Mr Nyberg comments on how EMU may affect the Swedish housing loan market and its financing

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, at Föreningssparbanken in Warsaw on 14 October 1999.

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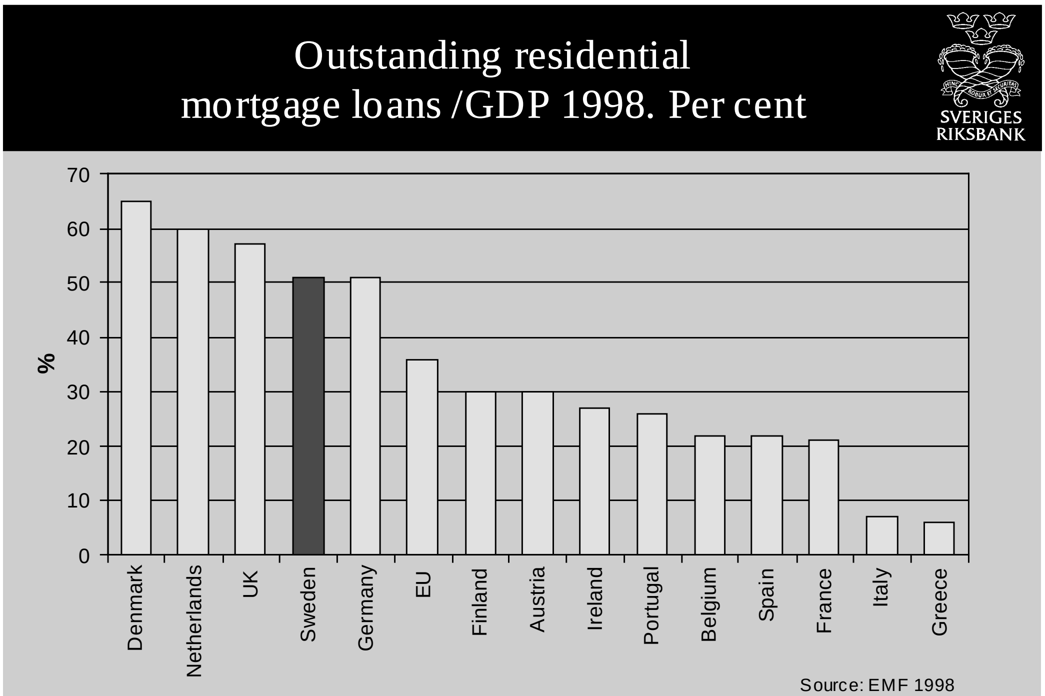
Thank you for giving me the opportunity to come here and give some points of view on how EMU may affect the Swedish housing loan market and its financing. This is undeniably an issue which we have every reason to take an interest in whether we take part in the monetary union or not.

One of the ideas with EMU is to create a more efficient market for goods and services where competition is increasing and consumers obtain better products at lower prices. In the housing loan market, this should mean that borrowers expect a greater range of products, more suppliers and lower interest rates. How should the Swedish housing loan institutions handle this challenge?

