SPEECH

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The housing market, the banks and household debt

The origins and the course of the financial crisis can be described in slightly different ways and in more or less detail. I will not provide any detailed account here - I have already done so on more than one occasion, not least here before the Riksdag Committee on Finance. An essential component of the crisis was the build-up of credit and house price bubbles over a number years in a number of countries. When these bubbles burst, the financial system was rocked to its foundations, and governments and central banks around the world were forced to take exceptional measures to stabilise the situation.

The decades prior to the crisis were marked by extensive deregulation of the financial markets. There was a strong belief that the financial sector was to a large extent self-regulating, and that it was able to resolve most problems on its own through market incentives. This belief was seriously undermined during the crisis. There is now considerable international agreement that the market's ability to "manage itself" was overestimated, and that regulations need to be stricter and supervision tightened. Of course, what one wants to achieve is to reduce the risk of future financial crises. Although more and stricter regulations may be linked to a certain cost, for instance, in the form of higher interest rate margins, studies indicate that this is more than counterbalanced in the long run by more favourable economic development.[1]

I would like to point out that I am not talking about a return to the strictly regulated credit and finance markets we had before – deregulation has of course had some positive effects and meant that the economy in many ways functions better. But I think that most people will agree that the financial sector needs a tighter rein than it has had for the past fifteen, twenty years.

[1] See, for instance, the report "An assessment of the long-term economic impact of stronger capital and liquidity requirements" by the Basel Committee and the Financial Stability Board (http://www.bis.org/publ/bcbs173.htm).

Tighter regulations and supervision planned

Reform work is already under way on an international level. The Basel III rules, which in brief entail the banks having to hold more and better capital and larger liquidity buffers, are one example of this. In the supervisory field, the EU has established a special body, the European Systemic Risk Board, which is to identify risks in the financial system as a whole and to provide warnings and recommendations to the countries and authorities concerned. Sweden of course supports and participates fully in this international reform work.

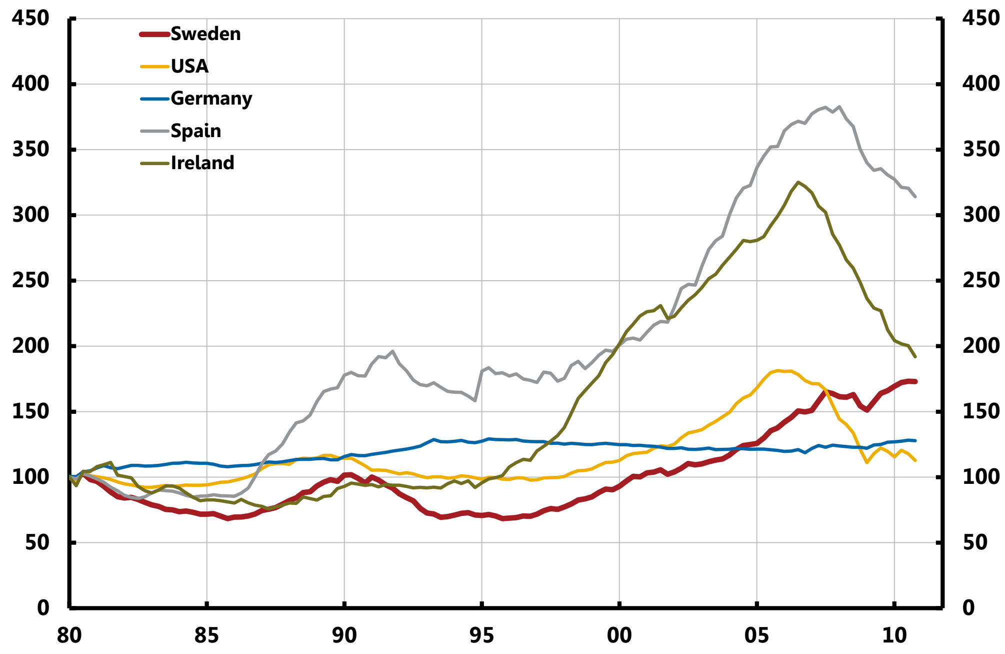
But one thing we really need to ask ourselves is whether this work sufficiently takes into account the specific circumstances prevailing in each individual country. Is it really the case that "one size fits all"? Or might there be reasons for Sweden and other countries to specially design our own solutions, over and above those imposed by international regulations?

