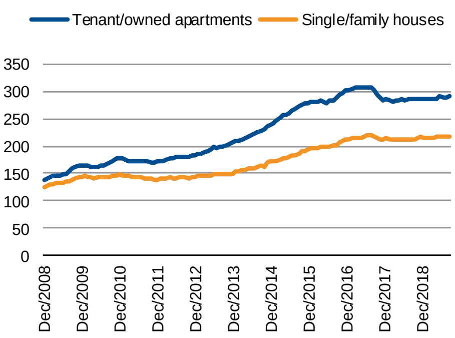
Swedish house price correction shouldn't lead to looser policy measures

Slower growth in Swedish house prices should not loosen policymakers' grip on the country's residential mortgage market. The high share of floating-rate mortgages remains a poisoned chalice for highly-leveraged first-time buyers. Structural changes could help to better isolate borrowers against shocks. Past measures to curb leverage and force borrowers to amortise are credit-positive – but not enough.

The low interest-rate environment could be the right time to modify interest-rate deductibility or push high debt-to-income borrowers towards fixed-rate mortgage products, isolating them from rate shocks for longer.

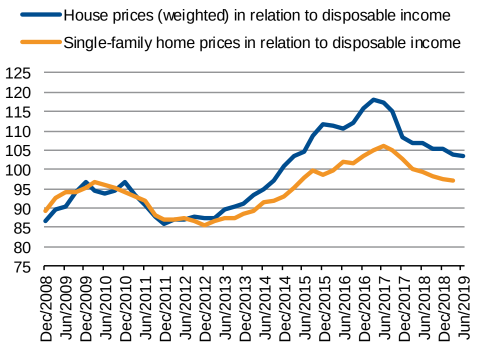
The Swedish residential mortgage market stands out as having the strongest growth rates in Europe in the last decade. 'Unsustainable', 'overheated' and 'bubble' are buzzwords that have gone along with any comment on the Swedish mortgage market. Calls to curb new mortgage lending growth are common. With a 50% share of mortgages to private borrowers on Swedish banks' balance sheets and an additional 16% share of commercial real estate financings[1], the state and resilience of the mortgage market is one of most important talking points for the credit quality of Swedish banks.

Figure 1: Nominal house price growth



Source: Riksbank, Scope

Figure 2: Deflated HPI



Source: Riksbank, Scope

Correction of Swedish housing prices sufficient to carry on ?

In the last decade, nominal house prices have doubled at a national level for apartments and houses. In some urban areas, the length of time taken for prices to double or even triple even has been shorter (see figure 1). Since their peak in August 2017, house prices have started to moderate, however. Using disposable income as a deflator to gauge the impact on affordability, house prices have seen quite a strong correction, suggesting that there is no need to introduce additional policy measures (see figure 2).

But this fails to address the fact that slower growth might be temporary. Most of the factors that fueled house price and credit growth are still present. House-price growth has been fueled by home-grown factors such as inflexible housing and rental policies as well as tax-related issues (such as tax deductibility of mortgage interest and property taxes). At the same time, imported topics such as the lower-for-longer interest rates and Sweden's softening-but-still-sound economic environment, continue to drive demand.

With a still-dominant share of floating-rate mortgages, borrowers who max out their financing capacity today are likely to face payment shocks if the benign interest-rate environment turns. Not surprisingly, policymakers should remain concerned about financial stability risks.

[1] Finansinspektionen, Financial stability report Nov. 2019, Figure 27 loans to private borrowers include loans to homeowners and borrowers in tenant owner associations.

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Policy measures not easy to introduce

Long history of policy measures indicates high awareness

The fact that Swedish supervisors and regulators were able to convince policymakers to impose higher-than-average capital charges for Swedish banks and were able early on to introduce macroprudential measures to mitigate financial stability risks for Sweden (see figure 3) is a positive. Swedish supervisors and regulators remain adamant about the imperative to raise awareness of the potential financial stability risks of an unbalanced mortgage market. At the same time, they have had to take on board that not all countercyclical policy measures are equally effective and there can be a significant time lag between their introduction and their impact.

