SPEECH

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■ Future scenarios for housing finance

Introduction

Housing finance in Sweden constitutes a significant part of the Swedish financial system. At the beginning of this year, total lending from banks and mortgage institutions amounted to approximately SEK 2200 billion, which was fractionally higher than Sweden's GDP. Mortgage institutions account for just over 50 per cent of this lending, which is why it is vital that financial market players understand the housing finance market, its participants and how it affects and is affected by the Swedish economy. For this reason the seminar today can play an important role in advancing knowledge within the field.

There are several factors that affect housing finance. These include demand factors, supply factors and structural factors. I will not be mentioning all of these but will instead be focusing on three important factors, namely internationalisation, changed regulations and adjustments of household and corporate balance sheets. I will also be attempting to make a connection to how changes in these three broad areas influence the financing of housing.

Allow me to begin by outlining the developments of recent years as a point of departure for future prospects.

A process of internationalisation has been ongoing for many years now and is driven by several factors. The process is particularly evident in the capital and financial markets. It is usually said that when global production increases by 1 unit, international trade increases by two units and capital movements by four. The increased commercial possibilities that arise as countries become more economically integrated are perhaps the greatest driving force. Another force that is driving the internationalisation process is IT. In spite of the IT crash, there is still considerable potential afforded by information technology. While IT companies have suffered badly on the stock market, the use of the technology itself does not represent a "bubble". IT has resulted in better accessibility to both customers and markets as well as to information. For example, it enables mortgage institutions to find buyers of their services in several locations without having a physical presence there. Moreover, it reduces costs for administration, given the initial costs, and this ought to lead to better conditions for consumers. Yet another driving force is the growth of international organisations such as the

EU. With 13 accession countries, the EU could soon be enlarged to include 10 new members, and this is leading toward the creation of a very large and important common capital market. Contacts with our neighbours in the Baltic States and Poland will be stimulated even further through co-operation in the EU. The euro area, which is now four years old, is developing and could include a greater number of countries in the future.

Another important development that has affected the financial markets is the introduction of minimum standards in a number of different areas, e.g. for the supervision of banks, insurance companies, securities trading, payment systems, accounting and auditing, corporate governance and money laundering. These standards were established to create a joint foundation in all countries that will form a basis for safe and efficient financial systems. The IMF and the World Bank have assumed the task of evaluating the extent to which the countries fulfil the requirements according to these standards and also to assist them in addressing the shortcomings that are found. So far over 60 countries, or one-third of the members of the IMF and World Bank, have been assessed. In addition, many countries have performed "self-assessments" voluntarily. The increased implementation of international standards is a very positive development as it demonstrates that the countries are genuinely striving to improve their regulations and supervision and thereby also the financial systems. It is not only beneficial for the countries themselves but also for the international community, as it makes it possible to avoid the weaknesses that can otherwise spread in the international network

The development of regulations through, for instance, the EU as well as other initiatives including a new, major currency in Europe will help enhance the efficiency of the financial and capital markets. It will affect mortgage institutions primarily in terms of their borrowing costs.

As a third point, I would like to mention the balance sheet adjustments that have followed the share price bubble and which have been having an impact in the financial markets. In the light of high expectations of future growth, households financed their consumption, and companies their investment, by increasing their indebtedness in the belief that these debts would be easy to repay due to high future earnings and income. Moreover, a large proportion of the companies' financing was obtained via the stock market. Balance sheets became inflated, as did the actual growth in the economy. When earnings prospects later proved to be lower than expected, there was a fall in both share prices and the value of assets. Debt levels appeared high, particularly in the corporate sector. In order to lower their debts, companies had to increase their income and reduce their costs, which resulted in weaker demand in the economy. Furthermore, the declining share prices prompted households and the financial institutions that invest households' money to seek out investment alternatives that appeared safer. The downward adjustment of the future outlook itself also resulted in uncertainty. This in turn was compounded by the uncertainty caused by international terrorism and the attempts to deal with this by putting pressure on Iraq. This contributed to an increase in the spreads between corporate and treasury bonds as well as to greater volatility in the markets. To counteract the effects of balance sheet and income statement adjustments on the real economy, monetary policy was eased in several countries around the world. At the same time, fiscal policy became more expansionary. The short-term interest rate fell while more subdued inflation prospects and a flight to "safe" investments caused a drop in long-term rates as well. The low interest rates together with the search for safe investments spread to other asset markets. The price of gold increased, and there was a rise in housing prices in several countries as households took advantage of the low level of interest rates to boost their housing consumption. The rising property prices counteracted the fall in the value of households' financial assets. This in turn has led to households in several countries continuing to increase their indebtedness, particularly to finance housing.

