Pentti Hakkarainen: International competition will change mortgage lending

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, to the Nordic Mortgage Council, Helsinki, 28 August 2015.

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Accompanying slides can be found on the Bank of Finland's website: Slides (PDF).

A level playing field for competition

The time is ripe for turning national mortgage credit markets into more integrated and competitive pan-European markets. So far, mortgage lending markets have been surprisingly local in nature, at the same time as many other segments of banking have become increasingly international.

Despite the current cross-country differences, the provision of housing loans is likely to become more similar across countries. The conditions for this development are already in place in the integrated financial markets.

First and foremost, more harmonised regulation and supervision, enhanced particularly by the Banking Union, has put banks on an equal footing across Europe. Secondly, the ongoing digitalisation and development of modern scoring techniques will give a strong boost for increasingly common provision of housing loans through online banking services, also cross-border. Finally, today's customers are well-prepared for comparing competing loan offers.

Housing markets and financial stability

Overall, stability in the European credit institutions sector has strengthened as economic and financial developments have gradually improved since the crisis. Regulatory and institutional reforms have also made the financial system more resilient against shocks.

However, financial stability reports published by many central banks and international organisations point to risks and vulnerabilities on a number of European housing markets and in housing finance (slide 2). Household indebtedness continues to be high by historical standards and house prices remain elevated and on the rise in some countries and metropolitan areas, in particular. In the four Nordic countries the high level of household debt is a common and growing concern, albeit to differing degrees.

Why are housing markets and housing finance so crucial to the stability of the economy as a whole (slide 3)? Housing booms and busts have been associated with many of the most serious financial and economic crises in developed countries. Rapid real estate credit growth has often been accompanied by current account deficits that have turned out to be unsustainable. The bursting of a housing bubble may have a devastating effect on the real economy, as it suppresses private consumption and investment. Therefore, in terms of output losses, the total costs of housing busts for society are much higher than the direct credit losses borne by mortgage lenders.

Housing markets are regional, still today

Euro area housing markets and housing finance are still structurally heterogeneous. There is considerable heterogeneity, for example, in loan characteristics, such as typical interest rate fixation periods, maturities, amortisation requirements and loan-to-value ratios (slide 4).

The housing market cycles are also quite country-specific. However, the latest financial crisis hit all markets by and large at the same time, albeit with differing force. Now the recovery from the crisis has continued and is becoming more broadly based across countries (slide 5).

The rebound in house prices has been strong in several countries (slide 6). The European Central Bank's estimates of potential over/undervaluation of house prices suggest that while euro area house prices are, on average, broadly in line with fundamentals, some pockets of vulnerability do exist (slide 7).

The recovery in house prices and lending has been supported by an improving economic outlook and more favourable financing and lending conditions (slides 8–11). However, developments continue to diverge both at country and regional level.

Housing markets and finance are heterogeneous across the Nordic countries, too, albeit these economies are in many other respects quite similar to each other. Structural differences exist between countries with respect to lenders' business models, typical loan products and the level of household indebtedness (slides 12–13). The four countries are also in different phases of their housing cycles, with real house prices rising fastest in Sweden and Norway (slide 14).

Some specificities in Finland

In Finland, housing lending is one of the key business segments of universal banks, and the loan market is dominated by the three largest banks. Average maturities of housing loans are short in Nordic comparison, and non-amortising loans are almost non-existent (slide 15). Loans are predominantly tied to variable interest rates and funded mainly by deposits and, increasingly, by covered bonds (slides 16–18).

Over the past 5 years there has been a soft, if lengthy landing in the Finnish housing market, reflecting the protracted economic downturn. The housing loan cycle in Finland is now passing its second trough after the burst of the global financial crisis (slides 19–22). The average interest rate on new housing loans has reached a record low, being the lowest in the euro area (slides 23–25). Yet, growth in housing lending is only slowly picking up and house prices are slightly decreasing relative to household income (slide 26).

Risks related to growing indebtedness

The mutually reinforcing cycles in housing and credit markets may, at times, turn out to be detrimental to financial and economic developments. In Finland, the growth in household indebtedness has continued without interruption since the end of the 1990s, albeit more slowly in recent years (slide 27). This debt accumulation includes features that increase risks and vulnerabilities for Finnish households and the economy as a whole.

Firstly, household debt and the related risks are very unevenly distributed among households. A large amount of housing debt is borne by a small proportion of households with the highest debt-to-income ratios. For example, about half of the total amount of housing debt is with the most indebted tenth of all households in Finland (slide 28).

Secondly, owing to variable rate loans, there may be considerable annual variation in household interest expenses. Lower interest rates and longer repayment periods since the turn of the millennium have kept households' annual debt-servicing burden in check, although the amount of debt has at the same time substantially increased (slide 29).

Regional differences within a country

There can be a strong regional divergence in house prices and household indebtedness within countries, too. These regional differences are driven by both demand and supply-side factors. Growth areas are typically characterised by increasing population, younger residents, a better employment situation and higher household income than the national average. This is also reflected in brisker housing markets and higher house prices in these areas.

For example, in Finland the market conditions in the metropolitan areas are diverging from the conditions prevailing in areas where the population is diminishing. The largest housing loans are concentrated in the biggest cities and growth centres (slide 30). In these centres, house prices are also highest (slides 31).

Is there a need for public intervention?

There is a strong public interest in preventing excessive credit growth and leverage. Macroprudential policy plays a key role in pursuing that objective. Housing market-related tools, such as maximum loan-to-value ratios, minimum risk weights for mortgage loans and countercyclical capital buffers, have recently been introduced in the toolkits of designated macroprudential authorities, including the Financial Supervisory Authority in Finland (slides 32–33).

Owing to the lack of experience, some question marks remain. Many of the macroprudential tools are yet to be tested in practice. Therefore, the consequences and effectiveness of these instruments are still largely uncertain. It is, however, clear that we are moving in the right direction. The authorities responsible for financial stability have stronger mandates, more analytical tools and better-targeted policy instruments to mitigate housing-related systemic risks than ever before.

Mortgage lending in the future

In the areas of retail payments, large corporate finance and consumer credit, European integration is already advanced and cross-border activities are day-to-day business. In some of the remaining areas of finance, SME lending in particular, corresponding developments require more time owing to the more complicated and work-intensive credit risk assessment.

The regulatory and supervisory framework is becoming more harmonised across Europe, creating a level playing field for banks. In addition, there are specific trends and factors that are likely to touch housing finance, in particular (slides 34–35). Examples of such developments include common standards in collateral valuation, innovations in financial technology, advanced data mining and credit risk scoring, and the already widespread use of online banking services. Furthermore, mortgage brokers, special firms that arrange loans, may gain a stronger foothold in housing finance, as has happened increasingly in Germany.

To sum up, the conditions for increasing international competition and integration in mortgage lending are improving. While the mortgage credit markets are still very national and regional in nature, it is likely that a considerable change is already underway. This will have a substantial impact on banking, especially in the euro area, where there is no currency risk in cross-border lending. We have to make sure that this welcome development is managed in a way that ensures the stability of the housing markets and housing finance.