Lars Nyberg: Developments in the property market

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, at Fastighetsvärlden (Swedish newspaper), Stockholm, 30 May 2007.

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I would like to begin by thanking you for the invitation to come here to Fastighetsvärlden and talk about the Riksbank's view on the property market. The property market is a subject that arouses considerable interest and is discussed frequently in many different forums, both in Sweden and abroad. I have on several occasions held speeches on the subject of the property market and I see good reasons for returning to this field to give the Riksbank's views on current developments.

In recent months the US mortgage market has come under focus, mainly because of developments in the subprime market. An increasing number of US households have experienced problems in paying their loan costs and some US mortgage institutions have gone bankrupt in recent months. This has given rise to some concern that we might see a similar development in Sweden. However, I believe there is very little likelihood of this. I will explain why a little later on.

Today I intend to speak mainly about how we at the Riksbank view the recent developments in the property market. In many respects, I am basing my answer on the reasoning put forward by the Riksbank in the Financial Stability Report published last week. Both commercial property prices and housing prices have risen substantially for many years and although we have been able to see that the rates of increase have slowed down slightly in recent months, they are still high. I believe that property prices may well continue rising at a fairly high rate over the coming period. But in the slightly longer term such a rapid increase is not sustainable.

Why is the Riksbank interested in the property market?

The fact that the Riksbank is interested in what is happening in the property market is based on the tasks we have been given by the Swedish Parliament. One is that we shall ensure that inflation is kept at a reasonable level, more precisely at two per cent a year. The other is that we shall safeguard the stability of the financial system. The way the property market develops can have significance for both of these tasks. Property often functions as collateral for the loans the banks grant to households and companies. If the properties are not reasonably valued; if prices have been pushed up through exaggerated optimism or speculation, there is a risk of a heavy price fall. During the crisis of the 1990s it was falling property prices, particularly office premises, that were the cause of major losses for the Swedish banks.

Developments in the property market can also affect activity in the real economy. For instance, rising house prices reduce households' loans in relation to the value of their assets. Recently, as prices have risen so much, it has become increasingly common for households to use the lower loan-to-value ratio to take out new loans on their housing. The new loan can then be used for further consumption, which stimulates activity in the economy. Correspondingly, falling property prices can contribute to subduing demand in the economy. If property prices were to fall heavily during an economic downturn, this could also lead to large loan losses for the banks and further aggravate the slowdown.

The property market can be divided into two markets; a market for commercial property and a market for single-family dwellings and tenant-owned apartments. Today I intend to discuss both markets, but I shall begin with the commercial property market. After that I will talk about why housing prices have risen so much in recent years. Finally, I will talk about my views on future price developments.

Commercial property

The commercial property market has a direct bearing on financial stability. This is because property companies are the banks' largest individual borrowers. Around 20 per cent of the four major Swedish bank's lending to the general public is to companies managing commercial properties, for instance, office premises or retail premises. The value of these properties is often pledged as collateral for the loans. When commercial property prices fell at the beginning of the 1990s, several property companies experienced problems paying their loan costs, which caused major losses for the banks.

Property is also an attractive investment for pension companies, insurance companies and other investors. So both investors and lenders are affected by commercial property price trends.

Prices for office premises are determined partly by the size of the rental income the companies are expecting to receive. Developments in rents are in turn affected by how strong employment in the services sector is expected to be, although this relationship is not entirely stable. As with prices of other assets, prices of office premises are also determined by investors' required rate of returns.

After the bank crisis, developments in prices of office premises largely followed rents. However, this trend has been broken during the past two years. Prices have risen much more than is justified by developments in rents. During the first quarter of the year prices of office premises in Stockholm rose by 14 per cent on an annual rate, and prices in Göteborg rose by 20 per cent. Prices were steadier in Malmö, with a rise of 5 per cent on an annual rate during the first quarter. At the same time as prices have risen substantially in recent years, rents and demand for office space have not increased appreciably.

While employment in the services sector has increased in recent years, this does not seem to have had an impact on the demand for office space. As both demand for premises and rent levels have remained relatively unchanged, it is therefore likely that the price upturns in recent years are due more to a decline in investors' required rate of return. The required rate of return depends partly on the yields on long-term government bonds, as these function as a risk-free alternative to investment in property. The required rate of return also depends on how much investors demand in compensation for investing in higher risk assets, such as property, that is, what risk premium they demand. Interest on government bonds rose in total during the first quarter of the year. All other things being equal, t his should raise the required rate of return. However, over the past year the required rate of return has fallen. This could either be due to investors expecting rents to rise in future, or that they have demanded a lower risk premium.

A lower risk premium is in itself not surprising. The risk premiums on a number of different assets have fallen around the world in recent years. But as for a number of other markets, there may be reason to wonder whether the low risk premium on office premises is reasonable.

