

Nordic Housing Loan Markets: Perspectives and Sources of Vulnerability

**Nordic Mortgage Council
Meeting in Helsinki 26th August 2011**

Anneli Tuominen, Director General, FIN-FSA



■ External environment:

- Sovereign debt problems:
 - Continued market unrest, greater funding risks and higher funding costs.
 - Increased risk of negative macro-economic developments.
 - Heavy reliance on secured funding, especially covered bonds.
- Regulatory changes (Basel III / Solvency II)
 - Impacts on banks' business models, profitability and funding requirements.

■ Internal long-term tendencies in Nordic markets:

- Increased household-sector indebtedness.
- High sensitivity to interest rate movements.

→ **The health of housing and real estate markets is a major contributor to financial stability.**

Banking crises in mature economies have been mostly due to credit risks related to real estate



Summary of past banking crises					
		Cause			Systemic risk involved
		Credit	Market Risk	Operational risk (incl. fraud)	
Switzerland (91-96)		X			
Spain (78-83)		X		X	X
UK	BCCI (91)	X		X	
	Small banks (91-92)	X			X
	Barings (95)		X	X	
Germany	Herstatt (1974)		X	X	X
Norway (88-93)		X			X
Sweden (91-94)		X	X		X
Finland (91-95)		X	X		X
Japan (94-02)		X			X
US	S&L (82-95)	X			X
	Continental Illinois (84)	X			X
	New England (90-91)	X			
	Sub-Prime (98-00)	X		X	
	Sub-Prime (07-09)	X		X	X

Source: Basel Committee on banking Supervision

- Credit risk, particularly real estate lending, led to widespread banking problems in Switzerland, Spain, the United Kingdom, Norway, Sweden, Japan and the U.S.
- **Real estate-related problems have been the most common source of systemic banking failures.**



Impacts of ...

- 1. external financial and macro-economic developments**
- 2. internal Nordic housing loan market trends**
- 3. the upcoming regulatory changes**

...on Nordic housing lending markets.

The main supervisory concerns?

4. Conclusion



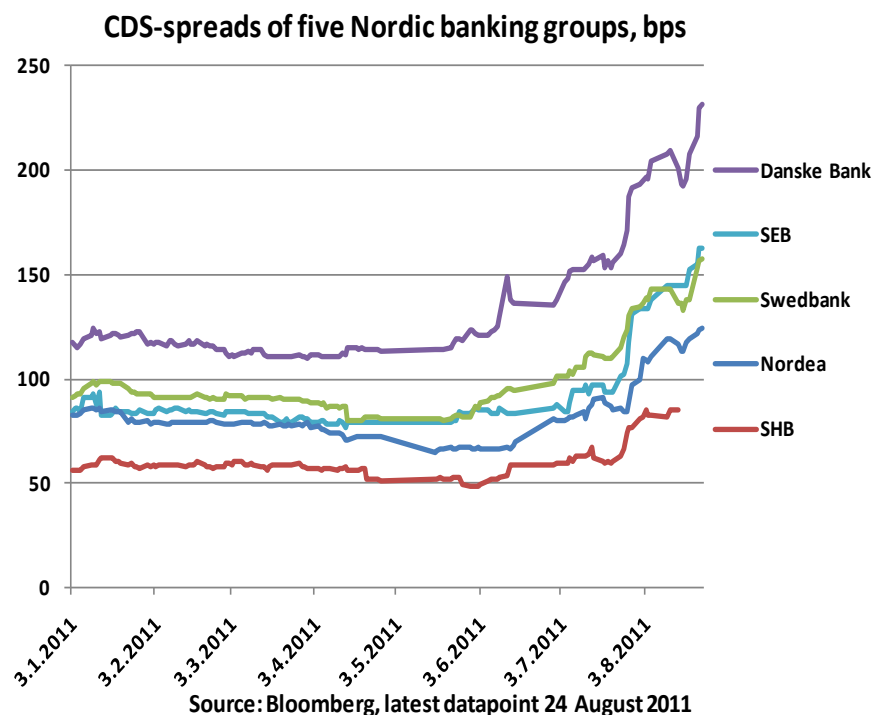
I. External Financial and Macro-economic Developments

Funding risks have increased for Nordic institutions as well



- Impacts of the sovereign debt crisis:
 - Direct GIIPS exposures are limited for all major Nordic institutions.
 - Funding risks and potentially weakening macro-economic growth are the main negative consequences.
- The risk that European banks will face difficulties to refinance maturing debt continues to increase.
 - Major Nordic institutions have a good market position, but are not insulated from the effects of the debt crisis.
 - Also Nordic banks' long-term funding costs started to increase in July – August, and issuances have been postponed (or frontloaded in early 2011).

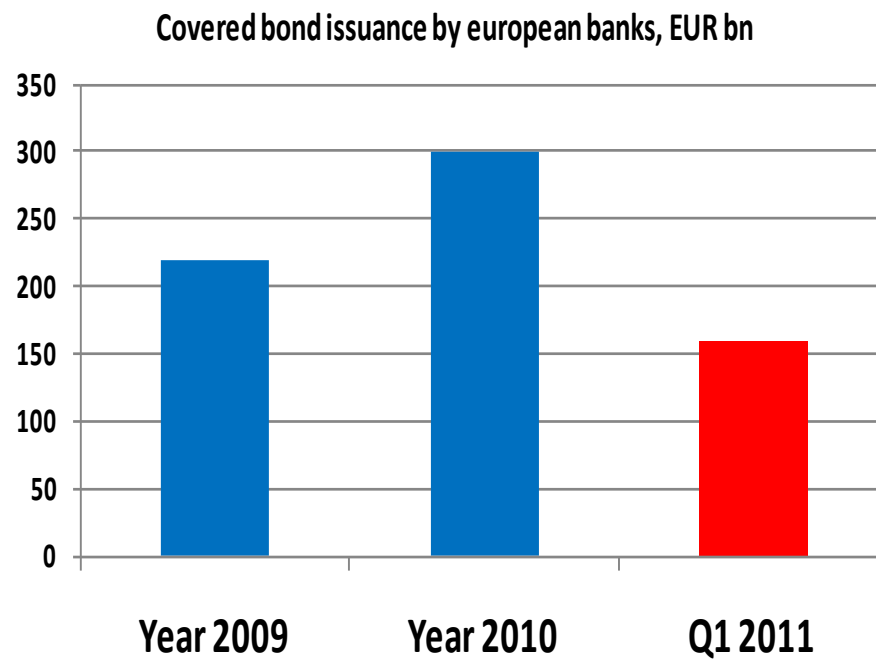
■ CDS-spreads have moved upwards also for Nordic banks



Covered bond issuance on the rise



- Covered bonds market enjoys strong demand as investors are seeking safe investments.
- Since the financial crisis banks have started to diversify their funding into covered bonds.



