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Finansinspektionen and macroprudential policy

Hello and thank you for inviting me here to talk about macroprudential policy. I shall today describe what we have done to manage the risks linked to household debt. I will also spend some time discussing how we got to where we are now, what alternative solutions are available and how they may affect indebtedness. But first I shall talk about Finansinspektionen's assignment and how we carry it out.

Finansinspektionen is responsible for macroprudential policy

There is a lot of talk about the new policy area known as macroprudential policy. But what is macroprudential policy? It is often described as analysis and measures aimed at the stability of the financial system as a whole. This is nothing new for Finansinspektionen, which has had the assignment of contributing to the stability and efficiency of the financial system and promoting sound consumer protection since 1995.¹

What has changed is that we have acquired both new regulations that give us an opportunity to make more stringent requirements and more resources so we can do more comprehensive work, not least with regard to analysis and control of systemic risk. These are risks arising from the complexity and interlinkage of the financial system that are not captured when assessing the risk situation of individual financial institutions. We have also been given a further assignment, which entails counteracting financial imbalances for the purpose of stabilising the credit market. We are to intervene if financial developments could lead to problems in the economy, even if the stability of the financial system is not in itself threatened. The new assignment was announced in autumn 2013 and has now been formalised in the instructions that govern Finansinspektionen's work.²

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.

Macroprudential policy is a partly new policy area and there is limited experience of this both in Sweden and abroad. It is therefore to an unusually high degree a question of taking decisions under uncertainty. The strategy we have chosen is to take one step at a time and to evaluate the effects of each measure and then to take the next step if it is necessary. We do not know exactly what effect our measures will have and if we act too strongly, we risk doing more harm than good. At the same time, we must deal with potential problems while they are still manageable; otherwise the problems may worsen so that stronger measures are necessary in the future. By taking measures gradually, we can analyse their effects and, if necessary, extend them or take other measures. A good illustration of how we work with macroprudential policy is the risks linked to household debt and the measures we have introduced in Sweden in recent years.

Finansinspektionen has taken several macroprudential policy measures to reduce the risks linked to household debt

During 1995-2010, household debt increased faster than their disposable incomes, at the same time as the average loan-to-value ratio for homes also rose. This made households vulnerable to falling property prices, as the borrower risked still being in debt if the home was sold. To protect households and counteract an unhealthy development on the credit market where credit institutions are using increasingly high loan-to-value ratios as a means of competition, we introduced what is known as the mortgage cap in 2010. Since then, both the debt-to-income ratio and the average loan-to-value ratio have stabilised and are now at around the same levels as in 2010.

Since then we have gradually raised the capital requirements for the banks. The purpose of these requirements is to ensure that the banks have margins that can manage potential loan losses and thereby can lend to households and firms even during tougher times. The higher capital requirements decided in 2014 correspond to a total increase of around SEK 230 billion, compared with the EU's minimum capital requirement within the framework of Basel 3. Our assessment is that Swedish banks are now well capitalised in an international perspective.

However, since the middle of 2012, growth in lending to households has begun to rise again and an increasing number of households are taking out loans with loan-to-value ratios over 50 per cent, at the same time as many are waiting before amortising their loans. This is a problem, as international experiences 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. An

individual does not think about this when taking on debt, but if everyone acts this way, the risks for society as a whole increase.

In a few years' time, rising house prices and low interest rates may push up credit growth and the percentage of households with relatively high debts even further and thus build up vulnerabilities. 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 eventually declines. The difficult balance here is once again not to do too much so we create the problems we are aiming to avoid, but at the same time not to do too little so the risks escalate.

Our work regarding household debt has been going on for almost five years. During these five years we have first taken care of the acute risks we saw for households by introducing the mortgage cap. After that, we have improved the banks' ability to withstand credit losses by requiring that they allocate more capital for their mortgage lending. And now we have begun to manage the remaining risks for the Swedish economy, the macro risks, by requiring that households amortise more on their loans.

If we had tried to do all this at once, we would probably have created major problems. The housing market would definitely have been under considerable pressure and we would have created considerable uncertainty for both households and banks. Instead we have taken one thing at a time. Acted, assessed and acted again. And if one looks at the results, they are positive. The housing market has not been knocked out, as some feared. And both households and banks are in better shape than before. But are we done now? No, that is not certain. We will continue to closely follow and analyse developments in household debt and we will take further measures if necessary. At the same time, the main part of the problem regarding household debt is that too little housing has been built. So how is our work affected if more homes are built?

