindebtedness and excessive house price movements. A number of questions may be raised, eg:

- To what extent has the structure of the housing finance market affected house prices?
- How vulnerable is the market to falling house prices, and are the current structures for housing finance capable of absorbing adverse movements?
- What is the nature of risk-taking in the household sector and the "equilibrium" level of debt? How do different mortgage finance structures affect households' ability and willingness to take on debt?
- What is the nature of risk-taking linked to housing finance in financial institutions?
- What is the scope for adopting effective micro policies?

Background information on the housing finance market in Sweden

The housing market

The debt burden of Swedish households has risen at a growing pace since the mid-1990s (Figure 2). Total lending to households has increased by an average rate of almost 10% annually during this period. Household wealth has also increased over this period and the debt-to-asset ratio is currently around 32%, which is slightly lower than at the beginning of the 1990s. Rising house prices and stock market values have resulted in increased net wealth over the years. Residential property prices have increased by a little more than 80% since 1996, while the corresponding number for household debt is 85% (Figure 3). Disposable income has at the same time increased by roughly 35% in nominal terms. Household debt in relation to disposable income has reached a level of 127%, last seen before the banking crisis at the beginning of the 1990s (Figure 4).

A system of rent control is operated; rents are centrally negotiated and do not reflect market values. House prices have outpaced the growth in rents (measured as the rent component in the CPI) since the mid-1990s, while rents have developed just in line with inflation. Approximately 60% of Swedish households own their homes (15% in terms of tenant-owned flats and 45% in single-family dwellings). The remaining 40% of all households rent their homes. The ownership ratio has increased by less than 10 percentage points since 1960.[4]

A large part of the rental sector is under public ownership through property companies controlled at the municipal level. Only a small and limited share of this property is devoted to social housing. The number of municipal dwellings is being reduced at a faster rate than new units are established.[5] There

---

4 M Atterhög, *Do government incentives make more people own their homes? An international survey and analysis*, Royal Institute of Technology, Stockholm, 2004.

5 K Scanlon and C Whitehead, "International trends in housing tenure and mortgage finance", Council of Mortgage Lenders (CML) research paper, November 2004.

has also been a clear tendency lately to convert public housing into private property. Ownership rights in combination with the legal design of lease contracts prevent the presence of a buy-to-let market for housing in Sweden. As such, housing is bought for occupation and this tends to reduce speculative elements in the Swedish housing market.

The tax system is designed to have a neutral impact on the incentives for home ownership, treating housing as a regular investment good for tax purposes. Capital gains from investments in housing and income earned on savings are taxed at a common rate of 30%. However, for housing, only two thirds of the capital gain is subject to taxation. Another important difference when it comes to housing, however, is that the actual tax payment may be postponed as long as the proceeds are reinvested for housing purposes. Interest rate expenses, not only for mortgages, are tax-deductible at the same rate (as are investments in private pension funds). The property tax rate, levied on 75% of the assessed market value, was recently reduced from a level of 1.5% in view of the rising property values.[6] The sharp increase in house prices in recent years, however, implies that the base value for taxation is likely to increase by almost 25% on average. The increased burden this development will impose on homeowners might eventually start to have effects on house prices. There is also a standard fee of 1.5% of the transaction price to cover administrative costs.

The administrative process surrounding housing starts, eg building permits, is perceived to be quite extensive compared to the situation in many other countries. Furthermore, the concentration of publicly owned and controlled land is presumably high compared to international standards. The level of influence from the government on the Swedish housing market has gradually been reduced over the last 10 years in line with new housing policies. Much of the risk associated with the market has therefore shifted from the public domain to owners (including contractors) as subsidies and support programmes have been reduced.

Borrowing and contract types

Since credit controls were abandoned in the mid-1980s, the market for credit has evolved rapidly in terms of size and routines for risk management. Over the last couple of years, the competition in the financial industry has increased, in terms of both the number of new entrants and standard requirements for granting credit. The overall assessment is that credit in Sweden to a large extent is demand-driven, in the sense that the customer, as long as their ability to pay is judged to be good, easily gain access to funds.

Four large banking groups dominate the market for financial services in Sweden. Mergers and acquisitions in the banking sector have increased in Sweden, as well as in the United States and the rest of Europe, since the early 1990s. Together with the entry of new, “niche” players, consolidation has led to significant changes in the financial infrastructure. Consolidation has, despite a number of new players, reinforced the skewed market structure in some aspects. Out of a total of 125 banks active in the market, almost 80% of banks’ total assets belong to these four, compared to around 70% in 1990.[7] The Swedish banking system today may as such be regarded as relatively concentrated.