Source: AMF 2011, Bloomberg

Several factors have led to the increased issuance of covered bonds



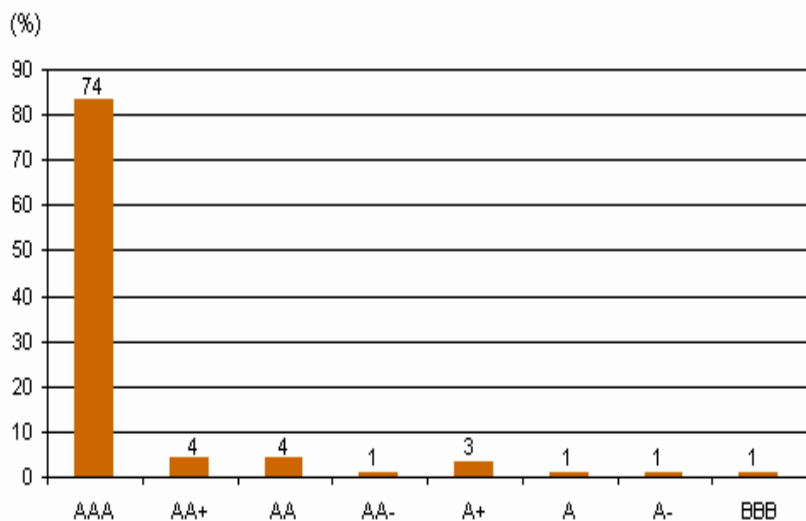
- **Low investor appetite for unsecured debt in volatile market conditions.**
- **Covered bond markets have continued to function fairly well.**
- **ABS/MBS-market has suffered since the subprime crisis.**
 - AAA-rated covered bonds issued directly from the issuer's balance sheet have been favored by investors instead of ABS/MBS issued via an SPV.
- **Covered bonds can be used as collateral in central bank repo transactions.**
 - Haircuts are considerably lower than those of ABS.
- **Long-standing and sound legal framework for covered bonds in many countries.**
 - However, significant legal differences across countries.
- **Forthcoming regulation (new liquidity requirements) favors covered bonds over unsecured senior bonds.**

Covered bonds enjoy AAA-ratings due to "double recourse" (issuers have to maintain the quality of the collateral pool)



■ Covered Bond ratings: Triple A predominant

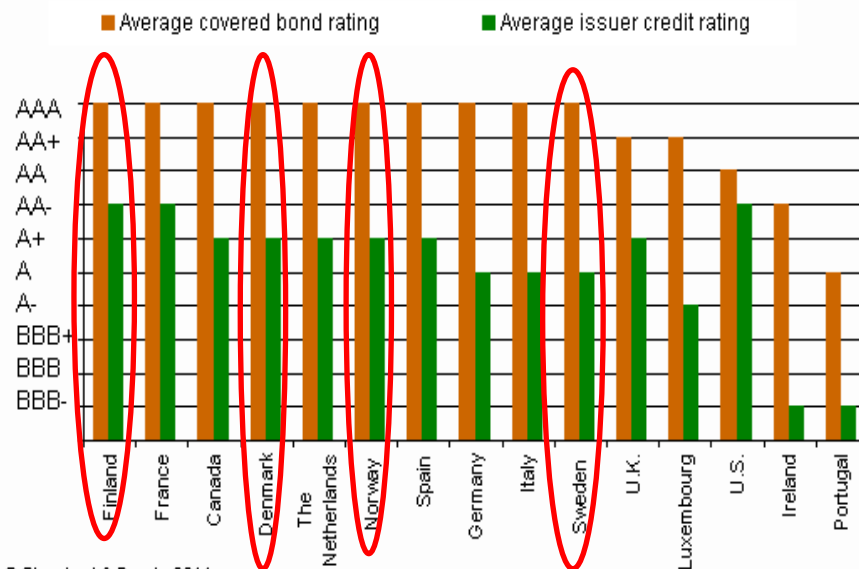
Distribution Of Covered Bond Ratings By Rating Category



© Standard & Poor's 2011.

■ Covered bond ratings higher than the issuer ratings

Average Covered Bond Rating And Issuer Credit Rating By Country



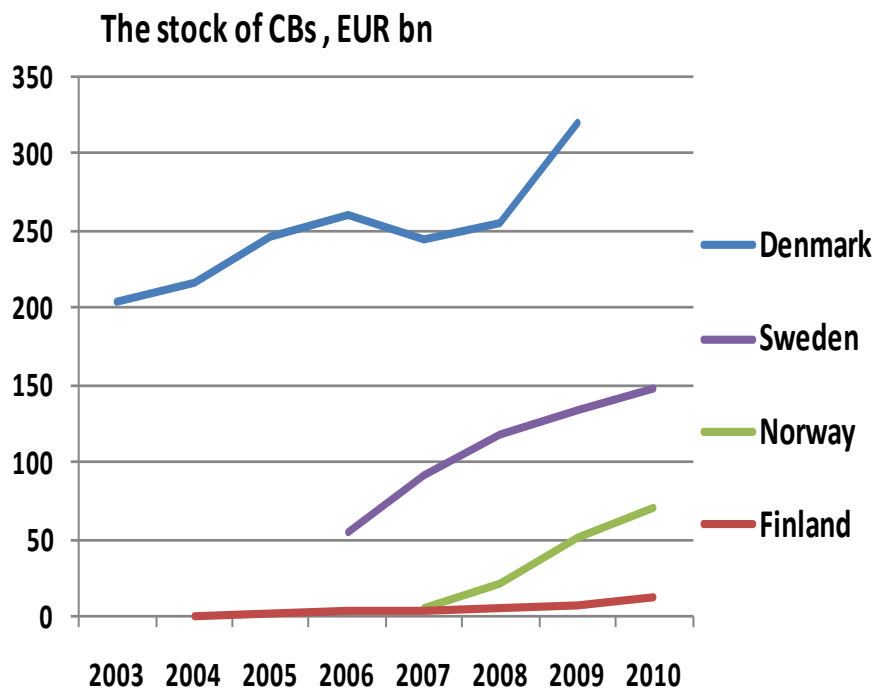
© Standard & Poor's 2011.