However, one must remember that property companies have had very strong profit growth in recent years. Unlike the crisis years, property companies currently have much better margins to manage some dampening of prices. I therefore do not believe at present that developments in the commercial property market comprise any threat to financial stability. But as it was the exaggerated commercial property prices that contributed to the banks' major losses in the 1990s, I consider that we should monitor future developments in these prices a little extra closely.

In recent years foreign investors have become more interested in the Swedish commercial property market. In 2006 foreign investors accounted for just over 40 per cent of all investments in the market. In terms of financial stability, this development has both advantages and disadvantages. More foreign participants mean that the risks are spread to different types of investor, which is positive. It also contributes to making the Swedish property market more liquid. At the same time, it is also conceivable that potentially negative developments in the international market could more easily spread to the Swedish market. If, for instance, an investor were to make losses on another country's market, it is conceivable that the investor would sell Swedish property to cover the loss. Prices could thus change quickly even without any change in the underlying factors.

That was the commercial property market. What about the housing market?

Why have house prices risen so much?

As you know, house prices have also risen substantially since the mid-1990s. A person who bought a house ten years ago would be able to sell it now for a price more than double what he paid for it then. Prices of tenant-owned apartments have probably risen even more[1]. It is more difficult to analyse prices of tenant-owned apartments. The statistics are more uncertain. But in principle, the reasoning with regard to the market for single-family dwellings also applies to the market for collectively owned

[1] According to estate agents statistics (maklarstatistik.se) the price per square metre for a tenant-owned apartment has risen by 300 per cent in ten years.

dwellings. The substantial increase in house prices has gone hand in hand with the increase in household indebtedness. Of all the loans granted to households, 85 per cent have property as collateral. A sharp fall in property prices combined with households experiencing difficulty in paying their loans could therefore cause problems for the banks. A central issue here is whether house prices have been pushed up by exaggerated optimism or by speculation.

Despite the rapid upturn in prices, I do not believe that we are currently seeing any general over-valuation of the property market. This is because there are a number of factors that can largely justify the rise in prices[2].

Firstly, interest rates have been historically low in recent years. Since the Riksbank introduced its inflation target, in the mid-1990s, the inflation rate has become lower and has stabilised. A more stable development in inflation also means that the real interest rates – interest rates excluding inflation – have fallen. At the end of 1996, after the crisis years, the real variable mortgage rate was around 7 per cent. Today it is around 2 per cent. Lower real interest rates mean that it becomes cheaper for households to take out loans when buying housing. The low interest rates are therefore an important driving force behind the price increases.

Secondly, developments in the real economy have been favourable after the crisis. Although unemployment has periodically been high measured by Swedish standards, households' disposable incomes have increased substantially. Higher incomes have meant that households can afford to pay more for their housing.

Thirdly, prices have also been affected by the fact that construction declined considerably directly after the crisis. When the demand for housing accelerated, it took some time before this could be met by a growing number of new houses on the market. Quite simply, it takes time to build houses. It was not until around 2000, when house prices had become higher and made new production of housing more attractive, that construction really accelerated.

Moreover, there have been some significant changes in the mortgage market, which have also contributed to house prices rising so sharply. I will return to these changes shortly.

The development of these factors largely explains why house prices have risen as much as they have in recent years. It does not appear to be a question of general over-optimism among households and lenders. I therefore do not see any serious risks to financial stability from developments in house prices at present.

Household indebtedness has also risen substantially

Household indebtedness has kept pace with property prices and has thus risen substantially. This development could also be a source of concern for those wishing to safeguard financial stability. If households have taken on more debts than they can manage to pay, it could lead to loan losses for the banks. Debts have also grown much more quickly than incomes in recent years. Today household indebtedness is even higher than it was prior to the crisis breaking out. Households' total debts in relation to their annual disposable incomes amounted at the end of 2006 to just over 140 per cent. Despite this high percentage, I do not feel any great concern.

This is because even if debts are now at higher levels than they were prior to the crisis, today the costs of bearing these debts are not as great. The low real interest rates have meant that households' interest expenditure in relation to their incomes is at a historically low level. In addition, the households with the most debts are also those with the highest incomes and largest assets. The Riksbank's analyses of individual households' finances show that these in general have good margins for managing rising interest costs[3]. Households' loan-to-value ratios therefore do not appear likely at present to cause the banks such large loan losses that they would be a threat to the stability of the banking system. But even if the household sector as a whole has good margins for paying its loans, there is of course always a risk that certain individual households have borrowed too much. If the household has made an overly optimistic calculation of its loan costs and taken larger loans than its

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[2] See also Financial Stability Report 2005:2 for a more detailed discussion of house prices.

[3] See also Financial Stability Report 2007:1 for the Riksbank's analyses of households' margins.

incomes can manage to bear, this could lead to payment difficulties. However, this is a question of each individual household to take into account.