Competition for customers

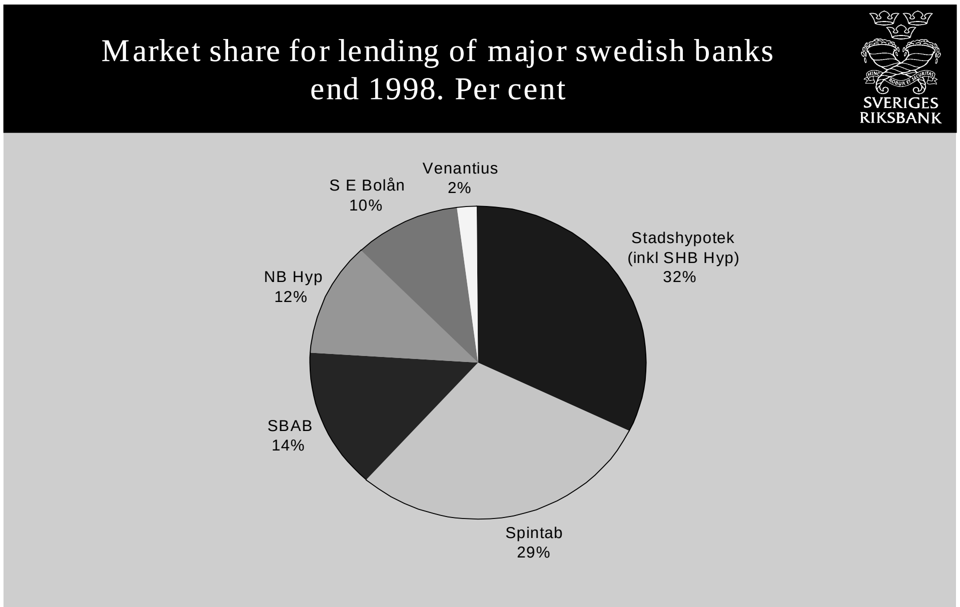
As we know, the national housing loan markets in Europe look rather different, which is illustrated by the following diagram (figure 1). In countries such as Germany, Denmark, Sweden, the Netherlands and the United Kingdom, the total outstanding stock of loans with mortgages in property totalled over 50% of GDP. In other countries, including Greece and Italy, the equivalent figure is under 10%. The differences depend on factors such as the systems of rules, tax legislation and market structure which vary from country to country. Housing finance has, as in Sweden, often been an issue of great political interest, which is reflected in all the above factors.



It might be thought that standardised financial products such as housing loans should be very suitable for cross-border sales, but cross-border activity has been little to date. This is probably related to the housing loan market being primarily focused on private customers, who are difficult to reach without a local distribution network. It remains to be seen what internet can change in that respect. However, why should people not purchase a housing loan on the net, when they now pay bills and carry out other transactions that way. There are already today good possibilities for finding the cheapest housing loan on the market via internet, so technology will certainly increase transparency and competition even within the traditional more inert private sector. We are far from the time when Swedish house owners waited respectfully for years to move their building credit at the bank to a real five-year loan at a housing loan institution.

Those wishing to sell housing loans on the Swedish market must, however, accept offering loans in kronor for the time being if they are to meet anything other than sporadic interest. This restricts competition to those who really actively want to sell their products in Sweden. If we enter EMU, it will be a different matter. We can then borrow in euro without being exposed to an exchange risk and access to potential lenders will increase dramatically.

Mainly as a result of the deregulations in the 1980s and 1990s and the ensuing increasing competition, the Swedish housing loan sector has been condensed to five companies, of which four are subsidiaries of banks and the fifth is state-owned. These five companies cover around 95% of the market (figure 2). As housing loans are very standardised products, it is natural that the price, i.e. the interest rate, will be a crucial factor in competition for customers. This means in turn that refinancing costs will be absolutely decisive for running a profitable business.



In the light of this, there is every reason to discuss what EMU and the euro can mean for the future financing opportunities and how Swedish businesses stand up to European competition?

Traditional housing loan finance – a good alternative

The Swedish mortgage institutions have traditionally been financed with collateral in their entire balance sheet. There is thus no direct link between a particular loan and the collateral belonging to it on the one hand and certain issued bond loans on the other. In many countries, mortgage companies are obliged to collect a number of housing loans and then issue bond loans in the market with these as collateral. There are different techniques for this to which I will return later.

The Swedish model thus has advantages to the extent that borrowing can take place without a fixed link to lending. In this way, large loans can be placed in the market, which will make it easier to maintain regular trade and good liquidity in the loans. This has occurred with the so-called benchmark bonds. However, housing loan institutions, among other things due to considerable loan volumes and a good price formation for domestic loans have also been able to successfully compete in the international bond market.