Source: Standard & Poor's July 17th "Global Covered Bond Characteristics and Rating Summary Q2 2011

Covered bonds are increasingly used also by Nordic institutions

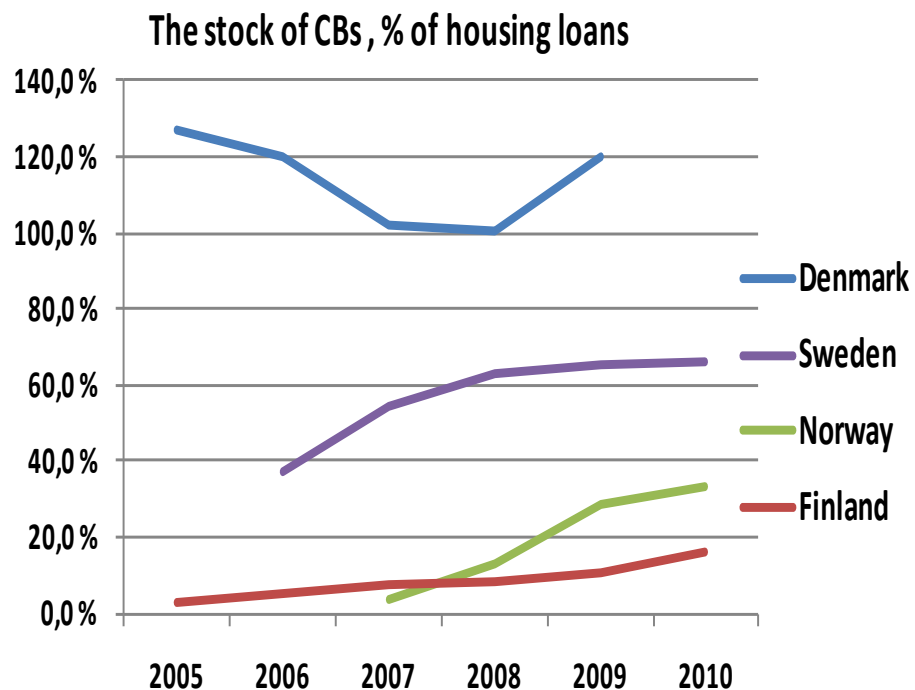


■ The use of covered bonds increased in absolute...



Source: ECBC Factbook 2010 and for 2010 data exchange of Nordic supervisors

■ ...and also in relative terms



Source: ECBC Factbook 2010, ECB: EU Banking Structures Report October 2010 and data exchange of Nordic supervisors



- **Covered bond markets have not witnessed any credit loss-events**
 - Emergence of first loss-events could shock markets widely.
 - Losses from one particular market could result in confidence problems in other markets (contagion risk).
- **Covered bond markets can be vulnerable to weakened collateral quality and insufficient legal requirements:**
 - Collateral quality will depend on the future development of real estate prices and households' debt servicing capability.
 - Legal (collateral pool etc.) requirements are weaker in some countries.
- **Supervisory aspects:**
 - Continued access to covered bond markets has become crucial.
 - Need to ensure high quality standards and seek to harmonize national legal requirements.
 - Adequate funding diversification is also important.
 - High share of encumbered creditors weakens the status of other creditors.
 - Initiatives to enhance transparency of covered bonds should be encouraged.

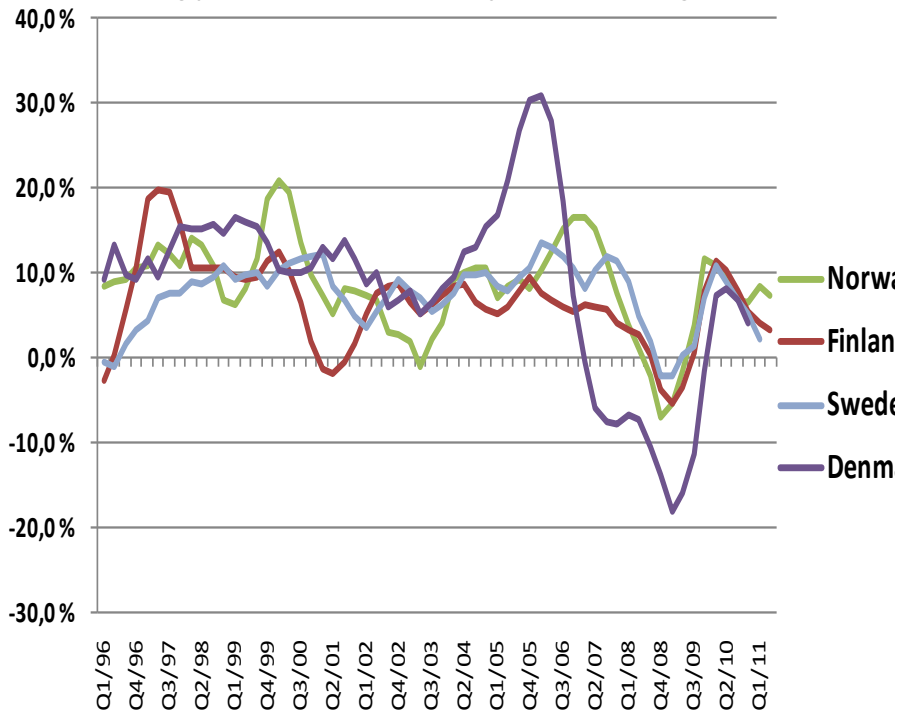


- **Need for sovereign de-leveraging in major western economies lowers growth prospects:**
 - Major uncertainties regarding future macro-economic development globally and in the Nordic countries.
 - Nordic economies are in a relatively good position, but face long-term challenges (countries differ in structural features).
- **Implications for Nordic housing markets:**
 - Higher risk of price and volume adjustments.
 - Increased credit risks, but (hopefully) also more rigorous lending standards and collateral scrutiny in the future.
 - Previous growth rates in lending volumes (as before 2008) could be difficult to attain.
 - **The “old environment” of strong dynamics in house prices and optimistic expectations could be behind us.**

