High household debt in the Nordics a key vulnerability

Cultural or policy changes needed?

Household indebtedness in the Nordics remains at elevated levels and regulators see mortgage lending as one of the areas they need to keep on close watch. Macroprudential measures are starting to bear fruit, but loan terms mean it will take time for the measures to become fully effective. Nordic mortgage markets are predominantly floating-rate so current good affordability levels can be subject to rate shocks. The credit quality of Danish borrowers is starting to benefit from higher resilience as they are gently pushed towards longer re-fix terms and fixed-rate mortgages.

With house prices in most Nordic countries following a similar path, similar extensions or switches to fixed rates could help address contingent risks. The current lower-for-longer rates environment might help switches, as higher costs for longer-dated loans are easier to digest. Stronger resilience against shocks will also help to put the banks on stronger footings.

Longer re-fixes will moderate early repayments and help the banks to close the gap between the economic and legal life of a mortgage loan. This could prompt Nordic banks to issue longer-dated covered bonds, making them less susceptible to refinancing shocks. Scandinavian covered bond programmes have an average maturity of only three or four years, compared to other core covered bond markets, where the average maturity is often more than twice as long.

The May 2019 Financial Stability reports of the Swedish and Danish central banks reiterated that most Nordic countries are strongly exposed to high household indebtedness, posing a high risk to their economies. High indebtedness among private households exposes borrowers to rising interest rates, higher unemployment and falling house prices. At the same time, this view has to be balanced with the comparatively high share of financial assets to which households have recourse.

The peak of household indebtedness in the EU was in 2010. Since then, total debt was effectively reduced by 6% to a net income multiplier of 1.21x as of end-2017. This reduction was mainly driven by shrinking household liabilities, since net disposable income in the EU increased at the same time by an annual rate of 2.5%.

The decreasing trajectory of household debt ratios is a consequence of the European crisis. Banks had to deleverage, have tightened credit standards and regulators imposed macroprudential metrics, together reducing household debt.

However, Nordic countries still stand out with above-average household debt levels. Denmark has the highest income multiplier (2.8x), followed by Norway (2.4x). In Denmark the multiplier has been reduced by around 15% since 2009. By contrast, during the same time period, the Norwegian and Swedish debt-to-income ratios increased by 11% and were still increasing in 2018.

According to Sveriges Riksbank's Q1 stability report, Swedish household debt has been stagnant since autumn 2018, supported by lower house prices and stricter amortisation requirements, but remains at a high level nonetheless. The level remains high, not only historically but also in comparison to that of international peers.

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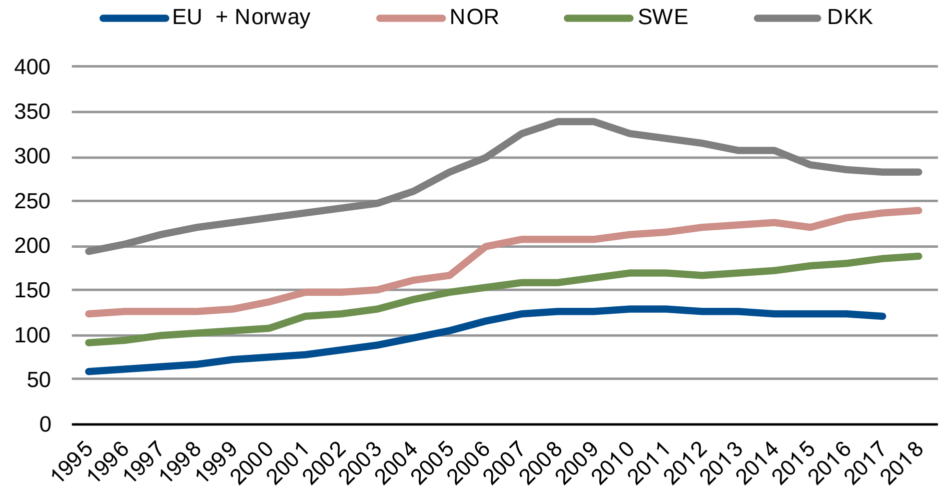
Figure 1: Household debt, as a % of net disposable income



