Speech

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The Euro's Role in Housing Finance

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First, I would like to express my gratitude for the opportunity to come here to talk about the EMU and housing finance. I intend to begin by pointing out some trends in the development of housing finance in Sweden in recent years. I will continue by attempting to place Swedish housing finance in a European context and to discuss how Swedish mortgage institutions and the system for housing finance that they represent hold their ground in relation to their European competitors. I hope that this description will provide a picture of where we stand today at the threshold of the start of the EMU in 1999.

I shall then describe the consequences that the EMU can have for housing finance. My focus will then be on tendencies in the development of the securities market, which are important especially for the market for mortgage bonds. I shall also say something about how the EMU can affect banking activities in general, and specifically property loans.

I would already at this stage like to point out something that is important to bear in mind since Sweden is not joining the EMU from the start. This is that the introduction of the euro is only one step, admittedly a very important step, in the process of creating a common market in Europe. The integration of the countries' markets has been taking place over a long period and it has not come to an end with the creation of the EMU. The financial undertakings and the markets are relatively far advanced in the integration process. Even though Sweden is not introducing the euro in 1999, Swedish companies and markets are a part of this

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ongoing integration. The increased competition and integration between markets that the EMU is expected to contribute to will have an impact on Sweden, despite non-membership. The effects for Swedish financial companies will in many cases not be so different from those for their competitors within the euro area.

Trends in Swedish housing finance

I will concentrate on Swedish mortgage institutions when discussing Swedish housing finance, since these account for the greater part of private housing finance.

As the figure shows, total lending by mortgage institutions has fallen during the past five years. On closer inspection, however, it is lending to financial institutions that has declined. Since loans to financial undertakings do not form part of the house mortgage institutions' core activity and the margins on this lending are normally low; this is hardly a major problem. With respect to the core activity, lending to households and non-financial enterprises or what is usually called lending to the non-bank sector, lending has been relatively stable during the latter part of the 1990s. Lending to households has increased slightly, while lending to businesses has fallen. The reduced lending to businesses can be explained by the low level of housing construction. If new construction starts to increase from today's low levels and property prices continue to rise, there is reason to believe that lending can increase during the next few years. This is naturally what most of those here today are hoping for. For my part, I will devote myself most to trying to assess whether such a development is justified from the point of view of stable, long-term development, and whether there is a risk that we are heading for a lending bubble such as the one which occurred at the end of the eighties. The analysis of the growth of lending at the banks and mortgage institutions is an important part of the Riksbank's work in striving for a stable, financial system.

[Diagram 1]

The mortgage institutions are financed primarily by issuing mortgage certificates and mortgage bonds. These securities make up around 70 per cent of the house mortgage institutions' financing. The market for housing paper is the clearly dominant market for interest-bearing securities issued by Swedish private institutions. The outstanding stock of housing paper amounts to around SEK 730 billion, and it is more than 13 times as large as the total stock of interest-bearing securities issued by other private institutions in Sweden. It is today a couple of hundred million less than the volume of treasury securities. However, this will fall as the state redeems part of the AP Fund's holdings of treasury securities and the stock of mortgage paper will subsequently be considerably larger.

During 1997 another type of financing has become considerably more important in the mortgage institutions. The mortgage institutions are obtaining financing to a greater extent through other financial institutions, especially Swedish banks and other mortgage institutions. The independence of the mortgage institutions rests on obtaining their own finance through the issue of bonds that are primarily purchased by various institutional investors. If the mutual dependence between Swedish banks and house mortgage institutions increases, there will be a greater risk for financial problems in one undertaking spilling over to others. This risk is usually called systemic risk. It is important to endeavour to reduce this to strengthen the stability of the financial system.

[Diagram 2]

Swedish housing finance in a European perspective

There are many different ways in Europe of financing housing. For us, the obvious way is to borrow money by a mortgaging the property to finance the greater part of the cost of building or purchasing a property. Lending with a mortgage in property as collateral occurs in all EU countries but its extent varies greatly in relation to other financial activities. Lending backed by a mortgage in property amounts to 65 per cent of GDP in Denmark, while the corresponding figure is only 6 per cent in Greece. Sweden is at a relatively high level at 51 per cent, compared with the EU average of 36 per cent.