However, these historically large changes in the asset and debt markets have thus far proceeded smoothly. In spite of the fact that we have seen the biggest decline in share prices since the 1930s, the largest suspension of national debt payments in history (Argentina), the biggest corporate bankruptcies (Enron, WorldCom), one major terrorist attack and a wave of small ones, the financial markets have been strong enough to handle this. Risk diversification and the emergence of new financial derivatives are two explanations for the preserved stability in the financial system. While developments in the real economy have been affected by the balance sheet and income statement adjustments, the business cycle bottomed out at a higher level of growth than was feared, given the considerable imbalances that existed at the height of the bubble in 2000. The economy is now undergoing a slow recovery, driven by the normal cyclical course of events but subdued by balance sheet adjustments and geopolitical uncertainty. Balance sheet adjustments will continue, however, as there are still substantial savings imbalances between different regions of the world. At the same time, the risk of war has caused flight to safer assets and thereby resulted in low interest rates. Recently, there has been an improvement in earnings and a slight fall in credit spreads. Nevertheless, the effects of asset price adjustments on pension funds, life insurance companies and non-financial enterprises are still been felt through various parts of the economy. Should the economy follow a debt cycle in the future, there is also a risk that the currently low interest rates will lead to the implementation of projects that would be unprofitable at normal rate levels.

How has housing finance in Sweden been affected in recent years by internationalisation, regulatory changes and balance sheet adjustments?

Developments in the Swedish asset and debt markets have largely been the same as those abroad. Shares and commercial property have declined in value since 2000. Investment in residential property and prices of permanent single-family dwellings have risen by 8 and 15 per cent respectively for the past two years. Prices of tenant-owner apartments have also increased. The rise in prices of owner-occupied housing, and to a certain extent the increase in the rate of construction of tenant-owner apartments, has caused mortgage institutions to continue to increase their lending over the past three years by an average of 8 per cent per year. The annual rate of increase surpassed 10 per cent toward the end of 2002.

Over the past 20 years, lending by banks and mortgage institutions has grown by approximately 8 per cent per year, while lending by mortgage institutions alone has grown around 10 per cent per year. This implies that mortgage institutions' share of lending has risen over the years. If one studies the borrowing of non-financial enterprises, the picture becomes somewhat different. Here mortgage institutions have become less important. During the middle of the 1990s they accounted for just over 40 per cent of corporate borrowing, but now their share has fallen back to just below 25 per cent. This is mainly an effect of increased international competition and increased bond financing.

The structure of the housing market and housing finance. Has internationalisation resulted in increased competition?

At the same time as we have seen large adjustments in the balance sheets of households and companies, other longer-term trends have continued to have an effect on the structure and competition in the housing finance market. The market for mortgage institutions in Sweden is characterised by a small number of participants that dominate the entire market. There are presently a total of 10 mortgage institutions in the Swedish market, which is slightly fewer than 15 years ago. The five largest have approximately 95 per cent of the market, which is an increase of just under 10 percentage points compared with 15 years ago. Mortgage institutions operate in two different markets. The first is a national and regional market for lending to consumers, while the second is a national and international borrowing market. Mortgage institutions' borrowing in foreign currency amounted last year to around 20 per cent but lending in foreign currency was negligible. If mortgage institutions on account of their size can obtain better terms in the borrowing market it should, given the competition in the mortgage market, be passed on to consumers.

Although mortgages are a relatively simple, standardised financial product that should be well suited for selling over national boundaries, such cross-border activities have so far been limited. The relatively small number of participants in the mortgage market both in Sweden and other countries can be explained by the fact that these markets are most often highly national in nature with distinctive national characteristics. The sluggishness is due in part to the difficulty in comparing the value of collateral under different national legal systems. This has implied that it is often domestic participants that are in competition in mortgage markets. In Europe, national mortgage markets are rather different. This is mainly because factors such as regulations, tax legislation, market structure, bureaucracy and corporate cultures are different in different countries. Moreover, it means that the costs of entry are high for new participants, particularly for foreign competitors, not least because of marketing. The effect of distinctive national features on the market has also been apparent to Swedish participants that have set up businesses abroad and then operated under other regulatory frameworks and according to other practices. Another limiting factor is the fact that as long as Sweden remains outside the euro area, foreign companies that wish to enter the Swedish mortgage market will have to provide loans in Swedish kronor, as Swedish borrowers do not generally want to expose themselves to exchange rate risk. However, should Sweden join the euro, the interest rates offered by lenders in the different countries of the euro area will become directly comparable. With a single currency, it would be easier for borrowers to judge which institution in the euro area offers the best terms. Swedish borrowers would be able to take loans in euro without exposing themselves to currency risk, and the availability of potential lenders would increase. Differences in regulations and taxation systems, however, would continue to constitute a limitation on increased competition.