There are currently eight mortgage institutions in the Swedish market, four of which belong to the largest banking groups.[8] Funds for housing purposes, more specifically, tend to be processed through the mortgage institutions. Loans are secured mainly by real estate mortgages or municipal sureties. The mortgage institutions usually lend up to 75% of the assessed property value when it comes to single-family dwellings and tenant-owned flats. The remaining part of the funding, apart from the customer’s own down payment of 10%, is usually provided by the parent bank and may as such be regarded as less secured.

Mortgage loans are typically arranged as a mix of fixed and floating interest rate agreements in the borrowers’ loan portfolio. About two thirds of the total stock of mortgage debt is currently arranged at

---

[6] At present, the real estate tax is 1% for single-family dwellings and 0.7% for multi-family houses.

[7] L Frisell and M Noréus; “Consolidation in the Swedish banking sector: a central bank perspective”, *Economic Review* 2002:3, Sveriges Riksbank, 2002.

[8] The rest of the financial infrastructure, excluding a number of 440 insurance companies, is comprised of 74 other credit market companies. See Sveriges Riksbank, *The Swedish financial market 2005*.

fixed rates of various lengths. About 45% of all mortgage loans are at fixed rates less than five years, where the typical horizon is between one and two years. Since the share of floating rates in new mortgage lending is much larger, approximately 60%, the sensitivity to interest rates is increasing. Generally there is a limited scope of different maturities and underlying contract types offered to the customer (Table 1). There are practically no products available for long fixed rate mortgage loans, where the longest is around 10 years.

Table 1

Standard contract types in mortgage lending

Maturity	30-50 years
Range of fixed interest rates	0-10 years
Amortisation	Straight/annuity
Interest-only	Limited availability. Applicable for short time intervals.

The typical mortgage loan has a maturity, or payment plan, ranging between 30 and 50 years. The part of the funding exceeding 75% of the transaction price, which also might be provided by the mortgage institution (if guaranteed by the parent bank), usually has a much shorter maturity (between 10 and 30 years).

There are no data available concerning mortgage equity withdrawal. However, in line with the recent increase in house prices, households have apparently taken the opportunity to release extra funds for maintenance of the existing housing stock and consumption of durable goods. Loans at floating rates may be subject to prepayment at any time at no cost. Loans at fixed rates, however, carry a prepayment penalty. Some banks, but not all, also require a marginal fee for transferring a mortgage loan from one home to another. In practice, all prepayment risk is borne by the borrower while the credit risk is with the lender, and this structure has not changed over the years.

In terms of financial products, no significant innovations have been introduced to the market in many years and there are no tendencies to improvement at present. One example of a small innovation, however, is that some banks have offered mortgage loans pegged to the ECB policy rate. Another special offering, recently introduced by a foreign bank, allows a household to gain the same interest on its savings account as it pays on the mortgage loan. Finally, sub-prime lending, ie lending to households with low or inadequate creditworthiness, has been introduced recently in Sweden, although still on a small scale.

Lending and funding practices

Swedish mortgages are almost exclusively held on the balance sheets of lenders. Since the beginning of the year, mortgage institutions have had the opportunity to issue covered bonds, like their international counterparts. Even if the legal framework is in place, the incentives for banks to issue eg covered bonds are small. The Swedish banks have less favourable rating conditions compared to banks abroad, which makes it unprofitable to engage in such activities at present. Another important factor is national regulation: the Swedish Financial Supervision Agency (FSA) has adopted comparatively high capital requirements on securitised mortgage debt, which makes securitisation less attractive.

In 2003, the approximate share of customer deposits and interbank deposits out of total funding in the banking sector amounted to 20%. The share of funding stemming from issuance of mortgage bonds and subordinated debt was accordingly 80%. During 2004, these proportions changed to 30% and 70%, respectively. In the second half of the 1990s, a market for debt securities started to evolve in Sweden; a restructuring and consolidation of the banking industry and a gradual rebound in market confidence (which was mirrored in improved ratings) paved the way for securitisation of various sorts of debt - for example, mortgages. The bursting of the stock market bubble at the beginning of 2000, however, put an end to the evolution in this area of finance, and the business has not regained momentum since then (even though conditions in the Swedish banking sector have improved considerably during past years in terms of increased profitability and better rating prospects).