Nordic housing price developments have varied significantly across countries

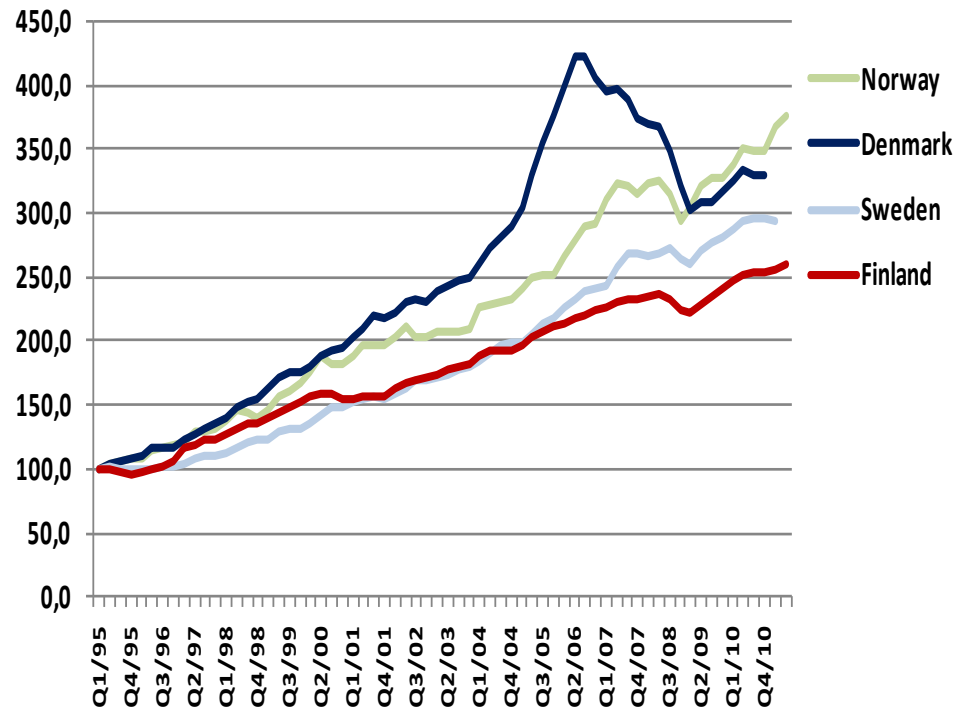


Housing prices in whole country, annual change, %



Sources: data exchange of Nordic supervisors, Statistics Norway and FIN-FSA calculations

Housing prices in whole country, index Q1/1995=100

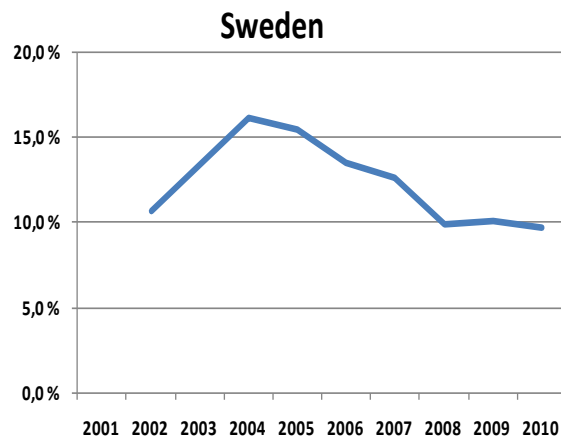
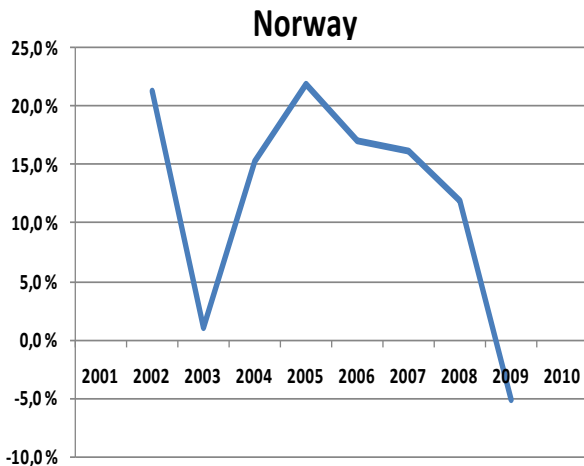
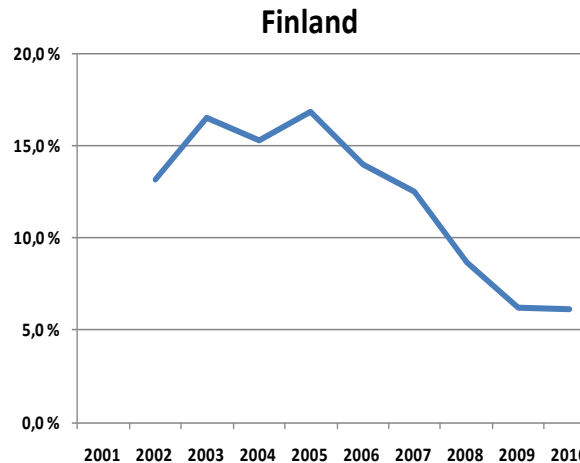
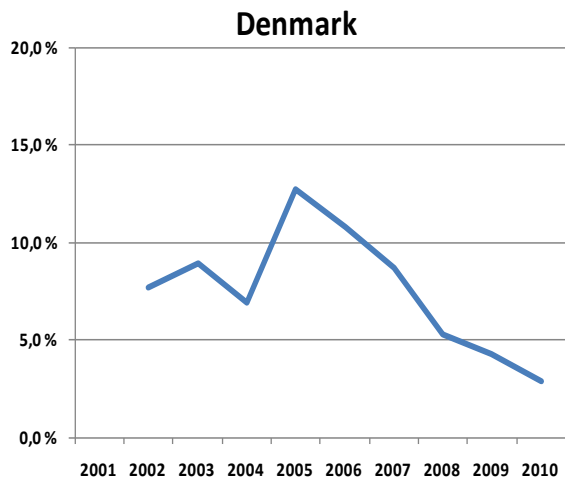


Source: data exchange of Nordic supervisors statistics Norway and FIN-FSA calculations

Housing loan growth rates have fallen from previous high levels



Housing loans: annual percentage change



Sources: Data exchange of Nordic supervisors and ECB: EU Banking Structures Publication October 2010



II. Internal Nordic Housing Market Tendencies

Drivers of increased household indebtedness can be found both on the supply side and demand side



■ Supply-side developments:

- Longer lending maturities
- Reduced collateral demands; a longer-term increase in LTVs
- “Interest only” housing loans (not yet common in Finland)
- Tight competition, low margins in some countries
- Low risk-weights for capital adequacy purposes when banks’ use IRB-models
- Abundant supply of short-term consumer loans

■ Demand-side effects:

- New generation demands bigger homes and faster!
- General increase in living standards.
 - Finland is converging to the level in other Nordic countries in terms of housing quality.