Figure 3: Macroprudential measures targeting mortgage lending growth in Sweden

Year	Measure
	Introduction of a max mortgage loan LTV (new loans) of 85%
2014	Risk-weight floor for IRB banks raised to 25% from 15%
2015	Amortisation requirement for new mortgage loans as well implementation of a 5x debt-to-income cap and more stringent affordability calculations (with interest rates at 7%)
2015	Renewal of 100% risk weights for commercial real estate loans
2016	Increased amortisation requirements for mortgage loans (>70%LTV: 2%; >50% < x<= 70%: 1%; maximum interest-only period five years)
2017	Countercyclical buffer raised to 2%, increased back-book monitoring and changes to affordability calculations for borrowers in tenant/owner associations
2018	Additional 1% amortisation requirement for highly leveraged borrowers (for loans > 4.5x loan to gross income)

Source: Scope; ESRB

Increased amortisation requirements have proven to be most effective as they are directly felt by borrowers.

40-year maturity of Swedish mortgages is longest in Europe…

Even today, however, amortisation requirements are still lower than in most other European countries. The average mortgage maturity of 40 years-plus is twice as long as in neighbouring Finland. Amortisation for Swedish borrowers generally stops when an LTV of 50% is reached and mortgages then become interest-only.

… as tax deductibility removes incentive to amortise more quickly

Borrowers as well as the banks granting the loans have no real incentive to ask for more aggressive amortisation. Borrowers are not inclined as they benefit from tax deductibility on mortgage interest. The State picks up about a third of the interest costs, effectively subsidising mortgage lending. When checking the cost of a new mortgage, most banks directly show the instalments after the effect of the tax break.

Banks currently benefit from the absence of full amortisation. Retaining a mortgage means retaining the customer relationship and receiving a stable flow of interest income. Borrowers who have amortised down to 50% also likely to become customers for asset management services – which also can provide higher margins than those achievable in plain-vanilla mortgage lending.

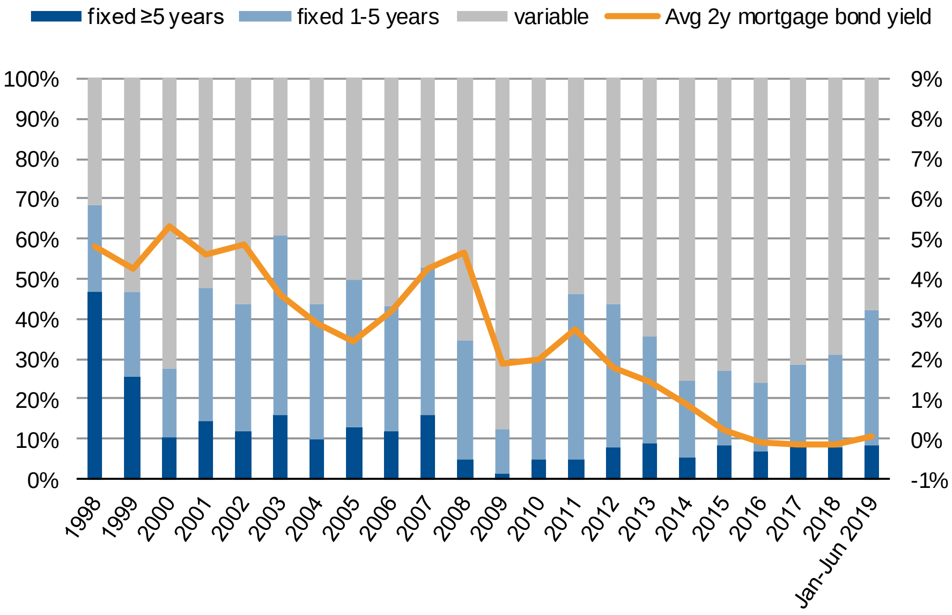
At the same time, the incremental default risk for a borrower with a mortgage loan below a 50% LTV no longer changes materially. Retaining mortgage loans allows the banks to get a higher share of the customer wallet. The lack of full amortisation requirements seems to be a win-win for the banks and their customers.