There are several reasons for the high degree of deposit-based and traditional on-balance sheet funding in Sweden. Above all, there are lower costs associated with traditional funding instruments. There is no standardisation of contracts for securities-backed mortgage finance and historical data on portfolio performance are non-existent. There is also a lack of liquidity in mortgage bonds, and in the market for mortgage-backed securities in general. The relatively small size of mortgage lenders in the Swedish market, due to the size of the domestic market, presumably implies a lack of sufficient critical mass to access capital markets as standalone.

In terms of quasi-public involvement, one of the five largest mortgage institutions is state-owned. The purpose of this institution, which has a market share of approximately 10%, is to increase competition by offering low interest rates on mortgage loans. Lately there have been discussions within the institution about raising loan-to-value ratios in order to meet the growing competition in the mortgage market. The outcome was an increase of the LTV ratio to 95%. Considering the size of the institution, it plays an important role in the market for housing finance. The government is also involved in the market by its owner influence in the large Nordea banking group.[9]

The risk management practices within the lending institutions in Sweden are highly developed and there seem to be strict guidelines in the lending process. Since the banking crisis at the beginning of the 1990s, some form of lending standard or risk scoring method is applied to each client. At the time of the crisis, mortgage loans were granted based on assessed property values; today the ability of the customers to pay is the focus. It is customary for an individual to turn to one financial institution which is able to provide all financial services demanded by the household. A household which purchases the whole spectrum of financial services from a bank can get a lower interest rate on its mortgage loan. The typical relationship between the bank and the customer implies a local structure for financial services. A structure of this kind might also imply better knowledge of local property markets and the assets securing the mortgages. As a consequence, a financial institution generally has a good notion of the risk in repayment associated with its clients.

Approximately 40% of all lending from credit institutions goes to the household sector and this share has increased over the past decade. The credit risk associated with household lending is much lower than lending to the corporate sector; the household sector accounts for a little less than 15% of all loss provisions made in the banking sector each year.[10] Provisions in the household sector have fallen back further since 2002 and constitute less than 0.15% of total household lending. The total number of suspended payments in the household sector has increased in recent years, but not related to mortgage lending.[11]

The access to high-quality registers of households with full coverage, at low cost, helps to improve the risk management of creditors. The general practice of assessing the credit risk of individual households has, according to the mortgage institutions themselves, developed over the years. Due to elevated house prices and rising debt, the required economic status of borrowers has gradually risen. The economic situation of households is stressed with higher interest rates and a significant economic buffer is required in order to ensure future ability to pay. There has been increased focus on the credit risk of borrowers since the mid-1990s, especially in the last couple of years.

Income protection insurance is available and offered to borrowers, which covers mortgage repayments and interest expenses in case of loss of income. Usually such an insurance product covers unemployment, critical illness, permanent health damage and protection for surviving relatives.

Regulation

Both the FSA and the Consumer Agency have a responsibility to act in the interest of consumers. The role of the FSA in this respect is to ensure consumer protection by regulating the degree of sufficient and correct information about financial products and services. The Consumer Agency has a mandate to intervene in case of customer complaints. The Agency may, for example, take action to terminate

[9] The Swedish government has a share of 18% in Nordea.

[10] During 1992, the worst year of the banking crisis in terms of loss provisions, the household sector accounted for less than 8% of total credit losses.

[11] The payment defaults are mostly associated with consumer loans of small amounts.

unreasonable contract structures and stop advertising activities which are judged to be misleading. Both institutions have over the past years investigated the risks related to potential interest rate increases and overindebtedness among Swedish households.

Unlike a corporation, a Swedish household cannot default on its loans, and as such the cost of not being able to repay debt is high for a Swedish household. The individual may apply for a debt removal, which may be approved if a legal agreement is possible to reach between the indebted individual and all creditors involved.[12]

The FSA authorises, supervises and monitors all companies operating in the Swedish financial markets. There is no special law applicable for mortgage institutions and they operate within the same legal framework as banks and other financial institutions.[13] The operational infrastructure in the Swedish banking sector may be regarded as highly developed. Efforts to improve modelling techniques for assessing credit risk within the new Basel II framework seem to be of high priority among financial institutions.

International links

Swedish banks finance half of their activities through deposits and the remaining half through borrowing from other banks and issuing securities. Roughly 50% of the latter funding is raised outside Sweden because the major Swedish banks have access to more liquid markets and consequently to cheaper funding. Thus, financing from abroad constitutes approximately 25% of all funding in the banking sector, which leaves foreign investors in the Swedish market as a whole an important role to play.