US households have had problems paying their loan costs

As a whole, Swedish households currently have a good ability to pay. As many of you have probably heard, there has been rather more turbulence with regard to US mortgage customers recently. A growing percentage of US households have had problems paying their loan costs.

Property prices in the United States have also risen substantially since the mid-1990s. As in Sweden the higher prices have led to increased indebtedness among households. In the United States the subprime mortgage market has also increased rapidly in recent years. This group includes in principle all mortgage customers who cannot show that they have a credit history sufficient to be granted a normal mortgage. These can be households with records of non-payment of debts, low or undocumented incomes. Thanks to the subprime mortgage market these households have been given an opportunity to enter the housing market.

When US property prices rose, the competition among mortgage institutions intensified over these volumes. The institutions cut their lending margins and in some cases also lowered their collateral requirements. When the US central bank raised its policy rate from 1 per cent to 5.25 per cent between 2004 and 2006, households' loan costs also rose. The construction of subprime loans meant that they were particularly vulnerable. This is because they often have a low interest rate during the first two years. After that the loans are renewed at market rate with a substantial increment to compensate the credit institutions for the high credit risk of the borrowers. A higher policy rate made the market rate higher and interest costs for many households with subprime loans rose substantially. When US property prices slowed down last autumn, the increase in borrowers' wealth was subdued. They could no longer use rising house prices to increase their borrowing and thereby finance the higher interest rates. This meant that more households in the subprime sector experienced difficulties in paying their loan costs.

These developments have led to a number of US loan institutions that specialised in the subprime going bankrupt. This has led to newspaper headlines and there has been much discussion of what the consequences might be. However, the effects should not be so great that they threaten the stability of the US financial system. It is still only a minor part of the total US mortgage market that has been affected. Subprime loans account for around 13 per cent of all mortgages in the United States. Around half of these loans are at variable interest rates and can thereby be initially affected by higher interest rates, and it is households with these loans who have experienced problems in paying them. Most US households still have a good ability to pay. At the same time, the financial institutions have, on the whole, strong balance sheets. This means that even a relatively large deterioration in credit quality in this sector would only lead to limited losses for the mortgage market as a whole. On the other hand, it is not impossible that developments may affect the US households' consumption.

Are there risks with subprime loans in Sweden?

Can we expect to see a similar development in Sweden? No, I do not see any risk at present that we will experience this type of development in the Swedish mortgage market. In Sweden, loans to the subprime sector comprise an extremely small percentage of the total number of mortgages, no more than 0.5 per cent. The percentage is much lower in Sweden than in the United States. This is largely because our mortgage market and the US mortgage market are very different. In Sweden, lenders focus primarily on the borrower's ability to repay. We also have greater access to information on borrowers' incomes and assets, which makes it easier to assess credit risks.

The Swedish and US mortgage institutions also have different methods of financing their lending. In the United States it is common that the bonds issued by institutions are tied to different parts of the credit portfolio, which have different risks. These types of instrument have been an attractive investment for many investors in recent years, as the return on more traditional investment instruments, such as government bonds, has been considered too low. The high demand for the higher risk parts of the portfolio, which includes subprime, have meant that the banks' financing costs for the higher risk loans have declined in recent years. This may have encouraged the rapid growth in the subprime market in the United States. The US method of securitisation is very rare in the Swedish mortgage market. In Sweden, mortgages are traditionally financed through the institutions and banks issuing bonds with the total assets as collateral. If a Swedish bank were to have a larger percentage of loans with poorer credit ratings, it would mean that the total financing cost would rise.

Although the market for subprime in Sweden is currently small, it is conceivable that it could grow with time. Essentially, this is a positive development as it enables more households to enter the housing market. More types of mortgage do not necessarily mean that credit management in mortgage institutions will deteriorate.

Changes in the Swedish mortgage market

Although no large-scale market for lending to the subprime sector has developed in Sweden, there have been a number of other changes in the Swedish housing market – changes that have affected and may continue to affect developments in household indebtedness and property prices.

This year new rules were introduced regarding how much capital the banks must hold in relation to the assets linked to risks, which includes lending. These rules are called Basel II. The new capital adequacy rules will take into consideration the actual risk in lending to a better extent than the older version. As lending is considered to have a fairly low risk, it will enable the banks to hold less capital in relation to their lending. This entails a lower cost for the banks. Lower costs will enable the banks to cut their margins on lending rates and compete for loan volumes. The fact that the banks have been aware that this rule would be introduced has probably contributed to the institutions cutting their lending rates in advance.