Housing market key to financial stability in Sweden

Financial stability risk due to high share of floating mortgages?

A continuous and strong focus on the housing market remains important from a financial stability perspective. Swedish home-ownership rates of two thirds are very high. Similarly, more than two thirds of mortgage loans reference variable rates or have short refixing periods, typically every two or three years. This means that any change in interest rates directly impacts the majority of the population and, more broadly, consumption in the domestic economy.

Figure 4: New interest-rate fixings in Sweden and 2-year mortgage bond yields



Source: Riksbank, Havers, Scope Ratings

Most borrowers have not experienced higher interest rates

Most Swedish borrowers have only experienced benign interest-rate environments. Thanks to decreasing interest rates in the last decade, higher borrowings and leverage have gone hand-in-hand with lower instalments.

The December 2019 increase in the Riksbank rate to zero from -0.25% is only marginal and will only translate into a minor increase of borrowing costs. It will not materially impact affordability of mortgages. In the medium term, the trajectory of Swedish interest rates is not expected to materially decouple from the low interest-rate environment in the rest of Europe.

Riksbank rate increase should be a wake-up call

The rate increase should act as a wake-up call, however. The high share of variable-rate fixings means that changes in the policy rate will, with a three-month time lag, directly impact most borrowers. At the end of 2018, the share of households with variable-rate fixings was slightly below 70%; placing Swedish borrowers among those in Europe with highest shares of variable-rate fixings[2].

By June 2019, a softening economy and increased talk of potential rate changes had prompted a visible change in the amount of new variable-rate fixings. The drop to a share below 60% was last seen in 2012. Changes were seen in medium-term fixings up to five years, which increased to 33% from 23% over the same period.

[2] Within the Nordics, Norway (94%) and Finland (95.2%) have similar high shares of floating rate mortgages only surpassed by Bulgaria (98.5%) and Poland (100%)

Current shift to short-term refixes not sufficient to isolate borrowers from shocks

The shift to longer-term fixings moderates the transmission speed of rate increases – but only a little. Comparing the five-year fixing to the 40-year average maturity of mortgages still means that only a small share of the loan has amortised, and the risk of a rate shock is only shifted to the near future.

Since the mid-1990s, household indebtedness has grown while longer-term fixings have reduced, and the share of interest-only loans increased. Longer-term financings never gained the momentum they had before – where they reached almost 50% of new production (see figure 4).

Current tax benefits discourage stronger amortisation

Policymakers have started to address interest-only mortgages through amortisation requirements. But unless changes to mortgage interest tax deductions are introduced, we do not expect a tangible effect to further reduce interest-only mortgages.

Gentle push towards fixed-rate mortgage lending needed

Dutch changes to tax deductibility a blueprint ?