Source: OCED, Denmark 2018 was extrapolated based on household debt to GDP growth (national statistics)

Household indebtedness as measured by total interest-bearing debt relative to annual net disposable income effectively shows how many years it would take if total net disposable income were spent to repay loans. For example, on average in the EU it would take a little more than one year of net disposable household income to repay the sum of outstanding interest-bearing debt. Interest-bearing household debt predominantly consist of loans – in particular mortgage loans for the purchase of houses. In contrast, the Danes would on average have to refrain from any consumption expenditure and save for about three entire years income just in order to repay outstanding debt.

North-south divide of European household indebtedness

Highly-indebted countries also with highest financial assets.

Indebtedness itself is only one part of the equation to measure household exposure to loan affordability. Available financial assets can buffer income losses resulting from, for example, an economic shock – provided they do not just comprise wealth from housing. In scenarios of rising unemployment, falling wages and decreasing mortgage values, high indebtedness creates a negative spiral – as seen in Southern Europe.

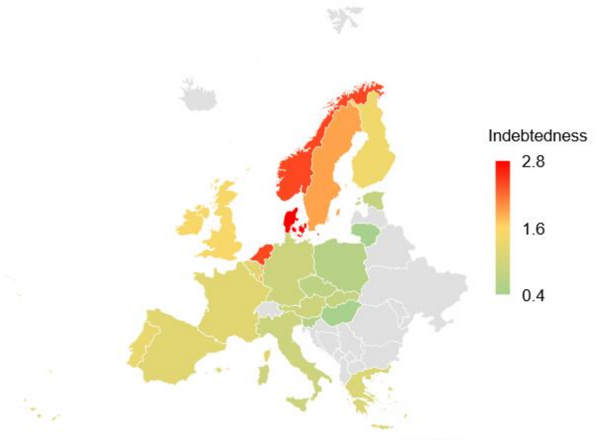
Norwegian households with less assets than those of Denmark and Sweden, but…

Looking at the household sector's financial assets in the Nordics, countries with the highest indebtedness benefit also from the highest levels of financial assets (see Figure 3: Household financial assets by type of investment). Valued at EUR 160k per household, the largest stock of financial assets is owned by Danish households, predominantly via insurance and pension funds (together 50% of total assets), followed by Swedish.

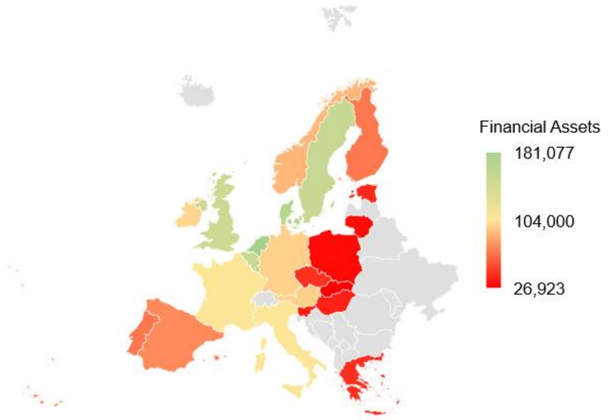
Denmark and Sweden hold large amounts of savings, counterbalancing risks from household indebtedness. In Norway, the amount of financial assets per household totals EUR 80k, although this does not incorporate the Norwegian sovereign wealth fund, which, at least theoretically, provides EUR 170k per inhabitant on top of that.