Challenges for Swedish housing finance ahead of the future

Looking toward the years ahead, developments in the housing finance market will be driven by a number of powerful forces: continued balance sheet adjustments, the effects of the continued internationalisation process in Europe and new rules for financial institutions. I shall concentrate on these three challenges.

Challenge 1 - Continued internationalisation

Allow me to deal with the different challenges in turn and therefore begin with the challenge posed by internationalisation and, in particular, European integration. One of the driving forces behind the trends in the capital and credit markets is increased international competition and increased awareness of international opportunities. The diversification of both financing and investment is increasing, and risk management instruments are being improved. Europe affects the financial markets through the euro. In addition to the 12 euro countries in the EU, there are a large number of countries in which the euro plays a pivotal role either as a means of payment or through some form of link to the euro. In coming years, when the current accession countries gradually introduce the euro, the euro markets will become larger. At the same time, the harmonisation of rules will continue and the markets will become more integrated. Meanwhile the euro has been accepted by the rest of the market; both the United States and the United Kingdom keep just over half of their official foreign exchange reserves in euro. Canada and Australia keep around 40 per cent in euro. There has therefore been a rise in demand for euro bonds and an increase in liquidity in the market. At the same time, the supply of bonds has risen as an increasing number of agents, both companies and states, are choosing to finance their activities through the bond market. According to the ECB, just under 30 per cent of all bond holdings in euro have been issued by foreign residents. The total stock of euro bonds issued by euro institutions is now EURO 7 400 billion. This market has grown substantially since 1999.

The introduction of the euro has consequently affected the interest rate markets. We can see that there has been a dramatic reduction in the yield differentials for 5-year treasury bonds between the countries that have introduced the euro from about 5 to 7 percentage points during the years 1994-1996 to approximately 0.2 to 0.3 percentage points in recent years. In January and February this year, the yield on Swedish 5-year treasury bonds was around 80 points higher than the euro area average. Of course, part of this reduction in the euro area has to do with the consolidation of government finances in the EU countries to meet the convergence criteria, but the risk premium for exchange rate risk between the currencies that has now disappeared has definitely contributed to the reduction. The remaining yield differential can largely be explained by the different credit ratings of countries in the euro area as well as differences in liquidity between various bond issues. The introduction of the euro has also helped increase the width and depth of European capital markets and has at any rate led to almost complete integration of the part of the money market trading that is closely connected to the Eurosystem's monetary policy transactions. The growing capital market in euro is becoming increasingly important as a source of financing for Swedish companies, so far primarily for major enterprises and institutions that can manage currency risk. This would provide a larger financing base without currency risk for Swedish companies if we were to introduce the euro in Sweden.

It is not just the interest rate markets that have been affected by European integration and the general trend toward internationalisation. The changed market conditions have also affected competition and thereby the structure among market players.

Financial activities tend to benefit considerably from large-scale operation. High, fixed costs in the form of training, highly skilled staff, large and resource-intensive computer and analysis systems, and information retrieval mean that unit costs fall as turnover volume increases. One way to attain a sufficiently high turnover volume for fixed costs or to limit the disadvantages involved in large-scale operation could be a strong specialisation of activities. The trend we can see today in individual countries, of banks merging to create larger entities, is a result of an attempt to reduce unit costs and thereby increase profit margins through economies of scale. However, very few banks have so far established operations on a large scale in other countries. Most institutions have the majority of their activities and earnings in their home country. The consolidation that has occurred through cross-border mergers and acquisitions has generally not yet led to a radically different market in the EU for the services traditionally provided by banks to households and small companies. In this part of the banking sector, there remains substantial overcapacity in the EU which has proved time-consuming to eradicate. Presently, we are seeing problems in the German banking system caused in part by overcapacity, major costs and different terms of competition for different institutions as a result of a slow restructuring of the banking system. On the other hand, a number of banks in Western Europe have expanded into Central and Eastern Europe and given rise to development and modernisation of the banking systems of the former planned economies. The reasons for this are that Central and Eastern Europe constitute a developable market that could soon be a part of an enlarged EU. At the same time, this has contributed to improved profitability in the parent banks as many countries in Central and Eastern Europe continue to show favourable growth compared with the present EU countries. The banks being acquired are mostly full-service banks, which means that the parent bank gets a larger customer base for its financial services, one of which is mortgages.

Another structural trend is a greater concentration of financial activities to certain centres in order to profit from cluster benefits. Companies that produce the same products and services discern benefits from being located close to each other for several reasons. These might, for example, be a skilled labour force, accessibility to the market, suppliers and customers, specialised service companies, market information, market knowledge or infrastructure. They are reinforced by economies of scale that benefit large financial companies gathered together in a few locations. One such example of a financial centre is London. Mortgage institutions with standardised products independent of distance to customers and borrowing in an international capital market ought to be activities that can profit from these cluster benefits. The concentration trend that we have been able to perceive over the past 15 years among Swedish mortgage institutions demonstrates that these are also following this structural trend.