Lending and house prices in Sweden relatively unaffected by the crisis

One area where Sweden stands out in comparison with many other countries, is the development of house prices and household indebtedness. As I noted earlier, house prices in many countries have fallen heavily after being pushed up in a credit-driven boom over a number of years. In Sweden, too, house prices and lending to households have risen substantially. But here we have not experienced any corresponding fall in housing prices in connection with the crisis; we can just distinguish a minor dent in the curve (Figure 1). Lending to households has also continued to increase rapidly.

Figure 1. Real house prices

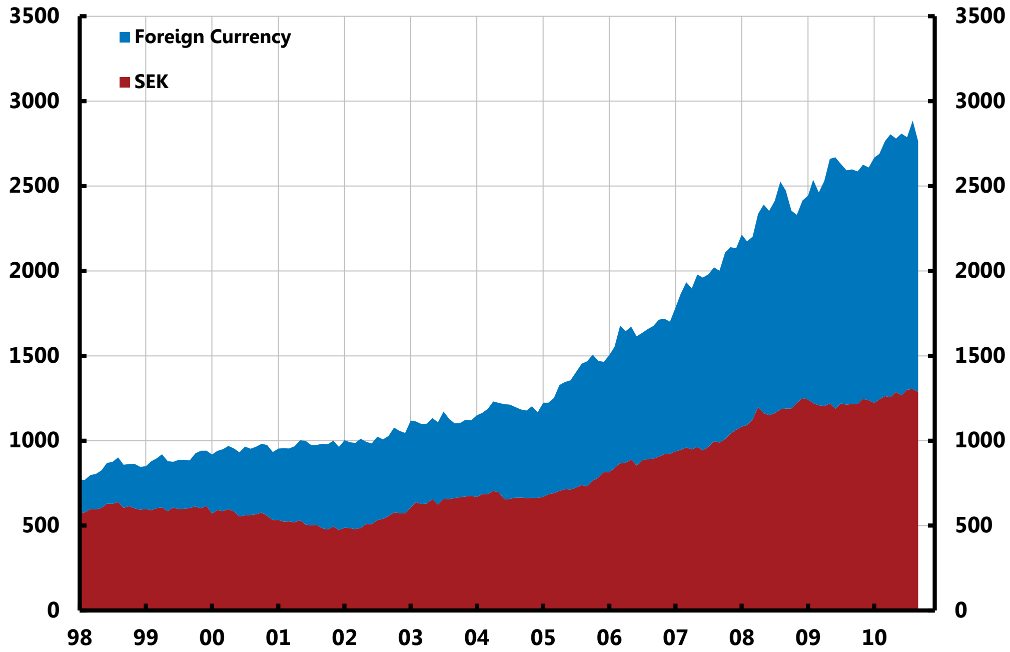
Index 1980 = 100



Sources: BIS, Reuters EcoWin and the Riksbank

- It has been profitable for the banks to fund the increase in Swedish mortgage borrowing in the international capital markets. Funding in foreign currency has shown an increase trend (Figure 2). This has meant that Swedish households have been able to obtain mortgages at a lower cost and probably to a greater extent than would otherwise have been the case.

Figure 2. The market funding of the major Swedish banks via Swedish parent and subsidiaries
Billion SEK



Sources: Statistics Sweden and the Riksbank

But this method of funding is not entirely without risk. It assumes that the rest of the world has confidence in the Swedish housing market and the Swedish financial system. Historically, foreign investors have often been the most "fickle" in times of financial turbulence. If their confidence in the banks is damaged, for instance, through a heavy fall in housing prices, investors will either reduce their lending or charge more for loans. This could happen so quickly and in such large volumes that the banks might experience problems.

The fact that we have not experienced a fall in housing prices is certainly one of the reasons why the effects of the crisis were milder for us, since it helped to sustain demand in the economy. But it is also a cause for concern, particularly as household debt has been increasing more than household income for a fairly long time. Ultimately, this is not sustainable. The danger is that this trend will continue so long that when it finally breaks it will be under dramatic forms and cause problems similar to those we have seen in other countries. We all want to avoid this happening.

The problems have varied from one country to another. In many countries the banks have suffered such severe problems that the state has had to intervene. At the same time as fiscal policy has been used to support the banking sector, it has also needed to uphold demand in the economy. As tax revenue has meanwhile declined as demand has weakened substantially, this has led to large budget deficits and rapidly growing government debt.

What many countries also appear to have in common is that the recovery is sluggish, even after the financial sector has once again begun to function reasonably well. A possible contributory explanation for this is that households no longer want to have such large debts and prefer to reduce these rather than increase consumption.