The foreign presence in mortgage lending is, however, very limited. Foreign exposure, via branch or subsidiary units, amounts to less than 2% of the total mortgage lending. There is, for example, no cross-border offering of mortgage loans available in Sweden, even if no regulatory restrictions for foreign institutions seeking to provide mortgage lending exist.[14] Except for the Nordea banking group (which is the result of a number of mergers between banks from Denmark, Finland, Norway and Sweden), cross-border mergers are still unusual and are often on a minor scale. The Swedish market for housing finance appears to be regional in character and there are no clear signs of change to this structure.

The four largest banking groups in Sweden (to whom the largest mortgage institutions belong) are active to varying degrees in the international markets, eg Germany, the other Nordic countries, Poland and the Baltic region. In Estonia, for example, Swedish exposure is very high, accounting for almost 90% of the total financial sector. The expansion in these markets has been rapid during recent years. Since mortgage institutions and banks involved in the Swedish market belong to internationally active banking groups, and since the amount of funding raised abroad has been increasing, international links have become more important.

The total collapse in confidence that followed the banking crisis at the beginning of the 1990s is still visible in terms of ratings; ratings for Swedish banks have been steadily improving since the mid-1990s, and the gap between these institutions and their international counterparts appears to be closing. However, there have been, and still are, considerable differences in ratings among banks. In line with the consolidation process mentioned above, in which the large mortgage institutions primarily gather funding through their parent banks, ratings also become increasingly important for housing finance. Increased presence in, and exposure to, foreign financial markets by domestic banks further improves the outlook for better ratings. Furthermore, the profitability of Swedish banks has been remarkably strong over the last year, implying an upgrade in ratings for at least one large bank.

---

[12] Very few individuals qualify for such an arrangement each year. In practice, this type of agreement implies an economic situation at an absolute minimum standard of living for the individual in question.

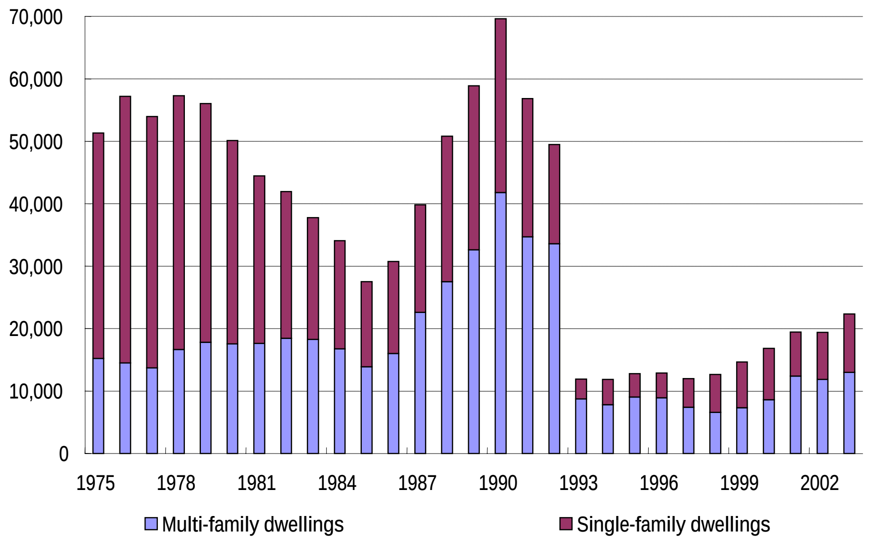
[13] See Law 2004:297 (on banks and financial institutions), Law 1994:2004 (on capital adequacy and large exposures for credit institutions and securities companies) and Law 2003:1223 (on issuance of secured bonds).

[14] Between 2000 and 2002, a Belgium-based financial company offered mortgage loans over the internet to Swedish customers.