Challenge 2 – International regulations

One of the intentions behind the EU's internal market and the introduction of the euro is to create a more efficient market for products and services in which competition increases and customers obtain better products at lower prices. One aspect of this is the EU's Financial Services Action Plan that is to be realised by 2005. The Plan contains 42 measures that aim to remove remaining obstacles to cross-border trade in financial services and to promote financial integration in the EU. At the same time, measures are been taken to support the supply of risk capital in the EU. These action plans will help realise the vision of making the EU the most competitive, knowledge-based economic area in the world by 2010. Three-quarters of the measures in the Financial Services Action Plan have already been decided. This will also affect mortgage institutions, as they are major participants in the markets for both lending and borrowing.

Another factor of importance is the new capital adequacy rules that are planned for introduction in 2006. Put simply, capital adequacy rules are rules governing how much capital a bank is required to hold for various borrower groups for each krona lent.

In the new rules, it is intended that the risk weighting will better reflect the actual credit risk. This means that the banks will be more careful in assessing the relationship between the risk of a loan and its return. It will therefore be possible to observe increased risk in the banks' interest rates. The new capital adequacy rules have both advantages and disadvantages. The proposed rules require the banks to hold more capital if the risks in their loans increases. If they do not have more capital than that prescribed by the rules, they must either acquire more capital or reduce the risk in their lending. In such a situation, a bank can decide against renewing loans, which of course would entail severe consequences for its borrowers. There is therefore a risk that the new rules will reinforce cyclical developments. Nevertheless, the new rules entail several advantages: a more all-round, individual risk assessment that better protects savers' funds and reduces the risk of tax payers via the Government having to step in, opportunities for cheaper loans to low-risk borrowers as well as increased interest expenditure for high-risk companies. Consequently, the pricing of loans will be fairer.

But how will the new capital adequacy rules affect loans and lending to housing companies that thereby affect the financing of housing? An initial reflection is that the banks will perform a more individual assessment of the object of the loan and the associated company than before. A second reflection is that the banks when pricing their loans will also focus on the cash flow of the loan, which in this case is the same as the company's cash flow. In most cases, housing companies have a large amount of the value of their properties as collateral and this will continue to be positive in the future, but the banks currently focus on the customer's ability to repay after which they look at collateral.

The proposed changes to the capital adequacy rules will apply from 2006, but developments in the capital market will probably entail the banks adapting their lending gradually in advance to the new rules. It is therefore important that capital-intensive businesses start preparing their activities for a more individualised credit assessment in the future. Opportunities for finding competitive financing in the lending market at a low rate of interest will be available for those that can convince lenders that their operations will generate a stable flow of future earnings. Higher risks in the form of varying earnings flows, for instance, will cost more.

Challenge 3 – The effect of balance sheet adjustments

In the wake of the fall in share prices, we have thus far seen the effects on housing finance in the form of low interest rates, which have enabled households to increase their indebtedness at a slowly rising interest ratio. As the interest ratio has risen marginally, this in turn has led to a continued increase in residential property prices in several countries, including Sweden. The lower expectations of future earnings that have resulted from the stock market decline has so far not markedly reduced housing finance demand in Sweden. Thus far, the effect of the low interest rates appears to be the dominant factor. As the balance sheet adjustments come to an end, the geopolitical uncertainty abates and the economy continues to recover, risk aversion will decrease, which in turn will lead to a normalisation of market rates. Consequently, this will dampen household demand for housing finance. On the other hand, expected earnings flows will rise in tandem with the rise in economic activity. The ability of mortgage institutions to find "cheap" financing will also be affected by the normalisation of interest rates. Investors will return to riskier investments as risk aversion declines. Furthermore, rises in long-term interest rates will reduce the value of the bond holdings that were acquired by investors during the current risk aversion period. Consequently, mortgage institutions will face challenges in the time to come on both the demand and supply sides.

Conclusion

All in all, most factors indicate that competition in the mortgage market for borrowing and financing will increase. A potential Swedish adoption of the euro, larger markets that generate a bigger financing base, the EU's Financial Services Action Plan, Basel II and the efficiency improvements in the infrastructure for conducting cross-border trade in financial services are all important factors in a future perspective of the capital market. As mortgages are standardised products, lenders will mostly compete through prices, i.e. interest rates on mortgages. Competition will ensure small variation in prices, which is why the question of financing will be of primary importance for mortgage lenders. As competition in the mortgage market increases, the borrowing costs of mortgage institutions will become the decisive factor in their ability to conduct profitable, competitive operations.