S P E E C H

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Measures to deal with the risks linked to household indebtedness

Hello, today I want to talk about our view of the housing market, the risks of household indebtedness and what measures can be used to dampen these risks. But to put things in the right context here, I shall start off by describing developments on the housing market and Finansinspektionen's assignment.

Housing prices have increased rapidly and debt is following suit

Developments on the housing market in Sweden are strong. The rate of increase in housing prices has risen steadily since 2012. Over the past year, the price of tenant-owned apartments has risen by almost 20 per cent and house prices by almost 14 per cent. And since 2012, prices of tenant-owned apartments in Sweden as a whole have risen by more than 40 per cent.

There are several reasons for this development. Households have had a good increase in their disposable incomes. The population has increased faster than the stock of housing over the past decade. And when an increasing number of people need somewhere to live, the demand for housing rises in relation to the supply. This means that prices rise. More and more households have moved to metropolitan areas. Over the past 20 years, for instance, the population in greater Stockholm has increased by 500,000 people, at the same time as only 150,000 new homes have been built, so it is natural that prices have risen most in the cities. Moreover, at the beginning of the 2000s households' loan conditions eased gradually and interest rates are now extremely low. It is thus simple and cheap to borrow to buy a home. Total taxation on housing has also declined.

All of this has contributed to pushing up housing prices and then debts follow suit, because the home purchases have to be financed somehow. What is more, the number of households owning their own home has increased – from 59 per cent in 1990 to 64 per cent in 2012 – which has meant that more households are indebted. Around one quarter of the increase in the debt-to-income ratio we saw during the period 1995-2010 is due to home owning having become more common among households.

Some say that today's aggregate debt-to-income ratio of 175 per cent is alarming. But if one studies the most recent financial crisis, one can note that Switzerland had a debt-to-income ratio of almost 200 per cent prior to the crisis. Nevertheless, consumption was in principle unchanged during the years after this. On the other hand, Hungary had a debt-to-income ratio of only 50 per cent, but there consumption declined by almost 30 per cent during the financial crisis. So the debt-to-income ratio does not show the entire picture. Instead, both research and practical experience point to a rapid increase in the debt-to-income ratio being the factor that may create problems further ahead.

The debt-to-income ratio rose from around 90 to almost 170 per cent during the years 1995-2010 and then stabilised. Although the debt-to-income ratio has begun to rise again, over the past year this increase has been at a modest 2 per cent. There are also indications that developments will calm down in the coming period:

- Interest rates cannot become much lower, but will probably rise when inflation picks up.
- A discussion is under way on reducing tax deductions for interest expenditure and introducing a debt ratio ceiling.
- We are about to introduce an amortisation requirement.
- The higher housing prices are, the more people will be limited by the banks' credit assessments.

At the same time, one cannot rule out the possibility that developments will continue in the wrong direction. Housing prices have risen rapidly and growth in lending to households has been rising since the middle of 2012. Rising house prices and low interest rates can push up credit growth even further, which can increase vulnerability.

Those buying a home may also have exaggeratedly positive expectations of future developments in income, interest rates or housing prices. If a household buys a home with an 85 per cent loan-to-value ratio and expects housing prices to rise by 10 per cent a year, the expected loan-to-value ratio after five years will be 50 per cent. If the expectations are not fulfilled and housing prices instead remain unchanged, the household may be forced to reduce its consumption.

And if these expectations prove to be wrong, there may also be severe adjustments in housing prices. Experiences in, for instance, Denmark, the Netherlands, the United Kingdom and the United States show that such adjustments can be very costly. We would prefer to avoid this.

Finansinspektionen is responsible for macroprudential policy

So what possibilities and obligations does Finansinspektionen have with regard to slowing down this development or preventing things from going in the wrong direction? We have had the task of promoting financial stability and good consumer protection since 1995.[1] This means that we shall ensure that the financial system as a whole can sustain its fundamental functions – the mediation of payments, the supply of credit and risk management – and that it also has good resilience to shocks.

We have now had this assignment for 20 years. What is new is that we are now, as of 2014, also responsible for macroprudential policy in Sweden. It is formulated in our instructions like this:[2]

"Finansinspektionen has the responsibility to take measures to counteract financial imbalances with a view to stabilising the credit market, but taking into consideration the effect of the measures on economic development."

This means that we are to intervene if financial developments could lead to problems in the economy, even if neither the stability of the financial system nor consumer protection is threatened. We thus do not have any direct assignment to slow down runaway house prices. On the other hand, we must prevent rising housing prices from leading to a level of indebtedness that can in turn create problems for society.