Figure 2: Household debt vs financial assets

Households indebtedness in % of disposable income



Households financial assets in EUR per household

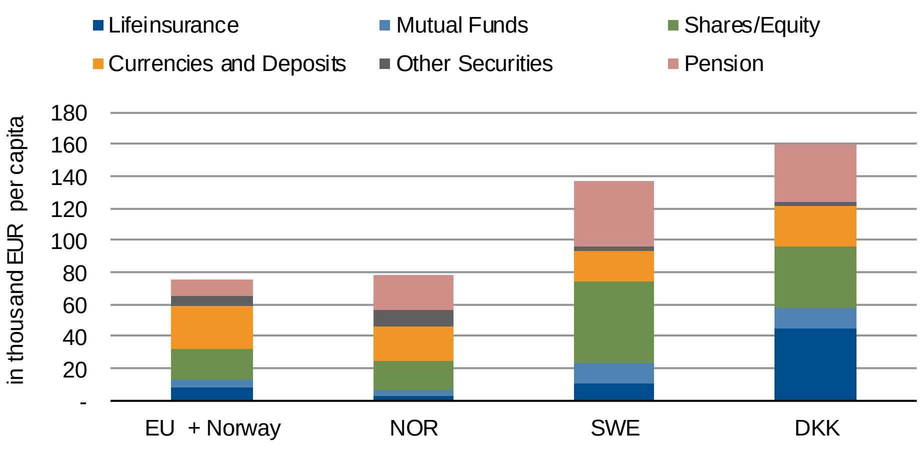


Source: OECD, Scope Ratings GmbH, Powered by Bing (GeoNames, HERE, MSFT, Wikipedia)

…Norway benefits from very high national wealth and a higher share of liquid financial assets.

On average, financial assets minus debt shows a surplus for each country in the EU, while net assets remain at the lower end for Norway, excluding the Norwegian wealth fund. However, financial assets in Norway are more liquid compared to those of Denmark and Sweden as half are invested in deposits, which we believe can be quickly liquidated in order to meet short-term spending needs if required.

Figure 3: Household financial assets by type of investment



Source: OECD, Scope Ratings GmbH

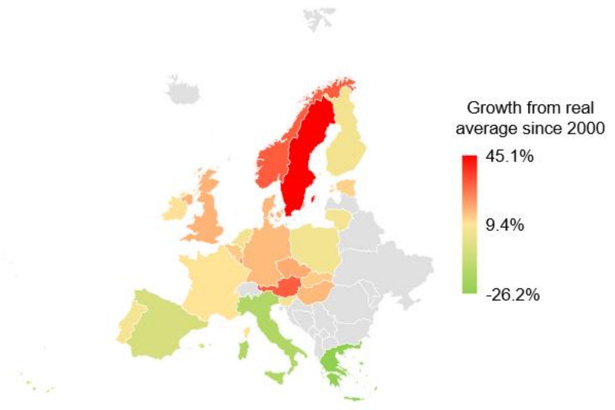
European house prices most elevated in the Nordics

House prices elevated, especially in Norway and Sweden, but…

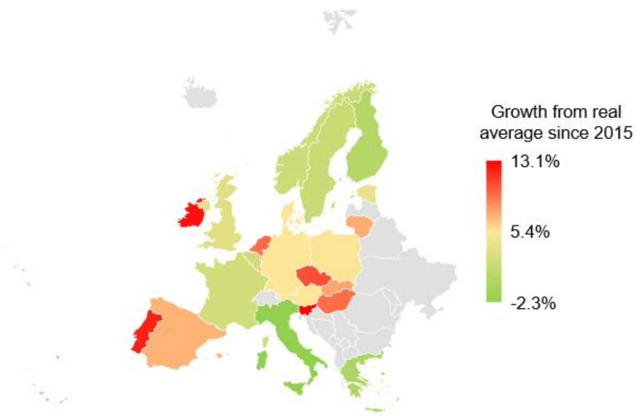
The long-term trajectory in house prices shows that prices are the most elevated in Northern Europe: in Sweden, followed by in Norway. Real house prices (2018) in Sweden have on average been 45% higher compared to their averages since 2000. In Norway, current market values are 31% above this long-term average. This compares with countries in the euro area periphery that suffered during the European financial crisis during which significant price corrections took place such that values – in real terms – are still below their long-term averages.

Figure 4: Real house price change

2018 vs. average since 2000



2018 vs. average since 2015



Source: OECD, Scope Ratings GmbH, Powered by Bing (GeoNames, HERE, MSFT, Wikipedia)

…stagnation or even a decrease of real house prices during the last three to four years.