Annex 1:
Figures 1-4

Figure 1

Number of new apartment starts

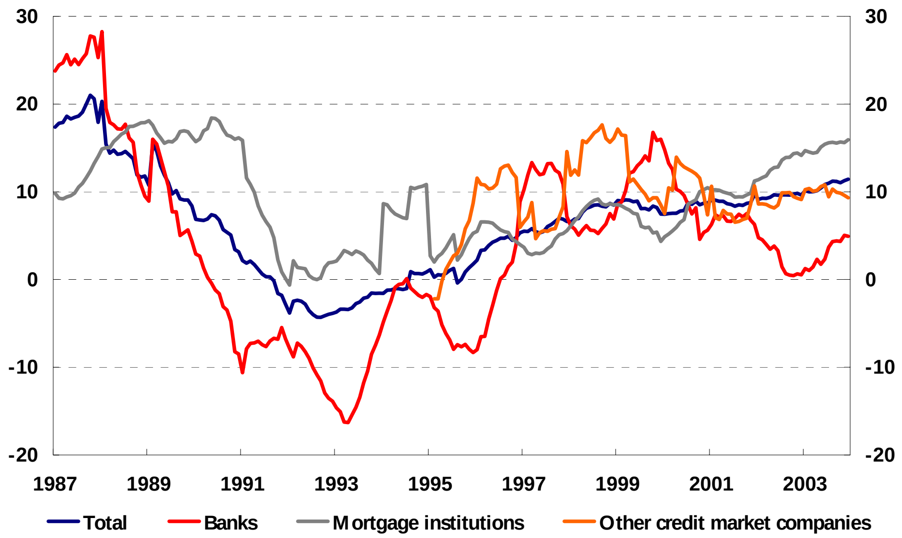


Sources: Statistics Sweden.

Figure 2

Household borrowing by type of credit institution

Percentage 12-month change

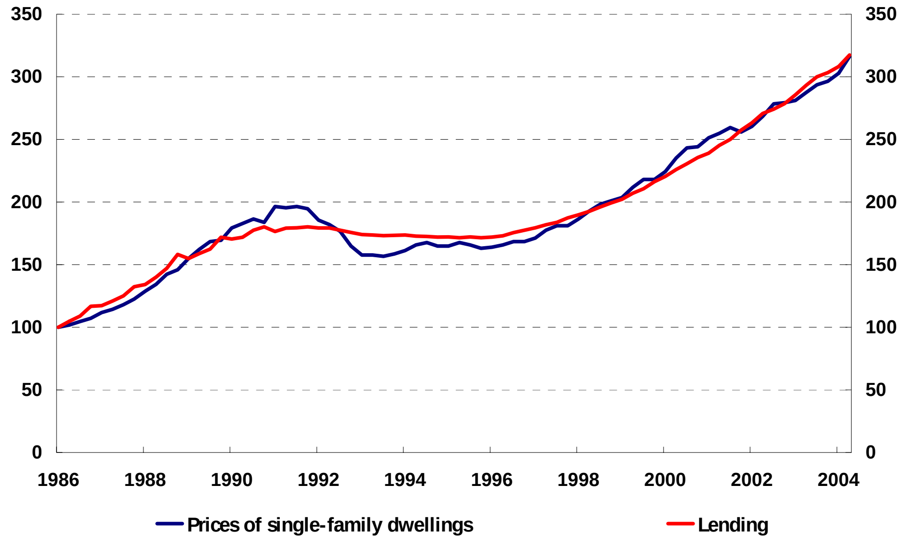


Source: Sveriges Riksbank.

Figure 3

Lending to households by credit institutions and prices of single-family dwellings

Index 1986 Q1 = 100

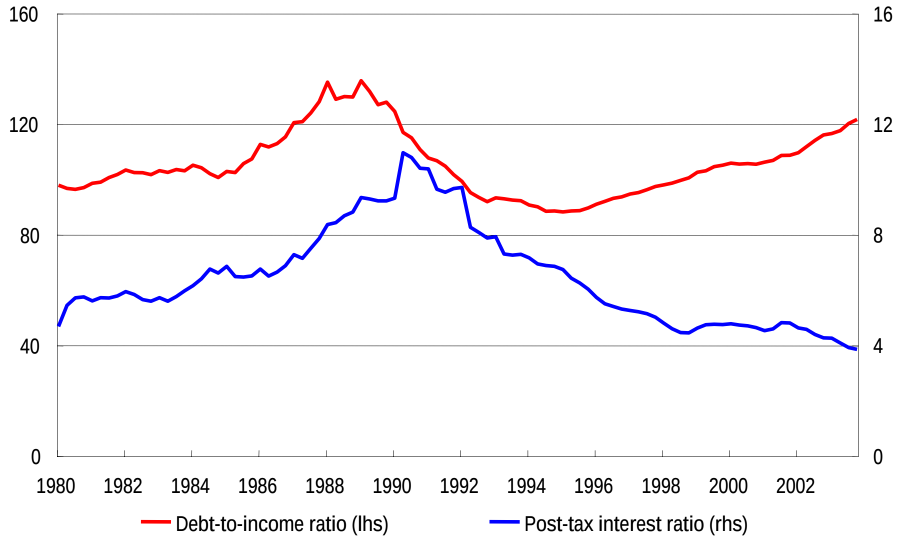


Sources: Statistics Sweden; Sveriges Riksbank.

Figure 4

Ratios of household debt and post-tax interest expenditure to disposable income

Per cent



Sources: Statistics Sweden; Sveriges Riksbank.