Counteracting financial imbalances is a difficult balance. If we do too little, the vulnerabilities may increase. But if we do too much, there is a risk we will create the problems we wish to avoid, for instance, a housing market crash.

At the same time, there are many other parties who also have a responsibility for financial stability or an influence over it. For example, developments on the housing market and the risks ensuing from household indebtedness are affected by both housing policy and taxation and monetary policy. Finansinspektionen's role is to ensure that the actual credit granting does not aggravate the problems.

Measures taken to reduce the risks linked to household debt

Let me now briefly sum up what Finansinspektionen has done so far to subdue the risks linked to household debt. We introduced the mortgage cap in 2010. The background was that debts had risen faster than incomes for 15 years, while the average loan-to-value ratio when buying homes had also risen. This made households vulnerable to falling property prices, as the borrower risked still being in debt if the home was sold. The mortgage cap was introduced as a consumer protection measure, but has also had positive effects on

[1] See section 2 of the Ordinance (1994:1538) on amending Finansinspektionen's Instructions Ordinance (1992:102). This amendment entered into force on 01/01/1995.
[2] See section 1 of the Ordinance (2013:1111) on amending Finansinspektionen's Instructions Ordinance (2009:93). This amendment entered into force on 01/01/2014.

macroeconomic stability. We can note that the average loan-to-value ratio when buying a home has stabilised.

Since then we have gradually raised the capital requirements for the banks and specifically tightened the capital requirements for mortgage lending. At present, the total capital requirements made of the major Swedish banks correspond to around 10 per cent of Sweden's gross domestic product (GDP). These capital requirements mean that the banks must hold capital buffers that enable them to manage potential loan losses and continue to lend to households and companies even during tougher times. Swedish households also have an extensive personal payment responsibility. Household debt thus does not at present primarily pose a risk that the banks will make such large loan losses that the stability of the financial system as a whole is threatened.

What concerns us is instead directly linked to our new macroprudential policy assignment. Since the middle of 2012, growth in lending to households has increased and more households are taking loans with loan-to-value ratios of more than 50 per cent. At the same time, 6 out of 10 households that have loan-to-value ratios between 50 and 70 per cent are choosing to postpone amortisation payments. This is a problem, not least because international comparisons indicate that households with loan-to-value ratios of more than 40-50 per cent can react particularly strongly to macroeconomic shocks. Naturally, they do not stop interest and amortisation payments on their mortgages when their incomes decline, but they reduce other forms of consumption. In this way, their behaviour could amplify an economic downturn.

This is an example of a market failure in the form of an external effect. The larger loan a household takes on now, the deeper the next economic recession risks being. The banks do not take this into account in their credit assessments, and it is thus not fully reflected in the interest that houses are required to pay on their mortgages. As the banks all act in a similar manner, the risks for society as a whole increase. This is why we are intending to introduce an amortisation requirement in Sweden. The purpose of the requirement is to equip households with a better resilience to shocks by ensuring that the percentage of households with relatively high loan-to-value ratios declines over time.

A further consequence of the amortisation requirement is that the size of households' balance sheets declines. Households' mortgages currently amount to a total of SEK 2,600 billion, while their assets in shares and mutual funds are worth SEK 2,800 billion. In addition, households have substantial tied savings, for instance, in private pension schemes. So far, many households have chosen to save in shares or mutual funds, largely financed by mortgages, instead of amortising their loans. This has proved to be an expedient choice for many; the more the household has borrowed and saved in other ways, the higher the return has been. At the same time, it means that households can become very sensitive to various types of shock. If housing prices fall, there is a substantial risk that the value of other assets the household owns will also decline. The purpose of the amortisation requirement is not to increase the total saving, but to get households to reduce their mortgages in the long run, and as a consequences also reduce the assets in their balance sheets. This makes them more resilient to this type of development.

The amortisation requirement can also act as a standard setter, that is, it can become something to which all households compare their own amortisation payments. This means that amortisation payments can increase among all households, despite the regulations only covering new loans.

During the autumn, the Government has presented a proposal as to how we at Finansinspektionen shall introduce an amortisation requirement. We welcome this. It means that the requirement can be in force in the summer, which will probably contribute to a calmer development on the housing market. At the same time, we cannot rule out the possibility that housing prices, and ultimately debts, will continue to rise. And we must therefore be ready to take further measures.