Despite elevated price levels in Norway and Sweden, we take comfort from stagnation in real house prices (or even slight real reductions) during the last three to four years. This of course only reflects country-wide average house prices.

Macro prudential measures effectively reducing risk

Moderation of house price growth in the Nordics partially reflects macroprudential measures, most of which became effective since 2017 and aim to lower credit growth and leverage mainly via loan amortisation rules as well as tightening regulations on loan to value (LTV) and loan to income (LTI) ratios.

Table 1 – Macroprudential measures affecting lending standards

Country	Type of measure	2010	2011	2012	2013	2014	2015	2016	2017	2018/2019
Denmark	Loan amortisation									✔
	Loan-to-income (LTI)							✔		
	Loan-to-value (LTV)						✔			✔
	Other	✔								
	Variable rate lending									✔
Norway	Risk weights on CRE					✔				
	LGD for retail on RRE					✔				
	Loan amortisation		✔*				✔*		✔*	✔
	Loan-to-income (LTI)								✔*	✔
	Loan-to-value (LTV)	✔*					✔*		✔*	✔
	Risk weights (other)						✔			
	Stress test / sensitivity test		✔*				✔*		✔*	✔
Sweden	Risk weights (RRE/CRE)									✔
	Risk weights on CRE						✔			
	Loan amortisation						✔*	✔*		✔
	Loan-to-value (LTV)	✔								
	Pillar II					✔				
	Risk weights (other)							✔		

Source: European Systemic Risk Board (ESRB); national measures of macroprudential interest in the EU/EEA
* not active anymore and generally extended or replaced

Loan amortisation requirements are generally triggered based on maximum LTV or LTI levels. LTI measures are defined by the maximum loan amount as a multiplier of the borrower's annual income; LTV limits require a minimum equity before granting a loan.

Regulatory intervention successfully reverted some imbalances, but more needs to be done.

Worth of note is that Denmark is the only country that has also introduced measures to limit variable-rate lending. In January 2018 as part of the "Supervisory Diamond", the Danish Finanstilsynet introduced limits for interest-only loans, lending growth, short-term funding and large exposures. It also ruled that loans with floating rates and fixings below two years can only be granted if mortgage loans do not exceed an LTV of 60%.

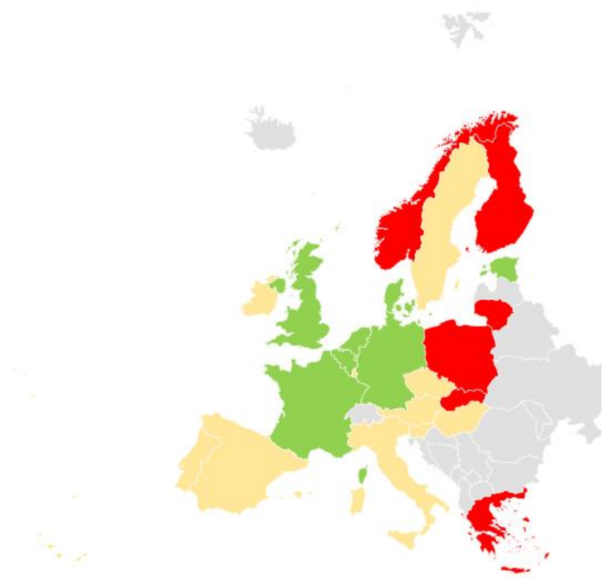
Affordability most at risk for countries with floating-rate mortgages

Variable rates reinforce affordability pressure where indebtedness is high.

Variable-rate lending remains one of the main contingent risk boosters in countries with high indebtedness. This has already materialised in Norway. 3-month Nibor, the reference rate for Norwegian adjustable-rate mortgage loans, was 1% on 1 June 2018. Since then, the rate increased to 1.50%, as of end May 2019. (On 20 June, Norges Bank increased its policy rate by 0.25%, which is not yet reflected in Nibor).

This means that borrowers have to pay 50% more than a year ago. Affordability is not at risk at the moment, as macroprudential measures have prompted banks only to underwrite new mortgages when debt-service coverage is still achievable with a rate increase of up to five percent. For borrowers already stretched as they maxed out on their mortgages, a 50% increase can impact consumption. In a weakening economy with increasing unemployment, such effects can spur a downward spiral.