[Diagram 3]

Even when housing is financed mortgage loans, this can take place in many different ways. The Swedish system with special mortgage institutions that specialise in providing first loans and which finance this lending by issuing bonds or certificates is only one variant. In a number of countries, housing loans are provided through the normal banking system. Mortgage institutions resembling the Swedish ones also have an important role in the market in Denmark and Germany. In nominal terms, the market for housing bonds is larger in both these countries although it is only in Denmark that the house mortgage institutions are as dominant viewed in relation to the size of the country as in Sweden. In Sweden the house mortgage institutions account for about half of all lending from financial companies.

[Diagram4]

In some countries, housing finance has special support from the state. In France for instance, there is an institution established by the state that finances housing loans granted by the banks by issuing bonds. Housing finance is often characterised by a specific national structure, in which it is not uncommon to find institutions with some state support. We have seen comparatively little European competition in the form of banks or other housing finance companies trying to enter the market for housing loans in new national markets, at least in relation to how competition has developed in other parts of the financial market. This is the case despite the fact that housing loans, at least to consumers, are a relatively standardised product, which normally means that entry barriers will be lower for new players to come into the market. Institutional differences, both those governed by regulations and those due to tradition, may be a contributory reason for cross-border competition not being present to any marked extent in European housing loan markets. Efforts to reduce the institutional differences brought about by the authorities in the European countries that lead to special treatment for national institutional solutions ought to be a major task in the work of improving competition within the EU after the start of the EMU.

Current issues relating to housing finance

I would like to devote some time to an issue that has been under consideration with respect to Swedish housing finance during the past year – the proposal to introduce so-called “gilt-edged” bonds in Sweden. This proposal was presented in a Swedish Governmental Official Report during the second half of 1997. One of the major arguments in the report was that it would contribute to a harmonisation of the markets for housing bonds in Europe. In my view, they would rather work against a real integration of the European housing loan markets. This proposal assumed a rather far-reaching detailed regulation by the authorities of the operations of mortgage institutions. The formulation in a EU directive that the proposal was based on was not intended as an attempt to harmonisation and it was unclearly formulated. A so-called harmonisation based on this directive will lead to the national authorities giving a different content to the detailed regulations; at any rate the existing systems that comply with the directive vary to a considerable extent. This will create differences between the different countries’ mortgage institutions that can entail barriers to competition.

In my view, it is better if the authorities adopt the rules that are necessary to maintain financial stability and refrain from unnecessary detailed regulations. In this way, different institutional variants can be tested against one another and a competitive situation will develop between the systems of various countries, where the system that can best provide cheap housing finance in the long term will probably eventually dominate the market. I see no reason why Swedish house mortgage institutions cannot hold their ground well in this competition between institutional forms.

A competing institutional form for housing finance, which has lately been frequently discussed, is securitisation. Securitisation means that banks, or other firms, remove assets from their balance sheets, mostly loans, and finance these by issuing bonds. Housing loans have been proven suitable for securitisation and this form of financing may become more important on a competing European housing market. Earlier it has been mostly in the U.S. securitisation has occurred on a larger scale. During 1997 securitisation outside the U.S. was made to the value of the GNP of Sweden. There is reason for the Swedish authorities to think of the risk that securitisation may involve for the financial system and consider any need for special legislation.

The effectiveness of European housing finance

In this context, there is reason to compare housing finance in various countries in some way. However, comparisons are made more difficult by the large number of distinctive national features in European systems for housing finance. I have made an attempt to provide some kind of indication of the efficiency of the various systems by comparing how interest rates on housing loans relate to interest rates on government loans in the particular country. The intention is to show what housing loans cost in relation to the general level of interest rates in the country. By showing the spread between interest rates on housing loans and the interest rates on government loans with the same maturity, it is at least possible to remove the differences that are due to currencies and the differences that arise from the use of different periods for the fixed interest terms for housing loans in different countries. Nevertheless, many differences in the loan characteristics, which affect the interest rates, mean that the comparison will not be precise.

[Diagram 5]

From the diagram, it is evident that the Dutch and German housing interest rates are approximately at the same level as the Swedish. Norwegian and Belgian housing interest rates are higher. In this comparison, Swedish housing financing looks competitive.

A more liquid and effective securities market
I now intend to take up in more detail the effects that EMU may have on the European securities market. Since Swedish house mortgage institutions will issue their bonds on this market, this development will be important for Swedish housing finance.