If one is to borrow on the balance sheet, it must naturally be in such a state as to be accepted by the lenders. The Swedish institutions have managed this by strict operating rules, which place limits on what the institutions may engage in and allow lenders to ensure that the institutions get involved in what they have said they are going to do and nothing else. However, a not inconsiderable risk capital or guarantees from the owners have also been required. Capital adequacy in the Swedish companies is shown in figure 3. If – or rather when – the owners' requirements for return on the capital contributed increase this can be problem.

Mortgage banks capital ratio and tier 1 capital ratio 1998. Per cent

SVERIGES RIKSBANK

	Capital ratio	Tier 1 capital ratio
• Handelsbanken Hypotek	10,7	10,0
• Stadshypotek	13,1	12,7
• Spintab	16,0	11,1
• SBAB	10,6	6,9
• Nordbanken Hypotek	10,5	8,8
• S E B BoLån	8,4	4,3

During the financial crisis in Sweden, the balance sheets were for obvious reasons insufficient to enable the institutions to borrow at competitive prices in the international market. This uncertainty on asset values was all too great for a while. Since then, however, creditworthiness has been continually increased, which is reflected in a gradually improved international rating.

The Swedish housing loan institutions have today around 13% of their borrowing abroad. Traditionally the Swedish insurance companies and pension boards have been large purchasers of housing institution bonds.

A part of the international borrowing has taken place in Europe, in particular in London, while the major part has originated from investors in the USA and Japan. An interesting issue is whether the ability to borrow in euro will make the Central European investors more interested in Swedish risks than before? It remains to be seen. However, obtaining capital in the international market is a laborious and long-term work that requires a systematic build-up of confidence. Every new lender must become acquainted with the borrower's name and history and eventually request a limit in his board. This takes time and the process is not simplified by a common currency. With regard to building up the international investment base, the Swedish housing credit institutions have perhaps had slightly different approaches and priorities. Having a well-established network of contacts among the European investors is surely not a bad idea the day that the euro becomes our own currency.

It is interesting to note the rapid increase in Swedish corporate bonds issued in euro during the autumn. The supply of government bonds has decreased which has led investors to look for other alternatives, but they have clearly become increasingly interested in assuming additional risk in exchange for some additional interest rate percentage points in the return. Eriksson, Volvo and now most recently Birka Energi are making company presentations at places in Europe where few investors have previously shown interest. And Birka can hardly be said to be a familiar name in the market outside Sweden. This development should also include opportunities for the housing loan institutions.

Gilt-edged bonds

If we wish to see how EMU can affect housing finance, it is close to hand to study conditions in Germany since these, together with the Danish model of housing finance will be given special treatment in the EC directives in the area. In Germany, housing loans are traditionally financed via so-called Pfandbriefen, which are essentially housing bonds with a clearly specified body of collateral. As has been pointed out, the Swedish housing companies finance the whole of their balance sheets without linking particular collateral to each loan issued. With regard to Pfandbriefen, legal regulation moreover plays an important role for the nature of collateral and checks on the parts of the authorities.

The Government has had a committee of inquiry investigate how the so-called “gilt-edged bonds” could be designed in Sweden and the legislation and supervision that should be required. In brief, this proposal means that the right of priority would apply to this type of bond, that clear limits would be introduced for the extent of borrowing against them (at most 75% for housing properties) and that collateral would be identified in a special register controlled by Finansinspektionen. The Ministry of Finance is at present considering its standpoint on these proposals.

When the discussion on gilt-edged bonds was initiated in Sweden at the beginning of the 90s, the background was concern that the new investment rules planned for the insurance companies would make it more difficult for the housing institutions to obtain finance. The requirements for diversification of assets would introduce stringent restrictions on the ability of the insurance companies to hold housing bonds. Representatives of the industry claimed that considerable volumes of housing bonds would be sold by the insurance companies for this reason and that this would affect the market and increase costs for borrowers sharply. The gilt-edged bonds could at least partly solve the problem since, according to the EC directive, they would not be affected so much by the rules for single-party commitment.