Of course, we do not know that we will face the same problems that other countries have faced. For instance, we have not experienced the same construction boom that many of the hardest-hit countries went through. But the difficulties faced in other countries underscore how essential it is to try to bring about a gentle slowing down in credit growth and property prices in Sweden.

What has been done?

What have we done so far with regard to developments in household debt and housing prices? Different agents have contributed in different ways. The Riksbank has *raised the repo rate* a number of times and further increases are forecast. These increases are part of our monetary policy, but of course also affect the housing market. Finansinspektionen (the Swedish Financial Supervisory Authority) has recommended a maximum loan-to-value level, a *mortgage ceiling*. The Swedish Bankers' Association has issued *recommendations on the requirement for amortisation* for new mortgages. With regard to the latter measure, I would like to point out that such initiatives from the banks are of course welcome and praiseworthy. But it is also essential that the banks follow up what is happening and that the authorities monitor to what extent the recommendations are actually followed.

Moreover, awareness that rising indebtedness and housing prices could entail problems has gradually increased among both lenders and borrowers. The situation on the housing market is now discussed regularly in the media. I would like to believe that this is at least partly because the Riksbank has long been pointing out the risks involved here.

However, it remains to be seen whether these measures and the increased general awareness will be enough to slow down developments and bring us onto a less risky course. Very recently there have been signs that developments in both lending to households and housing prices have entered a calmer phase. We are of course following developments very closely.

Continued vigilance necessary

Despite the calmer situation, there are nevertheless strong reasons to remain vigilant. If it turns out that this was not a break in the trend, but merely a temporary slowdown, and that housing prices and the build-up of debts among households accelerate again, we and others must be prepared to take action. We therefore cannot just twiddle our thumbs; the Riksbank and others must ensure that we have an effective toolbox of measures that can be quickly and smoothly put into operation. I will return to this shortly.

I would like to emphasise that the question of if and when we should take action ultimately depends on the risk aversion we have and the subjective assessments we make. One can never know in advance when the time will be right to take measures. It is not possible, for instance, to "calculate" that at exactly this particular level of household debt or of housing prices it will be the time to take action.[2] Different countries have experience problems at rather different levels of debt, both higher and lower than the one we currently have in Sweden. This uncertainty is something we have to live with; we must nevertheless make the best possible assessments and make decisions on the basis of them.

Given the uncertainty regarding whether or not the recent slowdown is a break in the trend, what measures do I think are needed? For the sake of clarity, I would like to distinguish here between three types of measure. The first type concerns remedying well-known problems and deficiencies. The second covers slightly more revolutionary changes in the longer run – measures that would improve our management of the type of problems caused by the mortgage market. The third type of measure involves strengthening the banking sector in general, regardless of whether future problems are caused by developments in the mortgage market or by some other market or phenomenon. I will now describe what I consider to be the most important priorities in these three areas.

Well-known problems and deficiencies

With regard to measures involving correcting well-known problems and deficiencies, I see three main priorities.

One priority is to gain a better overview of the mortgage market. Although we have information on aggregate changes and mean values with regard to household indebtedness, how much of their income goes on paying interest, etc., this type of data can disguise a substantial underlying variation. If we view it uncritically, there is a risk we will be lulled into a false sense of security. It may be enough for some households to be so much in debt that a fairly modest increase in the mortgage rate forces them to sell their homes. If a sufficiently large number are in this situation, it may start up a spiral of falling prices forcing further sales and leading to further price falls. But as I said, we do not know how many households are in this situation.