It is probably in turn the increased competition that has led to banks and mortgage institutions now allowing higher loan-to-value ratios. If one can borrow a larger amount with the same collateral, the need for a down payment declines. This makes it easier for households with good incomes but little wealth to enter the housing market. Typically, this often applies to younger households who do not already own their accommodation. At the same time, this change means that both borrowers and lenders become more sensitive to developments in house prices. All other things being equal, higher loan-to-value ratios should increase the risk of loan losses for the banks. However, while the banks are allowing a higher loan-to-value ratio, they appear to have compensated for this in recent years by tightening some of the requirements for granting loans.

It has also become increasingly common that mortgage institutions offer interest-only loans. This also increases the borrowers' and lenders' sensitivity to developments in house prices. The fact that households are choosing not to amortize their loans to the same extent may be related to the rising house prices. House-owners have been able to see their loan-to-value ratio fall even without amortization payments. Amortization is also a form of saving, but it is not self-evident that it is the best thing for a household to have its entire savings in its own housing. If they choose not to amortize the loan, they may perhaps have some other form of saving that can be used if their incomes unexpectedly decline or costs increase.

To summarise, I do not see any serious risks, from a stability perspective, in households' growing indebtedness and in rising property prices – not at present. However, the current developments cannot continue indefinitely.

Future price developments

While we have been able to see some slowdown in the rate of increase in house prices over the past year, the rate is still high; the average price of a single-family dwelling rose by 8 per cent between the first quarter of last year and the first quarter of this year. I believe that we will have to assume that property prices and indebtedness will continue to increase relatively substantially over the coming period. This belief also appears to be shared by the households in SEB's house price indicator and SBAB's estate agents barometer. The probability of this happening also seems to have increased recently. For instance, we have seen a rapid increase in the number of persons employed over the past year, which means that more people have the opportunity to be able to buy a house.

In addition, it now appears that the property tax will be abolished completely with effect from January 2008. This tax will instead be replaced by a municipal charge of a maximum of SEK 4,500. At the same time, tax on capital gains on housing will probably be raised from 20 to 30 per cent.

It is no easy task to quantify the potential effects this tax reform may have on house prices. Even if the abolished tax is financed through the housing sector, I believe that it will push up property prices to some extent. All households who have previously paid more than SEK 4,500 a year in property tax will have lower monthly costs, according to this proposal. If households choose to use the sum they save on the abolished tax to take out larger loans, it is possible that this will lead to a slightly faster increase in prices than would otherwise have been the case. If the increased opportunities to borrow were to have a full impact on house prices, the reform could push up prices by around five per cent. The price increases would probably be highest in the parts of Sweden with the higher taxation values, where they have previously paid a relatively higher tax rate. However, there are a number of factors that imply that this calculation probably overestimates the effect on prices. Firstly, the Government has been indicating for some time that it intended to lower property tax. It is therefore possible that house prices have already been affected to some extent by the decision. Secondly, the price increases could be counteracted by the higher capital gains tax. Thirdly, if households believe that the property tax will in some way be increased in the future, it is not certain that they will be prepared to increase their borrowing.

As I said, it is not easy to measure the overall effects of the changed taxes. This is a subject which I believe we will have reason to discuss further in the future.

In the slightly longer term, however, developments in indebtedness and also property prices will slow down. Quite simply, it is not sustainable in the long run for households to allow their debts to grow more rapidly than their incomes. Households would ultimately be unable to pay their loans. In the long run it is more probable that indebtedness and house prices will increase roughly at the same rate as nominal growth in the economy. This type of adjustment to more restrained growth rates will normally occur smoothly, as households begin to feel that their finances cannot tolerate a higher level of indebtedness. If there is an overly sharp correction, it could lead to weak growth in the economy for a long period of time. In this case it would also have effects on inflation.

Given these consequences, it is not reasonable to entirely ignore the risks with such rapid growth in house prices and loans. There may also be justification for taking these factors into account when we make our monetary policy decisions. To contribute to some extent to a smoother adjustment, we have therefore chosen on a couple of occasions to raise the interest rate slightly sooner than planned. This method of reasoning was also one reason why I entered a reservation against the decision to keep the repo rate unchanged at the most recent monetary policy meeting at the beginning of May. I advocated raising the repo rate by 0.25 percentage points. However, this is merely a question of fairly marginal adjustments in the timing of our interest rate decisions. Seen in a longer-term perspective, I believe that these considerations benefit stability both in the real economy and inflation. But I wish to point out that neither house prices nor household indebtedness have any independent significance for monetary policy. The important factors here are inflation prospects and developments in the real economy.

Concluding remarks

Let me summarize. In recent years we have seen prices soar with regard to both commercial property and housing. The rapid price increase has gone hand in hand with a substantial increase in household debts. At present I am not particularly concerned that these prices will lead to problems for financial stability. But this is a development that is not sustainable in the long term. House prices and household indebtedness cannot increase faster than household incomes in the long run. Otherwise there is a risk of imbalances building up, which may be costly for the economy. We at the Riksbank will therefore be closely watching future developments.

Thank you!