Lars Nyberg: Economic activity and housing finance in Sweden

Speech by Mr Lars Nyberg, Deputy Governor of Sveriges Riksbank, at a conference, in Frankfurt am Main, 4 June 2004.

* * *

I would like to begin by thanking you for the invitation to come here to Frankfurt and introduce "EuroCatalyst Investment Focus: Nordic covered bonds". I shall start with a few words about the Riksbank's activities. With the objective of maintaining price stability, the Riksbank conducts a clear monetary policy with an inflation target of 2 per cent one to two years ahead, with a tolerance for deviations of plus/minus 1 percentage point. In addition, the Riksbank has the task of promoting a safe and efficient payment system. As part of its work on carrying out these two tasks, the Riksbank publishes an Inflation Report four times a year and a Financial Stability Report twice a year. The most recent Inflation Report was published last week, while the latest Financial Stability Report was published the day before yesterday. For those of you that are interested in economic and financial developments in Sweden, I would recommend that you read both Reports.

Economic activity

Everything I mention now about economic activity and the assessment of inflation is taken directly from the Riksbank's latest Inflation Report (2004:02), which was presented on Friday, 28 May. In the Report we forecast GDP growth in the OECD area to average around 3 per cent over the coming three years. With regard to the outlook for Sweden, the Riksbank foresees an average annual growth rate of almost 3 per cent in the coming years.

Looking at inflation prospects, the rate of price increases is expected to rise in the period ahead as resource utilisation increases in Sweden and abroad. However, a continuation of relatively weak labour market conditions and a favourable cost situation mean that the rise in inflation is expected to be relatively moderate in Sweden. Our forecast in the Report is for a risk-adjusted inflation rate of 1.1 per cent one year ahead and 1.8 per cent two years ahead, measured as UND1X inflation.

Swedish housing finance

On 1 July this year the Act on issuing secured bonds (2003:1223) will come into force. One of the main incentives behind the new Act is to offer Swedish mortgage institutions the same favourable financing opportunities that these institutions face in European countries that have already introduced similar legislation. So will this new legislation result in a new financing structure for Swedish mortgage institutions and in large issue volumes in the international markets? This remains to be seen.

The Riksbank has, for reasons of principle, been hesitant towards the introduction of the legislation on secured bonds, primarily because the supervisory task charged to Finansinspektionen (the Swedish Financial Supervisory Authority) could be perceived as an implied government guarantee, but also because the legislation in this field entails a return to regulation in the credit market, which in itself can be questioned. However, similar legislation has been introduced in several European countries, and mortgage bonds regulated according to this legislation on secured bonds have come in various ways to be viewed as more creditworthy than mortgage bonds that are not. It can therefore be claimed that Swedish mortgage institutions should be given the same opportunities to issue secured bonds as mortgage institutions in other countries, which is also the view held by the Riksbank.

Swedish mortgage institutions today already observe such strict legislation that they can be viewed as a kind of special company in a securitisation. The potential effects of introducing particular legislation for secured bonds are therefore possibly less in Sweden than in other countries, and it is difficult to see that the legislation regarding secured bonds would entail any dramatic change in the activities of Swedish mortgage institutions. However, there are advantages involved in introducing such legislation.

Having legislation that is in line with that of other European countries will contribute to reducing any uncertainty, particularly from foreign investors, regarding the terms connected with owning securities issued by Swedish mortgage institutions. This should reasonably result in a broader circle of investors that are willing to invest in securities issued by Swedish mortgage institutions, and hopefully also reduce their borrowing costs. In addition, European central banks currently regard this type of mortgage bond as more creditworthy than mortgage bonds not covered by legislation on secured bonds, when market participants pledge collateral with them. Even the Basel II regulations, which will come into force in 2007, provide scope for regarding mortgage bonds covered by legislation on secured bonds as more creditworthy than mortgage bonds not covered by such legislation.

However, the Swedish market for mortgage bonds is already a large, liquid market that has functioned well since its deregulation at the end of the 1980s. It is the third-largest mortgage bond market in Europe, after the German and Danish markets. After the Swedish government, Swedish mortgage institutions are the largest issuers in both the money and bond markets in Sweden. As much as around 40 per cent of all lending to the non-bank public is mediated via mortgage institutions, which largely finance their activities by issuing bonds and certificates in the securities markets. The market is dominated by five mortgage institutions, which together account for around 99 per cent of all borrowing. The four largest mortgage institutions are subsidiaries of the four largest Swedish banks, while the fifth, SBAB, is state-owned.

The mortgage institutions' annual reports show that as much as around 30 per cent of securities borrowing is carried out abroad, which suggests that there was already considerable interest among foreign players before the legislation on secured bonds was proposed. However, there are considerable differences between the institutions. Some institutions have an explicit policy of raising half of their borrowing requirement abroad in their own name, while others manage their borrowing abroad via their parent bank, which issues securities in the banking group's name so as to ensure the lowest possible borrowing costs. Neither is it unusual for banks that own mortgage institutions to buy bonds issued by the mortgage institutions of competing banking groups. The reason for doing so is that banks are not allowed to use bonds issued by their own institutions as collateral when borrowing from the Riksbank, while they are allowed to pledge bonds issued by institutions outside their own banking group. As a result, mortgage bonds are largely owned by the banks, which contributes to reducing liquidity in the mortgage market.