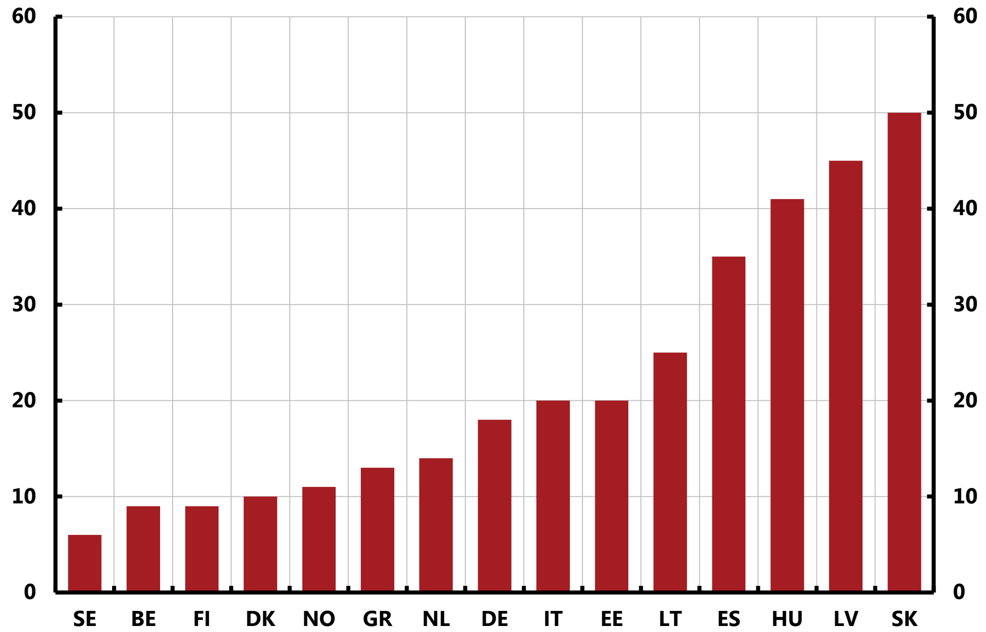
We also need to gain a better idea of the extent to which households amortise their loans. We hope to achieve this now. Together with Finansinspektionen, we are currently working on producing better and more detailed statistics on the mortgage market with the aim of gaining a better insight into potential causes of future problems. Because although - as I mentioned earlier - we will never obtain a clear, objective indicator that tells us when it is time to take action, there is every reason to reduce the uncertainty in our assessments of the situation.

[2] For a review of how different studies evaluated the housing market in the United States prior to the crash, see Gerardi, K.S., C. L. Foote and P.S. Willen, (2010), "Reasonable People Did Disagree: Optimism and Pessimism About the U.S. Housing Market Before the Crash", Public Policy Discussion Papers No 10-5, Federal Reserve Bank of Boston.

- The second priority concerns a serious discussion of the level of risk weights for mortgages in Sweden.[3] Our risk weights are actually among the lowest in Europe (Figure 3). The risk weight of a loan determines how much capital a bank needs to hold per krona lent. Lower risk weights thus mean that the banks need to hold less capital. But the less capital a bank holds, the less resilience it has to loan losses. The low risk weights also contribute to some extent to the credit boom in the mortgage sector, as lending to buy housing thus becomes cheaper for the bank in relation to other lending. Why do we have such low risk weights? The reason is that the current risk weights are based on actual data on historical losses on mortgages. And these were not particularly high even during the crisis of the 1990s.

Figure 3. Mortgage risk weights

Per cent



Sources: The central bank of each country included.

Despite this, I believe that there are two reasons for questioning the low risk weights for mortgages. The first reason relates to a possible reason why loan losses in Sweden have historically been low; namely that in times of difficulty the public sector has helped maintain the household sector's debt-servicing ability through the Swedish social insurance system. In practice, this means that when the household sector's debt-servicing ability is shaken, it affects firstly the individual, secondly public finances and only thirdly the lenders. This could mean that the banks lack an incentive to fully take into account the risks entailed in excessive credit-granting and high loan-to-value ratios. To put it another way, the risk weights we currently have for mortgages may be "correct"

[3] The risk weight of a loan is the risk that the borrower will not be ble to meet his or her obligations. Minimum Capital Ratios are set in relation to the total loan multiplied by the risk weight.

from the banks' business point of view, but they are potentially too low in society's broader perspective.

The second reason for questioning the risk weights is that they are backward-looking. And as we all know, history doesn't always repeat itself. This is one reason why I am concerned, despite the Riksbank's own stress tests showing that the Swedish banks would not suffer particularly large loan losses, even if the situation in the mortgage market worsened significantly. One can't help wondering whether it is reasonable that Sweden's risk weights are among the lowest in Europe, while our households are among the most indebted. And their debts are increasing. I don't think it is reasonable. And consequently I think that from the authorities' point of view we need to discuss whether the level of the risk weights is reasonable or whether it needs to be raised – perhaps by establishing a floor for the risk weights the banks use when calculating their capital adequacy.

The third priority concerns ensuring that public authorities stand ready to use the tools we currently have at our disposal to cool down the mortgage market. Finansinspektionen has already taken a stand by introducing a cap on the loan-to-value ratio. On our part it would involve using our possibility to require that the banks hold reserves with the Riksbank. By linking the size of the minimum reserve requirement to lending to the housing market, lending to mortgage customers would become relatively more expensive than lending to other sectors. And in this way it should be possible to steer the banks' lending away from the mortgage market.