Others were doubtful about introducing special rules for insurance companies to give them an incentive to have a larger proportion of housing bonds in their portfolios than they would normally choose. There are no good arguments for letting insurance policyholders subsidise either housing loan institutions or their customers.

Now the new investment rules were introduced for the insurance companies without this leading to any of the terrible consequences that had been predicted. The housing loan institutions began to borrow abroad to an increasing extent, which was a good idea from many respects. Hopefully, then the desire to create space for a larger proportion of housing bonds in the Swedish insurance companies’ portfolios will then no longer serve as a motivation for the gilt-edged bonds.

As long as the insurance companies had their undertakings in kronor, some concentration of investments was explicable. However, the day that Sweden becomes a member of EMU and we have the euro as currency, the portfolios of the insurance companies will appear rather remarkable if a predominant part of the risks in interest-bearing securities is in five housing loan institutions. Even if housing bonds are as gilt-edged as possible, the insurance companies in this situation will feel a need of increased diversification.

The main argument for enabling the Swedish housing companies to issue gilt-edged bonds is naturally that competitors in Europe issue them and they are established in the market. They would be easier to sell to investors, carry a higher liquidity and provide lower interest rates than traditional Swedish housing bonds. This would facilitate financing and hopefully give the consumers lower interest rates.

There is undoubtedly something in this line of reasoning.

However, the Riksbank has taken a critical attitude to this proposal more for reasons of principle. The housing institutions have every opportunity themselves – via clauses in the bond contracts or even in articles of association – to create the collateral arrangements that they consider appropriate and thus give their bonds the gilt edge that they consider necessary to facilitate financing. If the state assumes the responsibility of legislating about the design of bonds and moreover to check compliance by institutions, this is a regulation that cannot be motivated by concern for the stability of the financial system but rather aims at improving the institution’s profitability by reducing financing costs. Such regulations are usually called into question by both the industry and the legislative authorities.

There is undeniably something to be said for their view of this matter as well. It is, moreover, easy to create the impression that the state by its control takes a special responsibility for the collateral in the bonds, which is not the intention.

Perhaps one should also ask whether a gilt edge to the bonds would really give the effects hoped for. The large liquid securities with the best creditworthiness (AAA-rated) in the European mortgage market (Öffentliche Pfandbriefen) have in the first place collateral in loans to local governments or federal states and not in the market that the Swedish housing companies can use. They would rather issue "Hypotheken Pfandbriefe" with collateral in office premises and housing and both interest and liquidity are less favourable in the market. It does not seem either as if any uniform market for mortgages is in process of being established, but the regulatory framework differs considerably from country to country. Investors will hardly avoid making separate appraisals for each of these markets.

Moreover, it seems, not wholly unexpectedly, as if EMU would affect developments in the direction from relatively rule-governed national markets such as the Danish and German to internationally open markets, where new instruments can be developed in a flexible way as the need arises. In the light of this, one cannot avoid wondering whether it is wise and really in the market's interest to lock certain instruments into a separate legislation, which can be difficult to change once in place. If EMU really leads to the European market for borrowed capital being improved, which we all believe and hope, developments may move in a completely different direction. We shall have to see what the future holds in store.

Securitisation

The existing Swedish form for housing finance is, as pointed out, not necessarily a bad financing form in a developed European market with a uniform currency. On the contrary. The Swedish housing loan institutions are known and respected in the market, have large outstanding volumes that provide a basis for good liquidity and a transparent price formation and can moreover benefit from a rating that is improving as Sweden's does.

The great challenge from EMU is rather on a different level. When competition gradually increases, not only on the corporate side but also in the market for apartment blocks, tenant-owned apartments and houses, this will probably eventually reduce profit margins. The return on equity will then also fall. An issue that naturally arises is whether it is possible to find housing forms that make more economical use of equity provided by the owners.