Macroprudential policy is affected by housing policy

At present, household debt comprises almost 175 per cent of their disposable incomes. How did we get there? Our analyses indicate that the build-up of debt between 1995 and 2010 is mainly due to a much larger share of Swedish households owning their homes compared with 20 years ago.³ This shift in ownership from commercial and public sector ownership to individual households has moved debt to the household sector. Another explanation for the increase in debt is that taxes on housing have been cut. And a further explanation is that relatively few homes have been built in relation to the

³ See Hansen (2013), "Explanations for the development in household debt since the mid-1990s", Memorandum 1 for the Council for Cooperation meeting on 1 October 2013, FI ref. 13-11430.

increase in population over the past 10 years, particularly in the metropolitan regions, to which an increasing number of people are moving. When more people need homes and construction is low, housing prices rise and thereby indebtedness rises.

So what can be done about this? If too few homes are built, there is a risk that housing prices will once again begin to rise faster than incomes, resulting in a rising debt ratio. But what happens if more homes are built? It is clear that households' total debt will increase and there could be large sums involved. If, for instance, 250,000 new homes are built up to 2020, as is being discussed in the general debate, the financing need will increase by SEK 750 billion, which corresponds to a good 20 per cent of households' current total debt.⁴ What happens to households' debt-to-income ratio will depend on how housing prices and households' disposable incomes develop. But it also depends on who will own these new homes and how they will be financed. The more homes that are owned by the household and the higher the loan-to-value ratio, the higher the debt-to-income ratio will be.

So on the one hand, a too low level of construction has pushed up housing prices and thereby the debt-to-income ratio, but on the other hand increased construction can also push up the debt-to-income ratio initially. However, building more homes is the only solution to the fundamental problem and we will then have to accept that this will initially lead to increased debt. In the long run, the increased housing supply will dampen the increase in housing prices and thereby reasonably also household debt.

Another part of the solution is better regulation of the rental market and more rented properties so that this form of housing can be an alternative for more households. Rented housing is not owned by the household and an increased supply of rented properties would thus reduce household debt. Our analyses also indicate that lower taxes on housing have contributed to increasing household debt. A further measure is thus to review the way the tax system is designed, as it currently benefits home owning in relation to renting. If, for instance, the deduction for interest payments were abolished, it would reduce the need for further measures to reduce household debt.

Some say that the current debt-to-income ratio of 175 per cent is already alarming and that measures are needed urgently. One can then gain the impression that increased construction is a problem, as it will probably lead to an increase in the debt-to-income ratio. Finansinspektionen has on several occasions pointed out that the debt-to-income ratio is a poor indicator of potential risks linked to household debt.⁵ Crises are usually preceded instead by a period of rapid increase in the debt-to-income ratio, but not even this indicator shows the whole truth. The fact that increased construction can also

⁴ In this example we have assumed that a newly-produced home is sold for SEK 3 million.

⁵ See, for instance, Finansinspektionen's memorandum "Stability risks linked to household indebtedness", Finansinspektionen Ref. 14-15503.

lead to a higher debt ratio is further indication of the problems of focussing too one-sidedly on the level of the debt-to-income ratio. A broader perspective than this is required.

Conclusion

Let me summarise. Finansinspektionen's assignment has included for the past year or so now counteracting financial imbalances to stabilise the credit market. This currently concerns household debt. Our task is to ensure that credit granting is sound and that households have sufficient margins to avoid exposing themselves or society as a whole to unnecessarily large risks. We have therefore introduced a mortgage cap, raised the capital requirements for the banks and we are about to introduce an amortisation requirement. The fact that household debt is so high is mainly because too few homes have been built. But if more homes are built, debt may also increase, particularly if these homes are to be owned by households. If one wants to reduce household debt, one should therefore also find a better way of regulating the rental market, build more rental properties and review the taxes on housing. None of these measures comes under Finansinspektionen's mandate, but the measures we must take in the future will depend on what is done to resolve the problems on the housing market.

Thank you!