Debt ratio ceiling may be needed

Over the past year, household debts have increased by more than 7 per cent. At the same time, their incomes have only increased by 3.4 per cent. We have previously seen a trend towards more and more households owning their own home and thus taking on large loans. During such a transition phase the debts in the real economy are moved from private companies or the public sector to households. Such a transfer of debts means that households' total debts can grow faster than their incomes over a period of time without the risks needing to increase. The fact that debt is increasing faster than income in a single year need not be a problem. But at the same time, debts cannot continue to increase faster than incomes indefinitely. And the increase in debt we are seeing now does not seem to be due to more households owning their own home. We therefore assess that the development we are seeing now is not sustainable in the long run.

One measure that appears appropriate if the amortisation requirement is not sufficient is to introduce a debt ratio ceiling, that is, a limit as to how much a bank may lend in relation to the borrower's income. Countries such as the United Kingdom and Ireland have recently introduced such debt ratio ceilings. In the United Kingdom the debt-to-income ratio ceiling was set at 450 per cent and in Ireland it was set at 350 per cent. Both of these ceilings apply to new loans that are taken for the purpose of buying a home, and they are linked to the household's gross income. In both the United Kingdom and Ireland the regulations have been aimed at the banks' total new lending and they have also been flexible; the banks have been able to grant exceptions for 15 and 20 per cent respectively of the new mortgages granted.

When the regulations were introduced in the United Kingdom last summer, around 10 per cent of the new mortgages entailed a debt-to-income ratio in excess of 450 per cent. And in Ireland, less than 20 per cent of the new mortgages exceeded 350 per cent of incomes at the time of the introduction. Both countries have thus introduced a debt-to-income ratio ceiling at levels that did not entail any general tightening of their credit granting at the time the regulation was introduced. Nevertheless, experiences show that the debt-to-income ratio appears to have contributed to a calmer development on the housing market.

Thus, the purpose of the debt-to-income ratio has not been to severely and immediately limit credit granting, but to create an insurance against the risks ensuring from housing prices rising too quickly. Because if housing prices rise quickly, then indebtedness follows suit and regulation will then limit credit granting in the long run.

The International Monetary Fund (IMF) recently recommended that Sweden should also introduced a debt-to-income ratio ceiling similar to those in the United Kingdom and Ireland. Based on our preliminary analyses, a debt-to-income ratio ceiling for new loans could lie at around 600 per cent of the household's disposable income. If you think this sounds high, it may be because I am here talking about the household's disposable income after tax. If we adjust for the average income tax that households pay, it corresponds to just over 400 per cent of gross income, that is, the level is on a par with the United Kingdom and Ireland.

According to data from our most recent mortgage survey, just over 10 per cent of the new mortgages exceeded the 600 per cent debt-to-income ratio. So if we were to copy the regulations in the United Kingdom and Ireland, we may need to allow exemptions for 10-15 per cent of the new loans. Then the regulation would not entail any immediate tightening of credit in the economy as a whole. But it would act as an insurance against the risks entailed in continued rapid price increases on housing and the build-up of debt this causes. If indebtedness continues to grow faster than household incomes, the regulations will have an effect and limit lending. Such a debt-to-income ratio ceiling could also dampen the increase in debt in that it sets a standard, that is, households cannot assume that they will be able to borrow more than 600 per cent of their incomes.

But before we can establish the right level with any certainty we need to investigate further. I do not want to rule out the possibility that we introduce regulation in a way that means it more directly limits credit granting. Exactly where we land will depend on how the housing market and indebtedness develop.

Another measure that we have reason to examine more closely is regulating how large a share of its income a household should spend on interest and amortisation payments. A rough estimate shows that a debt-to-income ratio ceiling of 600 per cent would mean that a household could spend a maximum of around 40 per cent of its disposable income on interest and amortisation payments. A debt-to-income ratio ceiling could thus be translated into a ceiling for debt payment in relation to incomes. If regulation of the size of the debt payments is to have the intended effect, Finansinspektionen must also state how high interest rates households should manage to pay to be granted loans.

If housing prices continue to rise rapidly a regulation package could create an insurance against the risks this entails. This could be a combination of a mortgage cap, amortisation requirement, debt-to-income ratio ceiling, and regulation of how large a percentage of incomes goes to interest and amortisation payments. Together, these measures would dampen credit granting and thus reduce the macroeconomic risks. It is important to point out that it may also be necessary to take other measures that lie outside of Finansinspektionen's field of responsibility.

Finansinspektionen must be able to take measures

Our assessment is that household debts currently comprise mainly a macroeconomic risk that is directly connected to the macroprudential policy assignment we were given in 2014. However, Finansinspektionen did not receive any new powers of authority when our assignment was extended. We ourselves assumed that the amortisation requirement could be introduced on the basis of the so-called soundness provision. When this point of view was called into question, we realised that the legal situation was too uncertain to proceed. As we see it, we thus currently lack the powers of authority required to implement several measures that would counteract the macroeconomic risks we consider linked to household indebtedness.