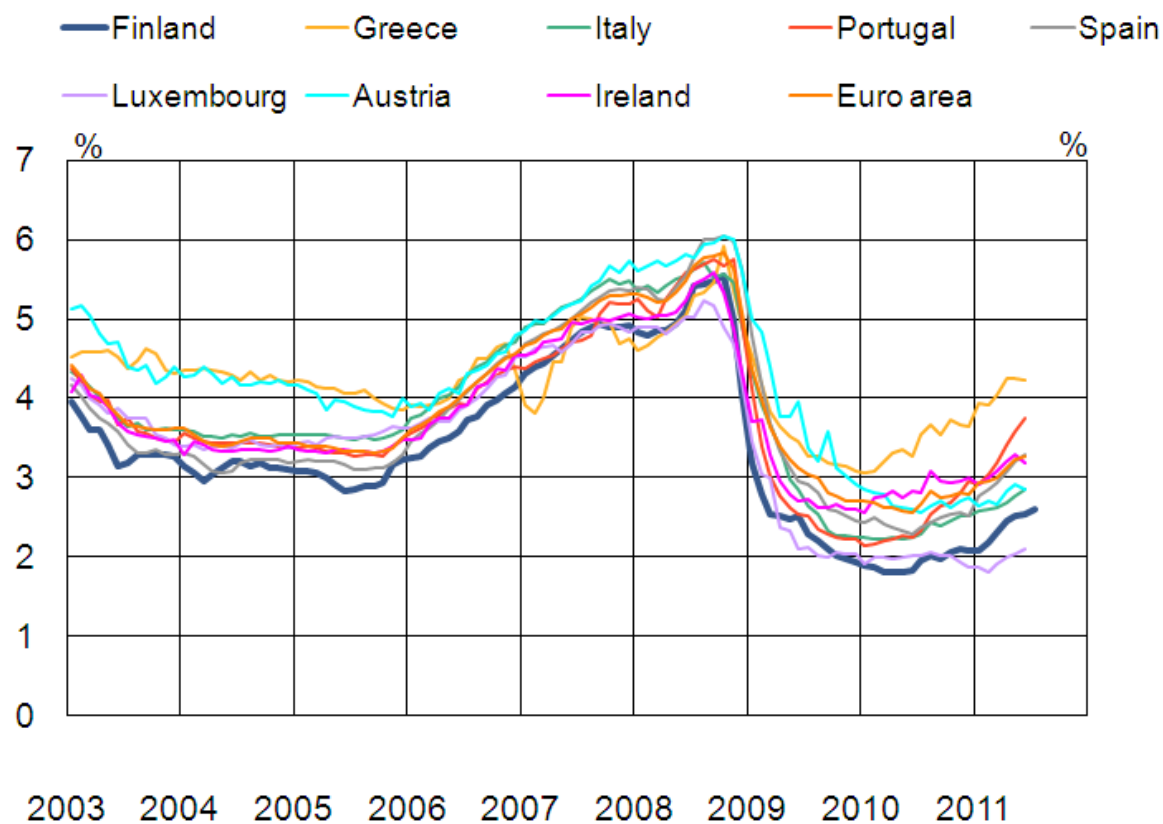
➔ **Long gradual increase in household debt burden vs. income and weaker lending standards.**

➔ **New phenomenon: Spreading of payment problems (yet mainly due to consumer loans).**

Finland has the lowest interest rates for new housing loans in the euro area after Luxembourg



Average interest rate on new housing loan business Initial period of fixation, up to 1 year



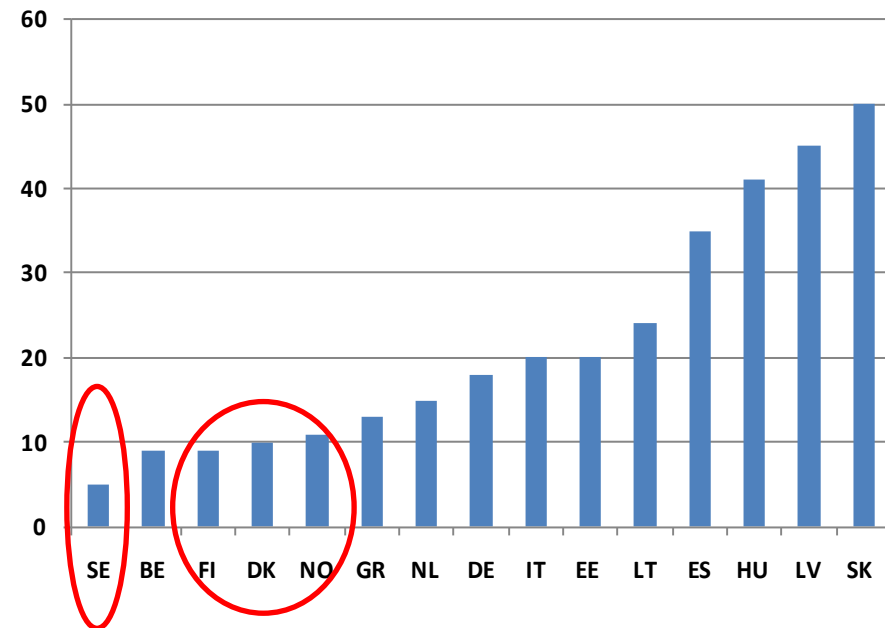
Source: ECB.

Risk weights for mortgages have been reduced by IRB-models and vary across countries



- Risk-weights are determined by PD and LGD estimates in IRB models.
- Modeling differences produce significant differences in risk-weights and hence in capital charges.
- Low level of capital charges in mortgages produce low customer margins.
- Are the risks modeled correctly?