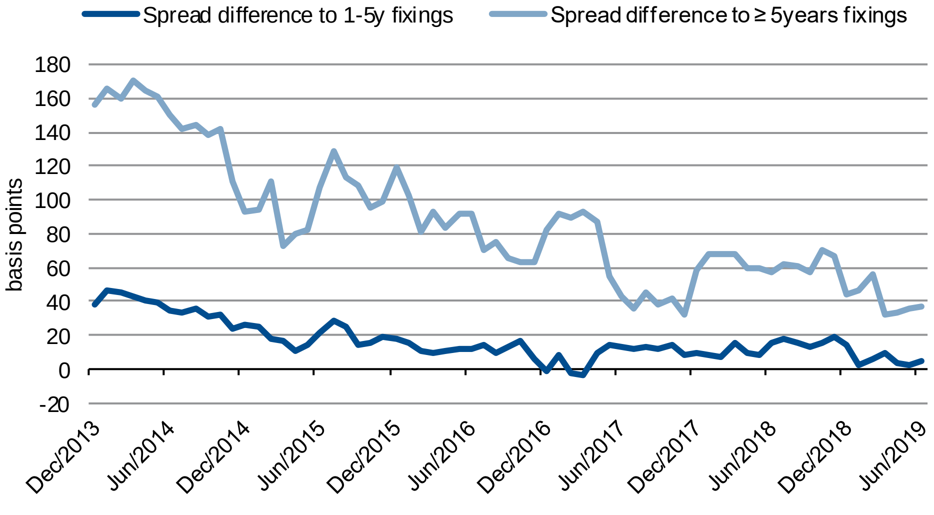
The Dutch mortgage system could act as a blueprint for Swedish policymakers. Due to tax deductibility, interest-only loans were the most common 'amortisation' type, and short-term fixings similarly had a two-thirds share in Q3 2013. Since then, the relationship has reversed. In Q3 2019 the share of fixings beyond five years exceeded 70%.

Key to the changes were changes to mortgage regulations as well as the tax system. Tax deductibility now requires that a loan has to be repaid within 30 years and has to amortise.[3]

Term structure of interest rates currently supports changes

The current almost flat interest-rate curve in Sweden provides a unique opportunity for improved financial stability in Sweden. In the past, long-term interest-rate stability and predictability of payments has come at a cost. These have significantly reduced.

Figure 5: Term premiums against variable mortgage rate fixings



Source: Scope, Statistic Sweden

Assuming a SEK 1m property financed at an 85% LTV, monthly instalments currently amount to about SEK 2,400[4]. Financing beyond five years would currently only increase monthly instalments by 12.5% or about SEK 300 compared to almost 50% or SEK 1,100 five to six years earlier.

[3] Tax deductibility for existing loans has been grandfathered but will decrease by 0.5% annually until 38%. In addition, maximum LTV restrictions were introduced in 2013.

[4] About SEK 1,400 would need to be attributed to the mandatory 2% amortisation and additional SEK1,000 to cover variable rates of about 1.4%

Decreasing interest margins – product innovations to counter

Mortgage lending margins have topped and are now under pressure

Swedish bank profitability relies significantly on the profitability of mortgage lending, given the 50% share on their balance sheets. Average mortgage margins peaked at more than 160bp at the end of 2017, supporting sound profitability. Increases reflect the fact that interest-rate reductions were not fully passed onto customers for new mortgages whereas the banks benefited fully because of their significant levels of wholesale funding – even when rates turned negative. The peak in 2017 ended a decade-long margin increase from the razor-thin 20bp observed in 2007 according to data from the Swedish FSA.

Competition for mortgage lending is increasing

Increasing pressure on margins shows that borrowers are increasingly questioning their effective rates, given the ultra-low interest-rate environment. Pressure also stems from competition, which has started to intensify. The incumbent mortgage lenders still have the majority of the mortgage market: the four largest banks (Handelsbanken, Swedbank, SEB and Nordea) still maintain almost 75% of the stock of mortgage lending.

Smaller players are becoming more active, however. Looking at new mortgage lending in 2019, the big four share is already below 60%. Challenger banks refinancing mortgages with covered bonds have become more active but new entrants – some of which are non-regulated institutions packaging mortgage pools directly for end-investors – are also becoming more successful.

New players not only competing on margins – but also on products

The Swedish FSA is monitoring the non-regulated segment closely and stipulates among other things that mortgage financing provided by such players should at least be 10 years. Combined with additional regulations in the consumer act limiting lenders' ability to increase rates (applicable to all – regardless their business model) we expect more and longer-term fixed-rate mortgages to appear. Indeed, November 2019 already saw one of the more traditional players, Danske Hypotek, starting to offer a 30-year fixed-rate mortgage loan.