There are several factors that affect the ability of companies to borrow in the market. These include, of course, the possibility to easily assess the borrowers' credit ratings and the quality of their assets. This is made easier if the borrower has an extensive contact network so that institutional investors are familiar with the borrower and its activities. Building up and maintaining this type of contact network and credibility requires time and considerable resources. The Swedish mortgage institutions have long established such contact networks, primarily in the Swedish securities market, where the liquidity for Swedish mortgage bonds is greatest. A rough measure of liquidity, the ratio of bonds sold and the stock of outstanding bonds, shows that bonds were sold around 4 times during one year in the Swedish mortgage bond market. This can be compared with the market for Swedish government bonds, where the corresponding turnover rate is around 7. The difference is not insignificant, and indicates that more can be done to create a more liquid secondary market for Swedish mortgage bonds.

The new legislation will create the conditions for improved terms for mortgage institutions and housing finance. However, the responsibility for making use of these conditions will lie with the banks and mortgage institutions themselves. A decisive factor as to whether the banks and mortgage institutions will succeed in utilising the new conditions offered through secured bonds is that they listen to investors' wishes. First and foremost, this requires establishing a liquid secondary market for secured bonds. This requires willingness to issue large volumes of bonds in the primary market. Maturities and constructions must also be tailored to investors' requirements. The institutions have not always had to work in this way in the domestic market.

The composition of mortgage institutions' loan portfolios, and the state of the institutions' borrowers, are of course decisive factors in pricing the securities issued by the mortgage institutions. The mortgage institutions' lending, broken down into different types of property, shows that most of the lending, around 94 per cent, goes to financing ownership of single-family dwellings and apartment buildings. It is therefore primarily the developments in the household sector and in the housing market that are important when assessing the mortgage institutions' assets.

The Riksbank's Financial Stability Report contains analyses of the household sector and the property market. The most recent Report observed that Swedish households are continuing to increase their debt burden at a rapid rate. Improved disposable incomes, low interest rates and high turnover in the housing market are some of the most important reasons behind this. Households' debt in relation to disposable income has increased from around 90 per cent in the mid-1990s to almost 120 per cent today. However, interest payments after tax on these loans have comprised around 5 per cent of disposable incomes, which can be compared with levels of almost 11 per cent at the beginning of the 1990s.

Both the debt ratio and the interest ratio are expected to continue to increase over the coming years. Nevertheless, Swedish households' ability to service their debt is relatively good. In addition to their disposable incomes, households also have assets that can be used as a buffer for increased borrowing costs. Their total assets exceed their total debts. A special article studies household debt and households' ability to service this debt in different income classes. In the article the Riksbank has examined how households would be affected by increased interest costs or rising unemployment. The results show that a significant part of the debt is accounted for by households that have both substantial assets and fairly sizable margins; not even a sharp increase in interest rates or unemployment would affect their ability to service debt to an extent where it would seriously increase the risks in lending to Swedish households. The risks in lending to the household sector therefore remain small, even when individual households are studied. Here it can be added that it was not the household sector that caused problems for the banks during the financial crisis of the early 1990s; despite the fact that the interest ratio rose to 11 per cent in 1991 and unemployment peaked during 1993 at 8.5 per cent.

With regard to developments in house prices, the assessment is still that Swedish house valuations are relatively reasonable. Fundamentals such as rising disposable incomes and falling interest costs could to a large extent explain the observed price trend. The demand for housing is expected to grow more rapidly than the supply. However, developments in house prices in Sweden vary considerably from region to region. Prices in metropolitan regions have risen by a significantly larger amount than for the country as a whole, although prices in the Stockholm region have stagnated over the past two years. There has also been a steeper price rise for tenant-owned apartments than for single-family dwellings.

It is difficult, at present, to envisage any tendencies towards imbalances that could lead to a substantial fall in prices. Some form of unforeseen event, such as changes in regulations or macroeconomic shocks, would probably be necessary to cause prices to fall sharply. The fact that interest rates will rise in the long term should be included in household expectations and can hardly be regarded as an unforeseen event in any economic scenario.

The market for apartment buildings has also been characterised by rising prices since 1994. Regulations such as those on utility value, and the system of central rent negotiations, normally leads to stable, even developments in the prices of apartment buildings. However, the conversion of rental properties into tenant-owner associations has resulted in recent years in relatively sharp price rises for apartment buildings. Price developments can, of course, be affected by changed conditions such as a substantial increase in new construction or a rapid decline in demand. However, a low level of housing construction and a high demand for housing, particularly in metropolitan regions, indicates that this will not be the case.

Conclusion

The Riksbank's work on monetary policy and financial stability emphasises the importance of transparency, clarity and predictability. These are also important factors in the securities markets in which mortgage institutions are active. I hope that mortgage institutions' own actions, coupled with the new legislation, will help to render the market for housing finance more efficient.