■ Average risk weights of housing loans

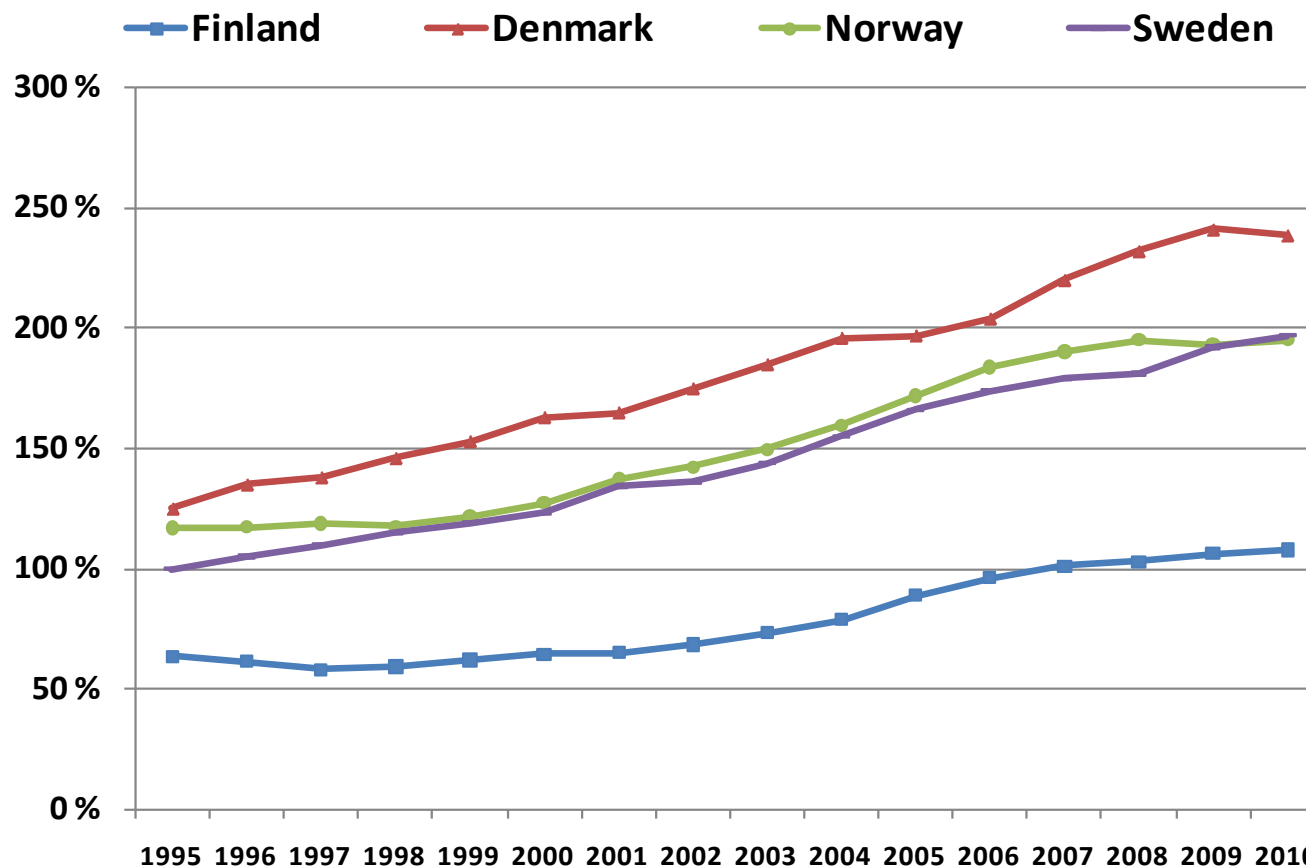


Source: Riksbank and respective central banks

Long upward trend in household sector indebtedness in all Nordic countries



Household's indebtedness (loans, % of annual disposable income)

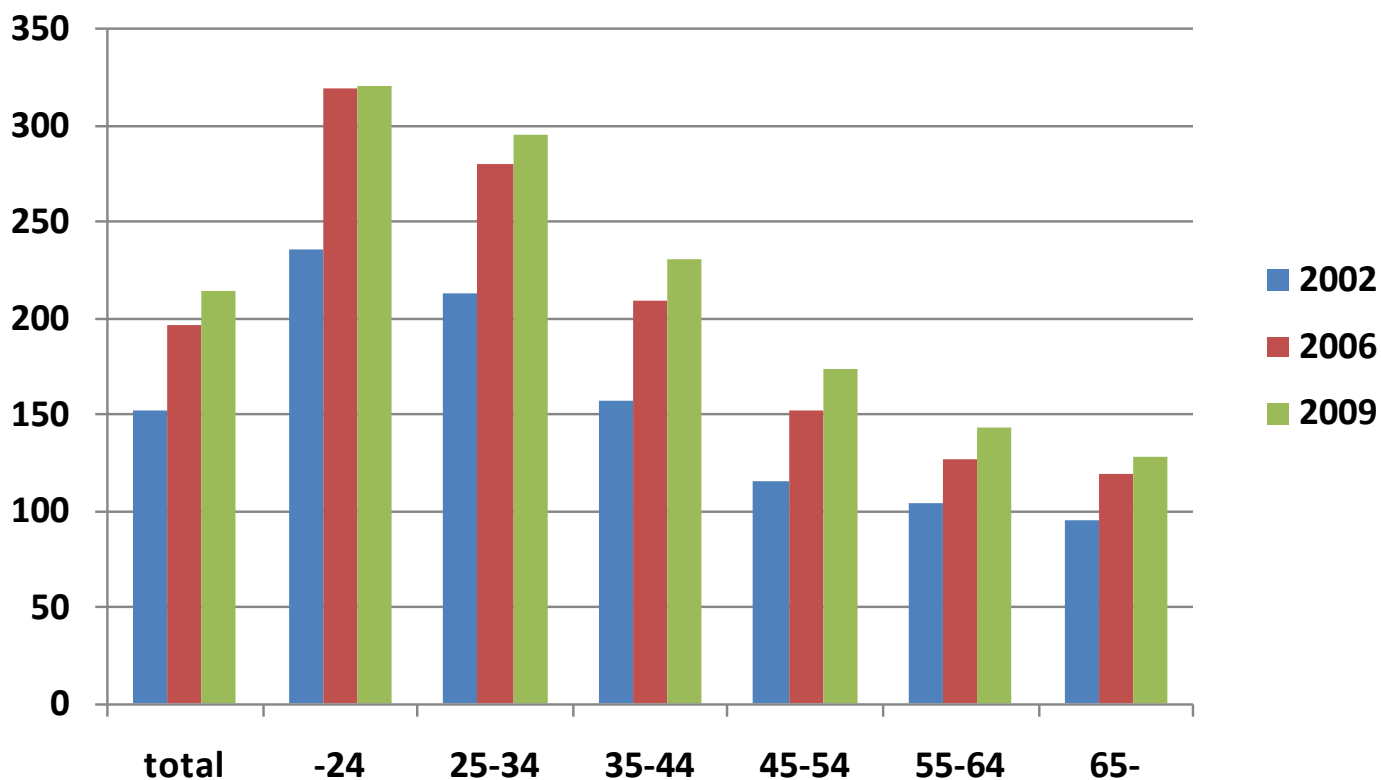


Sources: Data exchange of Nordic supervisors based on national sources and FIN-FSA calculations

Especially younger households' indebtedness has increased



Finland: Households with housing debt: Debt , % of disposal income in different age groups