We at the Riksbank are currently investigating what operational and technical requirements need to be met to launch a minimum reserve requirement for this purpose. Whether or not we then use the minimum reserve requirement would depend, of course, on the results of the investigation, but also on future developments in the mortgage market. It is in any case within the Riksbank's mandate to introduce a minimum reserve requirement, and the risks rising from a credit expansion in the mortgage market fall within the Riksbank's area of responsibility.

Better management of systemic risk

At the same time, there is a need to revise and clarify the division of responsibility between the authorities so that we become better at managing the type of problem we now see in the mortgage market. I am now talking about measures that are needed in the longer run.

A central issue concerns the current hesitation over which authority should deal with a runaway development in the mortgage market. The government has a role to play here, of course. But so do Finansinspektionen and the Riksbank, because we are the first natural "line of defence" as public authorities with the task of managing this type of problem. Unfortunately, it is at present unclear exactly *which one* of us is responsible for *what*.

As you know, we have our own respective areas of responsibility. Finansinspektionen focuses on the supervision of individual financial institutions and upholds consumer protection, while the Riksbank is responsible for price stability. But there is also some overlap. Both Finansinspektionen and the Riksbank oversee the financial system and try to prevent financial crises. But we do this for partly different reasons, as we have different tasks. The risks now building up in the mortgage market concern individual banks. But risks are also building up that threaten financial stability – what are known as systemic risks. Ultimately, the macro economy may also be affected. This means that the division of responsibility is unclear.

The problem with the division of responsibility can be illustrated as follows. If we assume that the trend in household indebtedness and housing prices does not slow down, despite all efforts, and continues at an alarming pace. Which authority should be the first to take action and on what grounds? Is it a question of consumer protection *or* of inflation and resource utilisation? Then the answer is simple. But what if it is a question of risks that threaten the financial system? Or perhaps everything at once?

We in Sweden are not alone in struggling with these issues. Around the world there is intensive debate on the management of systemic risk - what is usually known as macro-prudential supervision. As I have already mentioned, we in the EU have agreed to establish a European Systemic Risk Board to monitor the build-up of systemic risk in the member states and to recommend measures to deal with it. It is of course necessary that we in Sweden have a framework ready to respond to any such recommendations, in the form of allocation of responsibility and tools.

Happily, the government has now appointed a financial crisis commission with the task of looking more closely into these issues. This is good news, and the sooner we can reach a satisfactory solution regarding how best to allocate responsibility, powers of authority and tools, the better.

And although I do not wish to anticipate the commission's inquiry, I see a future role for the Riksbank with regard to macro-prudential supervision. Monitoring and preventing systemic risk is very much in line with our current macro-oriented work on safeguarding price stability. Not least because the cyclical factors affecting price stability may lead to the build-up of systemic risk.

Increase the resilience of the banking sector[4]

The third type of measure concerns, as I said, strengthening the banking sector's resilience in general. This is important not just because of the current developments in the housing market. The financial crisis showed very clearly that the current regulatory framework for the banking sector is inadequate. Although Swedish banks escaped relatively lightly this time, we could see how banks in other countries suffered acute liquidity and capital shortages. And this is why we now have an international agreement on the new regulatory framework for the banking sector - Basel III - which establishes new minimum requirements that the banks must meet with regard to both capital and liquidity.

This is, of course, welcome. But the fact is that some weaknesses still remain. For example, the implementation period for the Basel III rules is very long. This may be justified with regard to countries where the economy is still on its knees, to avoid slowing down a recovery. But in a country that is doing as well as Sweden there is less reason to wait before introducing the new regulations.

[4] A more detailed description of the Basel III regulations and the Riksbank's view of them can be found in the speech by Stefan Ingves on 2 February 2011 – "Basel III – much-needed regulations for a safer bank sector".

Moreover, the Swedish banks already meet many of the requirements. The adjustments would be relatively minor.

But it is not just a question of when the regulations should be introduced. It is also a question of the levels for the capital adequacy requirements, which will be higher than currently agreed levels. They will include the cyclically-based capital requirement now being prepared, and which is expected to be in the interval of 0 to 2.5 per cent. They will also include the extra capital requirements that large banks that constitute a particular risk to the financial system will need to fulfil. The four major Swedish banks are systemically-important in the Nordic-Baltic region and will most likely be covered by these rules. In total, thus, the capital requirements will be raised. In addition, these are minimum requirements and there is nothing to prevent countries from voluntarily choosing higher levels if they consider it necessary.