But if housing prices and debts were to continue to increase rapidly, we reach a situation where financial stability is threatened or where consumers need protection. We therefore need to be alert. The future stability of the housing bond market is something that needs to be closely monitored, for instance. If we were to see clear signs that the banks had problems with their market funding, we would be able to take measures within the framework of the assignment and powers of authority we have had for a long time. However, it would be unfortunate if we needed to wait until things have gone this far before we can act. The damage to the economy can occur at a much earlier stage and it is the need to protect the economy that lies behind our macroprudential policy assignment. It is therefore essential that our powers of authority are clarified.

There are two different ways of giving Finansinspektionen the possibility to take measures to counteract financial imbalances. One is that the Government amends legislation and introduces a general wording that granting credit should not contribute to the build-up of financial imbalances. They could then provide examples in the preparatory work for the act of the type of measures that Finansinspektionen could take if such imbalances begin to build up. This could concern a debt-to-income ratio ceiling, a limit on the percentage of a household's income that can be spent on interest and amortisation payments, a reduction in the mortgage cap or a tightening of the regulations covering the banks' credit assessments.

Given a general wording, one could also give Finansinspektionen the authority to issue the regulations mentioned without the approval of the Government. This is as long as the regulations are aimed at the banks and give them some possibility of exemptions. At the same time, it is reasonable that the Government must approve the regulations if they have far-reaching direct effects on the finances of individual households, as with the amortisation requirement. The same applies if the regulations may have substantial effects on the total demand in the economy. This is the format chosen in the United Kingdom, and the financial stability council in Germany has proposed a similar format.

Another means of extending Finansinspektionen's powers of authority is instead to manage one measure at a time. Finansinspektionen sees a need to be able to introduce a debt-to-income ratio ceiling now. In this case the act can be amended with a more precise wording on limiting credit in relation to the borrower's income. Finansinspektionen can then have the power of authority to issue such a regulation. Even here it may be reasonable for the Government to approve the regulation if it is directed at all households. At the same time, the type of debt-to-income ratio ceiling introduced in the United Kingdom and Ireland, where the banks have the possibility to grant exemptions, could be delegated entirely to Finansinspektionen.

One experience from the work on introducing an amortisation requirement is that it can take time to amend legislation. Households can then anticipate a measure that has been notified by changing home before the law is amended and Finansinspektionen introduces the regulation. There is a risk that the problems we are trying to remedy will be aggravated. Finansinspektionen therefore prefers the more general solution. It is also reasonable that the Government does not always need to approve the regulation, so that measures can be taken quickly when required. At the same time, democratic legitimacy reasons indicate that the measures that have far-reaching direct effects on households' finances should ultimately be approved by the Government first.

Finansinspektionen has been given responsibility for macroprudential policy in Sweden. One advantage with the Swedish system is that one single authority is responsible for the macroprudential policy tools such as various capital requirements, amortisation requirements, debt-to-income ratio ceiling, mortgage cap and so on. This makes it easier to coordinate the measures, both with regard to different macroprudential policy measures and other measures aimed at safeguarding financial stability or contributing to a high level of consumer protection.

A further advantage of the Swedish system is that it becomes easier to demand accountability. But to be able to demand accountability, Finansinspektionen's powers of authority must be extended and clarified. It is important that this is done quickly so that we do not need to wait until financial stability is actually under threat or consumers need protection before we can take the necessary measures.

Conclusion

Let me summarise. Developments in the housing market have been strong and debts have increased. The development we are seeing now is not sustainable in the long run. However, household debt is not primarily a threat to financial stability. It is rather the macroeconomic risks that concern us. Therefore, it is good that we will have an amortisation requirement in force in the summer. We believe that this will calm development on the housing market.

But if developments continue in the wrong direction, a measures package can create an *insurance* against the risks that ensue from housing prices rising too fast. This could be a combination of a mortgage cap, amortisation requirement, debt ratio ceiling, and regulation of how large a percentage of incomes goes on interest rates and amortisation payments. Together, these measures would dampen credit granting and thus reduce the macroeconomic risks.

Finansinspektionen needs to have new powers of authority to be able to introduce such regulations. It is important that this is done quickly so that we do not need to wait until financial stability is actually under threat or consumers need protection.

Thank you for the invitation to come here and thank you for listening!