Figure 5: Prevalent variable (red), mixed or fixed (green) interest rates



Source: Hypostat, regional statistical bureaus, Scope Ratings GmbH, Powered by Bing (GeoNames, HERE, MSFT, Wikipedia)

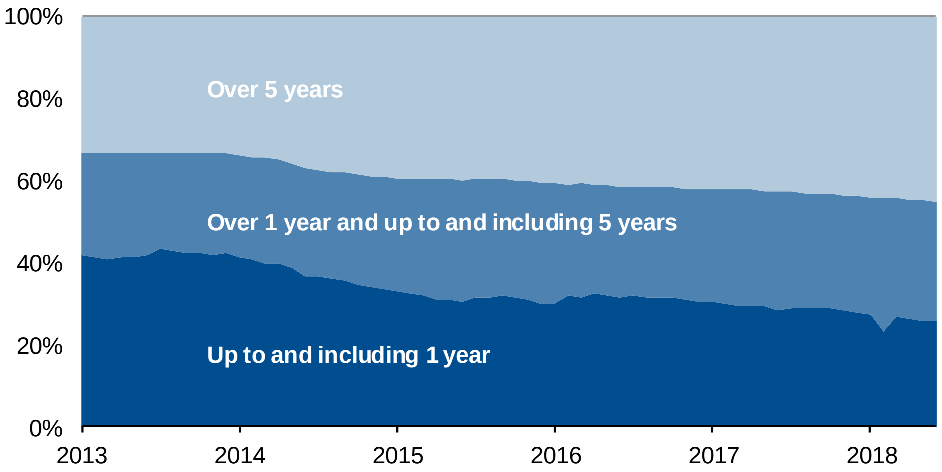
Variable rates also prevail in Finland and Eastern European countries, where household indebtedness is more moderate, reducing exposures to increasing interest rates.

In Sweden, around 70% of new mortgage loans are currently variable. This has remained stable over the last few years while the share was even lower in the past. On average around 60% of new loans to households were on variable rates between 1998 and 2012. This is at risk in light of increasing household debt.

Denmark is a pioneer in adopting fixed-rate culture within a short timeframe.

In Denmark, around 25% of total mortgage loans today have an interest-rate fix of one year or below. This compares with 44% only four years ago. However, 45% of total outstanding debt faces an interest-rate fix of five years and above. For new loans in 2019, only 16% have an interest reset below one year. Accordingly, in Denmark, we can see that a market once used to variable rates has adopted a culture of fixed rates in order to respond to the risks arising from high household debt.

Figure 6: Danish mortgage loans to households (owner occupied) by variable or fixed interest rate



Source: Danmarks Nationalbank, Scope Ratings GmbH

Positive impact from reduced variable rate lending not immediately visible

Measures reducing variable-rate lending immediately mitigates risks from high household debt.

The challenge of high indebtedness, predominantly driven by ever-increasing house prices in most Nordic countries, is increasingly being addressed by regulators. However, levels remain elevated and can only partly be mitigated by high levels of available financial assets. As such, the high exposure to short re-fix and variable-rate loans in Norway and Sweden is a contingent risk that may crystallise when the current benign economic has reached a turning point.

Measures to limit loan-to-value ratios or to foster speedier amortisation are required and will help to reduce the absolute levels of debt. The impact of such measures can be easily observed as their transmission to house price levels or credit growth are very direct. At the same time, measures to foster fixed-rate lending require a cultural change. Furthermore, regulatory measures that restrict loan to income ratios are less popular. Oftentimes, they only impact younger households and first-time buyers, and their benefits only become visible in less benign economic times as they address the risks from lower affordability.

Today's lower-for-longer rate environment together with a flat interest-rate curve can help smooth the impact on borrowers today and support stability tomorrow. With supervisors and banks gently pushing borrowers towards higher shares of fixed term mortgages, higher stability against shocks can be achieved – as we see in Denmark.

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