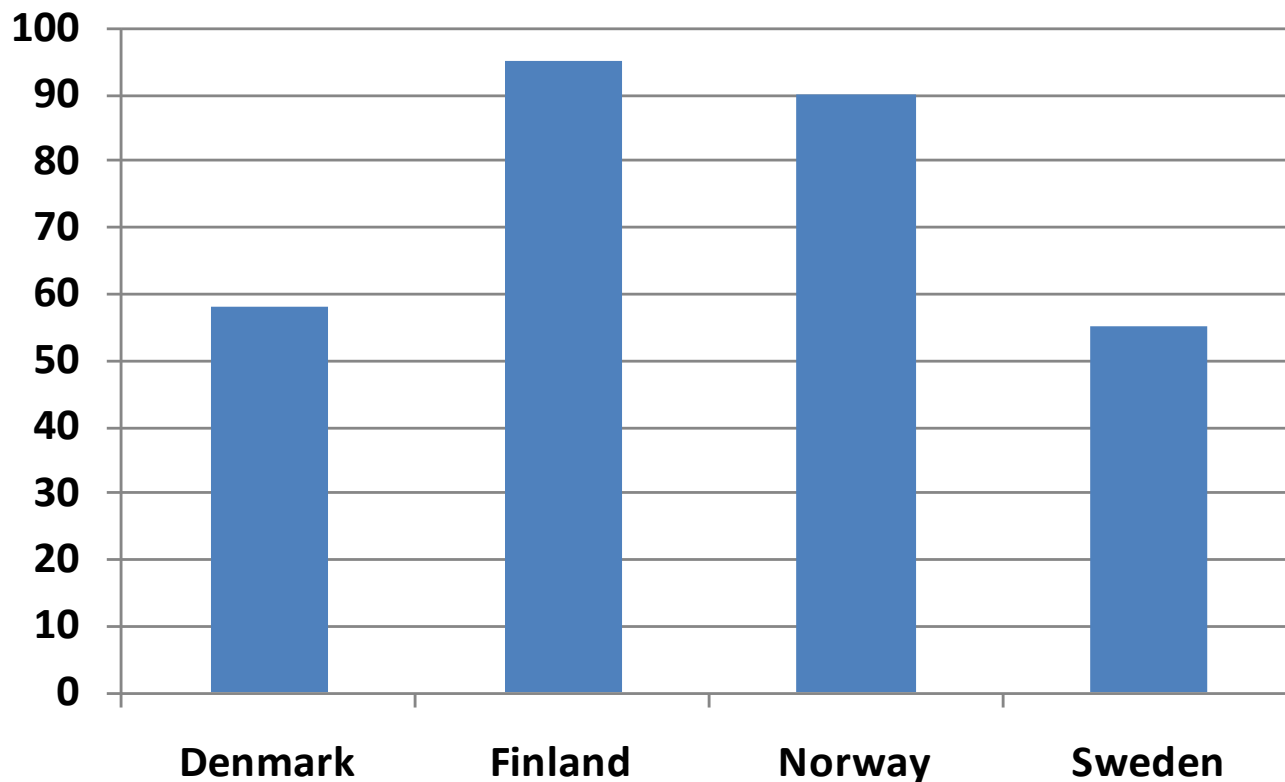


Source: Statistics Finland

Households' interest rate risks are significant, as variable rates are much used in lending



Variable rate loans, % of total loans



Source: Standard & Poor's 30th May 2011 Report, except Denmark's data exchange 2010 of Nordic supervisors

FIN-FSA sample survey on housing loans at the end of 2010: Customers ability to repay is poor in some cases



■ Main findings:

- First time buyers: in 50 % of cases LTV over 90 %.
- In some cases, customers had poor ability to service their debt.
- The survey did not demonstrate that a risk-based approach to the pricing of housing loans had been applied.

■ FIN-FSA recommendations regarding housing loans (2010):

- Banks should undertake systematic calculations of housing debt servicing capability in respect of all new housing loans applicants.
- Debt servicing capability assessment should be conducted with 6 % p.a. interest rate and with a maximum of 25 years' loan maturity.
- LTV maximum 90 % not to be exceeded but in exceptional circumstances, where customers' ability to repay is well-checked.



- **Focus on avoiding very high LTVs for both consumer protection and financial stability reasons:**
 - Need to prepare for possible falls in real estate prices.
 - Supervisors have recommended LTV-ceilings in Sweden, Norway and Finland.
- **Limited hedging against interest rate risks by households:**
 - Need to increase households' awareness of interest rate risks.
- **Quality of banks' credit processes is crucial.**
 - Subject to on-site inspections by supervisors.



- **Inadequate risk-based pricing of mortgages, pricing should also cover the risks of higher funding costs.**

- **Sustainability of lending developments will be subject of increasing macro-prudential attention:**
 - Possibility to demand higher capital buffers in Basel III when lending growth rates are unsustainable (counter cyclical capital buffers).
 - Possible use of other micro-prudential requirements for macro-prudential purposes.

- **Adequacy of risk weights for mortgages? Insufficient convergence in IRB models across banks.**
 - Need for supervisory cross-border coordination.