As for all assets, the degree of liquidity affects the pricing of bonds. The degree of liquidity in a bond is usually measured by how easy it can be transformed into cash. Investors who invest in bonds usually therefore require a liquidity premium equivalent to the cost required to transform a bond to cash. It naturally follows from this that loan costs will be relatively high for borrowers who obtain finance by bonds issued on markets where liquidity is low. The introduction of the common currency will create a larger and more liquid bond market for potential investors. The transformation of bonds denominated in a number of different local currencies to euro-denominated bonds, will create a common bond market of impressive size. This market will probably be characterised by good liquidity and efficient pricing which, in combination with stiffer competition in the credit market, can lead to lower loan costs among other things.

The currency union will generally – as an anti-inflationary monetary policy is the common foundation - lead to a convergence in interest rate levels between the high interest rate and low interest rate countries. A further indication of this is that the foreign exchange risk premium on bonds issued in different countries will wholly disappear, since there will only be one currency in the EMU. What will remain, even after the transitional process is wholly implemented, is above all credit risks and legal risks associated with various kinds of securities.

With the disappearance of the foreign exchange risk, investment decisions will be based to a greater extent on credit risks. Evidence suggests that well-developed cross-border European markets may be established for different types of bonds such as corporate, housing and municipal bonds. Interest on the part of investors in spreading their risks by diversifying their portfolios to a number of countries to reduce loss risks in the event of asymmetric shocks in one country will probably contribute to this. The more stringent budget discipline in European states will probably lead to the outstanding stock of the different countries' treasury securities falling. This will mean that there will be an increasing need of secure, liquid bonds for investors. Swedish housing bonds have the prerequisites to be such an alternative.

In order to become a real part of the common European securities market, it will probably be necessary for housing institutions to issue bonds in euros. As long as lending takes place predominantly in Swedish kronor, there is a foreign exchange risk in housing credit institutions if borrowing takes place in euro. This risk will persist as long as Swedish borrowers do not begin to take loans in euro instead of in kronor. It is not so probable that this will take place to any great degree, however.

Even Swedish bonds that are denominated in kronor will surely be affected positively if a common European securities market develops. European investors will, as I mentioned earlier, be more focused on trading bonds that are not issued by national governments. The foreign exchange risk need not then be an insurmountable obstacle.

Even if there are few who deny that the securities market within the EMU will be large and efficient, harmonisation can, however, be delayed as a result of different taxation rules, accounting practices and rules on investment in different countries. However, it is probable that the competitive pressure will result in these differences being obliterated relatively quickly to the extent that they impede the competitiveness of the individual markets.

Harmonisation of market structures within the EMU

In order for this positive development that can be associated with a larger and more effective capital market to be possible, a well-developed financial infrastructure is required where transactions can be settled securely and efficiently. The infrastructure makes it possible for purchasers and sellers to meet in a simple way. The infrastructure includes a number of interlinked parts which are mutually dependent in various ways. From a Swedish perspective, it is naturally important that the Swedish market appears as attractive in comparison with competitors, especially as the Swedish market will seem relatively small in a European perspective. The market shall have a high liquidity and a well-functioning infrastructure.

The Swedish market must clearly be easily accessible and effective. If it is technically difficult and expensive to make use of the Swedish market, it is fairly easy for both foreign and Swedish actors to find an alternative market or for foreign investors to find substitutes for Swedish investments in their portfolios.

Looking at the four central infrastructure systems in the Swedish market, the Stock Exchange, OM, VPC (the Swedish Central Securities Depository) and RIX, they are each relatively well to the fore in an international perspective. What is important in my view is to improve *the integration* between the systems. A technical integration of the entire transaction chain - acceptance, clearing, settlement and account-registration – would simplify access to the Swedish market, in this way strengthening its competitiveness and contribute to a welcome reduction of risk in the financial system. High security is a competitive factor *per se*. A successful integration naturally does not only involve "linking up" a few technical systems. It also involves systems of rules, issues relating to access and supervision where the basic purpose is to secure a good, transparent handling of risks.

With respect to the linking up of computer systems and systems of rules between different countries, I would also like to mention the unique legal prerequisites that exist for linking up the financial infrastructures of the Nordic countries. An obstacle that is often encounters in international link-ups of this type is namely that the system of rules encompassing financial trade in various countries rests on different civil law foundations. The fact that the system of rules of the Nordic countries is based on similar civil law foundations provides considerable opportunities for linking together the securities markets and thus creating a market which can be competitive with respect to size and depth, even in a future EMU. An integration of the Nordic financial infrastructures would in this way be able to serve as an example for other regions in EU. The Riksbank would naturally be pleased to participate in carrying out such integration.