Longer refix periods allow to lock in margins for good…

Other mortgage lenders should be incentivised to lengthen re-fixing periods to avoid margin pressure in the back book. If they are able to lock in current margins with longer-dated loans – and are able to refinance them in the capital markets with longer-dated covered bonds, they would be in a win-win situation.

From a financial stability perspective, if borrowers are able to refinance at ultra-low rates, they receive long-term predictability on their payment obligations and become cushioned against payment shocks in a rising interest-rate environment.

… and cushion borrowers against payment shocks…

Assuming mortgage loans have amortised down to a 50% LTV, monthly payments will reduce to about SEK 600[5] positively impacting affordability for the borrower. However, remaining leverage can still result in a significant payment shock. Assuming the 7% interest rate Swedish banks have to use when testing a borrower's affordability, instalments would jump back up to almost SEK 3,000 per month. Longer-term fixings have the potential to cushion the borrower from such shocks – in particular from creeping increases and thus are credit-positive for borrowers.

[5] Assuming a remaining loan balance of SEK 500'000, an unchanged collateral value and interest rate. Net payment will only amount to about SEK 410 due to tax deductibility.

Longer refixes can also become credit-positive for covered bonds

…and also support the credit quality of covered bonds

Longer-term interest-rate fixings for mortgages could also positively impact the credit quality of Swedish covered bonds if they gain further traction.

The credit quality of covered bonds hinges foremost on the credit quality of the issuing bank providing the first recourse. As such, most protection for Swedish covered bonds is currently provided by the solid credit quality of Swedish banks.

The lower the issuer rating, the more relevance has to be attributed to the credit quality of the cover pool dynamics when assessing the rating of a covered bond.

Expected loss of the cover pool only marginally impacted from longer refixes.

Protection for covered bonds is typically measured in the amount of over-collateralisation (OC) the banks need to provide to elevate the credit quality of the bonds above the credit quality of the bank. Most investors are concerned about the credit quality of the cover pool, but credit risks and the amount of OC needed to mitigate expected loss generally requires the smallest part of the rating supporting OC.

This predominantly reflects that even when a borrower is in default, the maximum eligible 75% LTV for residential covered bond collateral already provides a significant cushion in case the loan needs to be foreclosed. Even though only marginal, longer re-fixing periods mean lower sensitivity to payment shocks and thus a lower probability of default in a very stressed environment.

Mis-match risks are more relevant for the OC needed to enhance credit quality. Here, higher shares of longer-term fixings could provide stability when needed.

More fixed-rate mortgages can reduce hedging costs…

High shares of variable-rate mortgage collateral refinanced with fixed-rate covered bonds means that banks need to hedge most of their cover pool to reduce interest-rate risk for the covered bond programme. As such, longer re-fixing periods will lower hedging costs.

Floating or short-refix mortgages also enable borrowers to refinance mortgages with another bank without incurring a pre-payment penalty. This is also one of the reasons why Swedish banks in an international context issue relatively short-dated covered bonds. For Swedish covered bond issuers, most covered bonds typically have three to four-year maturities.

…and more prominently reduce asset-liability mis-match risk

From a rating but also financial stability perspective, more stable and longer-term financing would be beneficial for Swedish banks. Based on the weighted average maturity, the gap between the cover pool and the outstanding covered bonds often exceeds 20 years.

Most covered bond protection is needed to mitigate the risk that upon the maturity of covered bonds, parts of the collateral pool would need to be sold at fire-sale prices. The flexibility that borrowers have to change their banks would clearly be lower if they opted for longer interest-rate fixings. At the same time, better predictability on the repayment of mortgages would allow the banks to fund longer.

Costs for introducing changes to the Swedish mortgage system would currently come from a position of strength. The low interest-rate environment will likely not change any time soon so can provide sufficient breathing space for the impacts to become visible. A gentle push towards longer refix periods – in particular for first-time buyers – could help to calm the Swedish Riksbank and moderate financial stability risk in the long run.

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