In my opinion, it is in this perspective that the discussion on securitisation is to be viewed. Securitisation means that a given loan stock with the collateral pertaining to it is lifted out of the balance sheet in the housing loan institution and invested in a company separately created for the purpose (a so-called special purpose vehicle), which is then financed in the market by issuing bonds. This company has a clearly defined risk scenario and does not carry out any activity besides holding the specified loans. It need not therefore be subject to the capital adequacy rules that apply for housing loan institutions.

Assume that the housing loan institution must set aside four million kronor of a loan stock of 100 million while the market accepts financing the securitised stock with a capital of 1 million kronor in the company created for the purpose. If the stock provides a return of SEK400,000 after financing and operating expenses, this gives a return on capital in the housing loan institution of 10% before tax. The same loan invested in the special company will provide a return on capital of 40% before tax. A buffer for investors can also be added on via credit guarantees, which further reduce the requirement of equity.

A number of objections can be raised to this example, but it serves well to illustrate the driving mechanism behind a securitisation. In practice there are many difficulties. One such is naturally that it is not possible to build special purpose companies in Sweden without their being subject to the Act on Financing Operations and thus being affected by the same capital adequacy rules as the housing loan institutions. In a ministerial memorandum from 1998 dealing with better prerequisites for securitisation, a change is proposed inter alia in this respect. Such a change is also proposed in the banking legislation committee's report from last spring. The Ministry of Finance is at present considering these proposals as well as gilt-edged bonds. It is planned to introduce proposed legislation early next year.

Now there are also other objections to securitisation. It has to date been relatively complicated and therefore expensive to create special purpose vehicles and it has not been possible to invest their bonds with such good interest rates as their rating should occasion. One reason for this may be that the market is undeveloped, and that issues have been few and small in this context and that liquidity in the bonds has consequently been low. Another cause may be found in the regulatory framework, since securitised bonds in banks and other financial institutions, which are expected to create a market for bonds, are affected by higher capital adequacy requirements than ordinary housing bonds.

In the USA, as we know, securitisation of housing loans is a common occurrence, which is partly due to institutional reasons. In Europe, housing finance has mainly taken other forms. If now EMU leads to increased competition in the housing loan market, which should be an effect of monetary union, there will also be an expanded need to finance housing loans in way that is economical with capital. It is not unreasonable to believe that securitisation in this perspective will attract increasing interest.

Increased competition can accordingly drive forward a growing market for securitisation. However, the causal connection can also be the opposite, namely that improved opportunities for securitisation will increase competition. This is the experience in Australia, where the housing loan market was deregulated in the 1990s. A legislation that facilitates securitisation reduced the previously high entry barriers which existed in the market, cleared the way for new players and reduced costs for the housing loan customers – in fact by as much as a couple of percentage points.

Some conclusions

Taken as a whole, we seem to be moving towards greater competition in the housing finance sector. New financing forms, new technology and possible EMU membership are driving factors that will together reduce entry barriers and thus increase competition. Since housing loans are standardised products, it is above all price which is the means of competition. The financing issues will thus be at the centre of interest.

The traditional Swedish form for housing finance where the entire balance sheet constitutes one body of collateral has many advantages. It is possible that the investors' demands for collateral in the form of equity may gradually make this form too expensive. A more developed market for securitisation may be one way of tackling this problem. It requires, however, assistance from the authorities in the form of a simplified regulatory framework. A well-developed market for gilt-edged bonds may also work in the same direction, but this also requires the approval of the authorities.

A general reflection is that the financial innovations in a new market develop best if they are controlled by the wishes of investors and issuers. It is impossible to say what these wishes will be like in future. The role of authorities is to create a body of rules that provides scope for changes and preferably avoids locking the market into special structures or instruments.

The Swedish housing loan institutions are well run and should have good opportunities for borrowing competitively in the European market however it develops. However, no one can borrow without systematically building up relations with the funds, insurance companies and other institutional investors which make up the so-called investor base. All the Swedish institutions have a task here in the market for euro.