As a small country, it is particularly important that we work actively for free trade. This is a good Swedish trade policy tradition that we should also apply here.

I shall mention two, partly related areas, where we at the Riksbank have been active. One of these applies to the central banks' provision of credit for collateral in foreign securities and the other concerns the future EU system of payments,Target.

The issue of foreign securities as collateral has been discussed both in a Nordic context and in the EU sphere. In the latter case, it is after all in an EMU-perspective patently necessary to be able to use paper that exists in one part of the union, let us say Germany, to obtain credit at, for instance, the French central bank. Apart from the purely technical problems relating to such a procedure, which are naturally substantial, it is in my view difficult to see any fundamental problems of principle with such arrangements - with or without the currency union.

Nevertheless this has been regarded as very problematic in some quarters. With respect to arrangements within the EMU, it is to be a minimum requirement that the paper must be issued within the EEA. The question that must then be asked is what is relevant when obtaining collateral for a loan. It must reasonably be the case that it is the issuer's credit-worthiness, rather than the country in which the party in question happens to be domiciled or where they have decided to carry out the issue. However, we have noted that this view meets intensive opposition.

With respect to the Target system, the ECB has decided that while the banks in the EU countries outside the EMU will be allowed to take part in the system, that access to so-called intra-day credit in the system will be restricted. Since intra-day credit from the central banks is the "lubricant" for payment flows in this type of system, this will then make the Swedish banks' use of the system difficult and more expensive. The official argument for this is that intra-day credit to "outs" could make monetary policy in the EMU more difficult in certain situations.

We believe we can demonstrate this argument is not sustainable – in the first place, such monetary policy effects are improbable, and in the second place, they can be fully dealt with should they nevertheless occur. However, notwithstanding this, the decision entailing a de-facto protectionism most regrettably stands fast.

If our analysis of the monetary policy aspects with respect to intra-day credits is viable, there are from this point of view really no reasons of principle for restricting foreign participation in a national system of payments. As I mentioned earlier, I do not either see any problems of principle in using securities from different countries and in different currencies as collateral for such credits. As an example of the Riksbank's openness in the issue, I might mention our decision to accept, for instance, Finnish treasury securities as collateral in the provision of credit in the RIX system. It is to be regretted that this openness has not so far led our Finnish colleagues to take the corresponding action.

Increased competition between lenders

It is also probable that EMU will not only affect the financial markets but also the prerequisites for carrying out traditional banking operations, for instance, loans for housing finance. The deregulation and internationalisation process we have been involved in during the past decade is a global phenomenon rather than a European one. Nevertheless, it is evident that integration within the EU in general and EMU in particular is accentuating these trends.

These tendencies point towards a continued rapid development of the financial markets with new instruments, sector gliding and concentration of certain specialist functions. Competitive pressure within traditional banking operations will probably continue to intensify at the same time as the long-term demand for financial services will increase and customers – regardless of whether we are speaking of enterprises, local government or households – will make increasingly high demands. The number of "full-service" banks has already declined at the same time as their size is increasing. The tendency for traditional deposits and lending in banks is falling, at the same time as the supply and demand for market-based instruments is expected to continue.

As a result of these tendencies, profitability in the provision of credit on the Swedish market has fallen recently. With respect to housing finance, it can be noted that lending in this sector is exposed to particularly stiff competition and a consequent fall in prices. This is probably due to the large banks' specialist knowledge of borrowers' credit situation being a less significant advantage here because lending being backed by property, the value of which can be determined with the aid of relatively objective criteria. A traditional bank's established customer contacts, local knowledge and a network of branches in a traditional sense, thus becomes less important. This means that the entry barriers for companies wishing to enter the market are relatively low, which has also been shown by a relatively larger number of actors on the housing loan market.

Probably EMU and the development of technology will interact to further reinforce these tendencies. Technology will facilitate the access to customers and while EMU will increase the market's transparency and facilitate price comparisons between actors from different countries. For these reasons, it can be anticipated that the housing loan market will be one of the consumer markets in the financial area that will be most affected by EMU. With these concluding words, I would like to say thank you.