Further regulation in specific areas where Swedish banks are particularly vulnerable may also be necessary. Here I am mainly referring to the Swedish banks' extensive market funding, particularly from abroad, which I discussed earlier. And which has in many ways enabled the expansion in the banks' mortgage stocks. There is international work on producing new regulations in this area, too. When the work regarding the technical details for liquidity regulation is complete, we must also decide how and when the regulations should be introduced in Sweden, taking into account the structure of our financial sector.

Don't forget the supply side

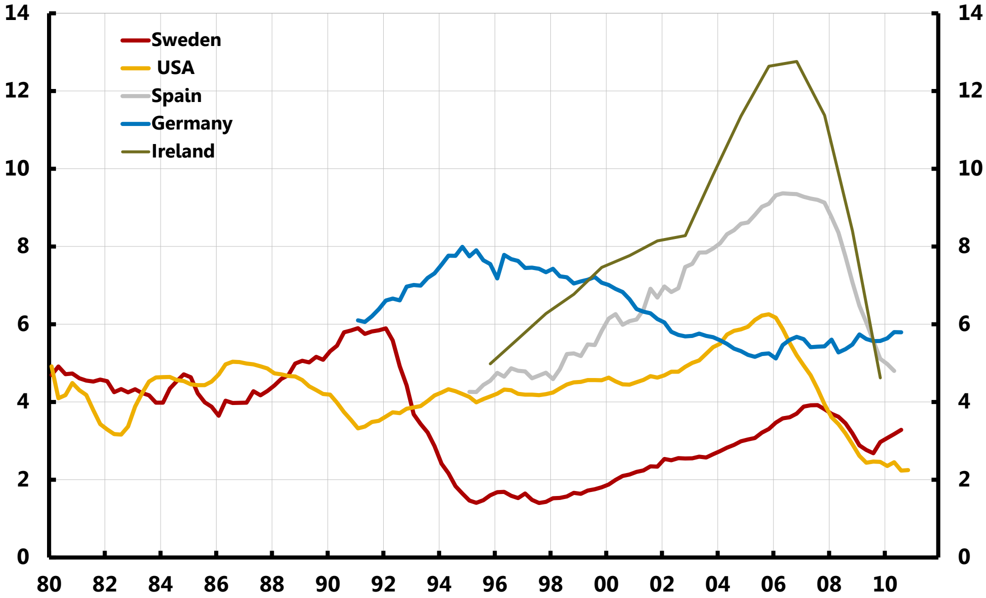
In talking about the housing market I have mostly talked about the demand side and how we can ensure a balanced development there. This is what much of the general debate has concerned. But I would like to conclude with some words on the supply side, or housing construction, and what role this plays and has played earlier. While this is something that is fairly often discussed in this context, I nevertheless feel it deserves a little more attention.

One of the explanations usually put forward for the high housing prices is that relatively little new housing has been built in the past fifteen years or so (Figure 4). The low level of construction is what is usually termed a "fundamental explanation" of the upswing in house prices. And this is probably true.

But I also feel there is reason to ask how fundamental, in the sense of how natural and sustainable, the low level of housing construction actually is. After all, it seems rather remarkable that the rising prices in the housing market have not stimulated supply more. If construction had reacted in what might seem a more natural way and followed prices and demand better, the increase in prices would have been less dramatic. Part of the explanation is probably that we had some excess production of housing during the economic boom, that led to the crisis in the early 1990s. But this is not enough to explain why so little has been built in the past fifteen years. There appears to be some form of obstacle or sluggishness that has held back construction. It is important that we analyse what this is and, if possible, try to remedy it.

Figure 4. Housing investments

Per cent of GDP



Sources: National Statistical agencies, Statistics Sweden and the Riksbank

I would like to point out that I do not believe that the solution is to try to stimulate massive housing construction. One problem in many countries was that there was a boom in the housing market, not just with regard to demand for housing, but also supply, where excessive resources were attracted to the housing sector. The large supply – the over-capacity that was built up – probably meant that the fall was much greater once demand declined and housing prices began to fall. But here in Sweden developments have rather been the opposite. Construction has not been excessively high; if anything it has been excessively low. The challenge in the coming period will be to try to get the supply of housing in a better long-term balance with demand without transitional problems, for instance in the form of overly rapid price falls, being too great.

These questions are not easy ones. They are also beyond the domain of monetary policy and cannot be managed very well through better supervision and regulations in the financial sector. But they are nevertheless part of the overall picture, and I think it is important that they are discussed.