III. Impacts of the upcoming regulatory changes

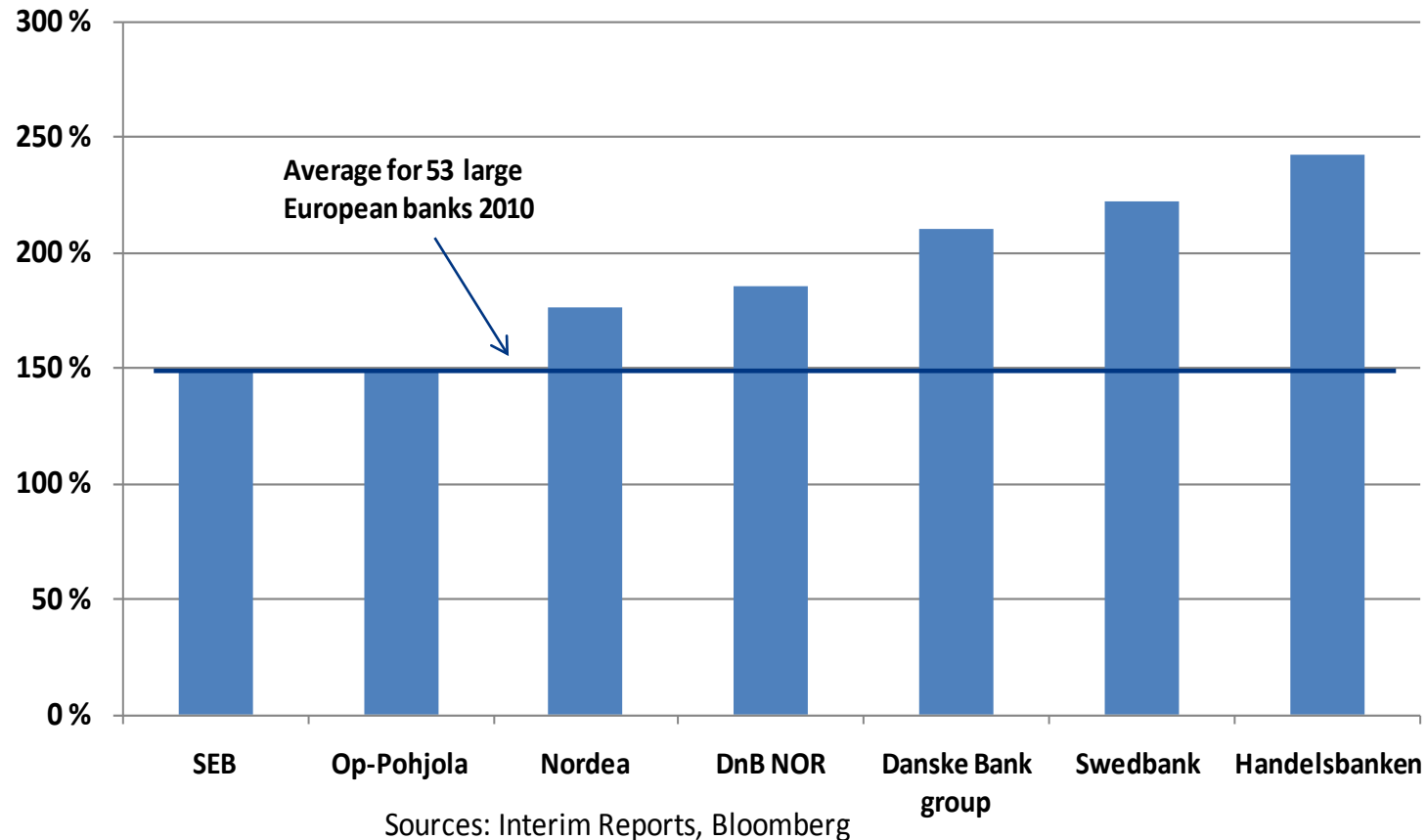


- **New rules enhance the size and quality of capital and liquidity buffers, which is a major positive step.**
 - Strengthening loss-bearing capacity through higher levels of good quality capital is very important.
- **New capital regulations (including leverage ratio) and especially new liquidity rules will have an impact on banks' funding structures and profitability:**
 - Nordic banks have higher than “average EU bank” needs to increase long-term funding and liquid assets.
 - Higher funding and liquidity needs coincide with high sovereign issuance requirements and difficult market conditions
 - **Pressure on funding costs. Lower return on assets in the liquidity portfolio.**
- **Basel III is likely to result in higher customer margins (costs of Basel III passed on to customers).**

Relatively low share of deposit funding could explain the larger relative impact of new liquidity rules in Nordic banks



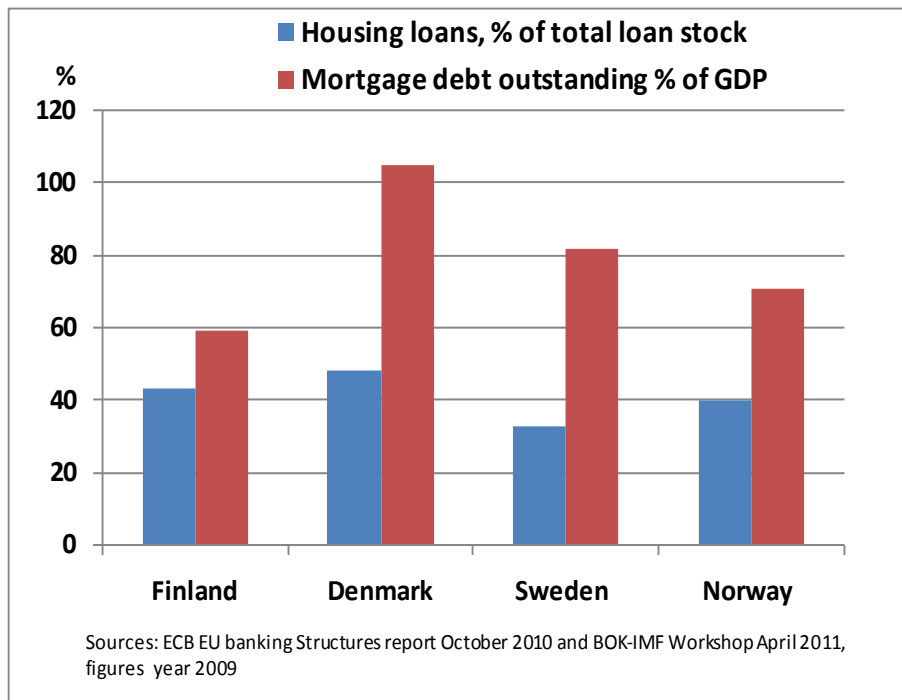
Loans to deposit ratio of major Nordic financial groups Q2/2011



New regulations enacted after the crisis have biggest relative impacts on retail banking and trading activities



■ Share of housing loans is substantial both in loan portfolio and in economy



- The leverage ratio and liquidity regulations hit relatively more retail-oriented, lower-risk business models than corporate lending.
 - Nordic banks have a relatively high share of retail lending.
- Capital requirements are increased for activities that caused major losses in the financial crisis.
 - Significantly higher trading book and off-balance sheet capital charges.
- Regulation forces banks to rethink business models.



- Movement to risk-based capital requirements also in insurance will raise capital charges for counterparty risks and investments in bank bonds (depending on issuer rating).
- This might affect insurance companies' willingness to hold bank bonds.
 - Relevance of this effect is uncertain, however.
- On the other hand, insurance companies propensity to make bond investments could increase at the expense of equities (due to much higher equity risk and asset-liability matching requirements in Solvency II).
- Covered bond financing is supported by Solvency II (as well as by Basel III liquidity rules).

IV. Conclusion





- **Financial condition of major Nordic banks is stable, but Nordic markets are not isolated from the ongoing crisis:**
 - Negative consequences for banks' funding conditions and macro-economic development also in Nordic countries.
 - Fortunately, the sustainability of public or private debt levels is not questioned by investors at the moment.
- **A trend-wise growth in household indebtedness is an issue in the Nordic countries as well.**
 - Particular concern is the concentration of indebtedness in young households.
- **Currently, supervisory tools to prevent housing market instabilities are limited.**
 - Ability to issue binding regulation should be considered.
- **Timing and details of the new regulations may need to be re-considered in order not to aggravate the present problems.**

THANK YOU!

