M E M O R A N D U M

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Finansinspektionen
Box 7821
SE-103 97 Stockholm
[Brunnsgatan 3]
Tel +46 8 408 980 00
Fax +46 8 24 13 35
finansinspektionen@fi.se
www.fi.se

Preconditions for mortgage-based business activities

Summary

The traditional bank-based model in Sweden for granting and financing mortgages is being challenged by actors offering alternative financing models. Greater competition on the mortgage market is fundamentally positive, but not if it comes at the expense of the interests of consumers or financial stability, which the regulations are intended to protect and that FI as a supervisory authority is tasked with monitoring.

In this memorandum, FI describes a set of preconditions that need to be met to ensure that new actors (henceforth *newcomers*) to the mortgage market do not increase the risks for consumers or the financial system.[1] FI will place special emphasis on these preconditions when assessing applications for authorisation and in its supervision of actors in the mortgage market.

A fundamental point of reference is the fact that mortgages are large and important commitments for consumers. Therefore, a well-functioning mortgage market must have responsible actors who will be there for their customers in the long term. Banks, which today are the actors that issue mortgages, have relatively short maturities on their funding. This means that banks bear a refinancing risk, but this risk is limited by rules requiring them to meet capital and liquidity requirements. The banks are also subject to in-depth supervision, resolution and other protective rules.

Consumer protection rules, including the requirement that mortgage agreements normally must be long-term, also apply to newcomers in the mortgage market. However, the newcomers are not subject to the capital and liquidity requirements and other regulations that apply to banks. The requirement on longevity and robustness must be met in some other way. FI makes the assessment that this needs to be done by limiting the newcomers' refinancing risks. In practice, many borrowers pay back their mortgages early,

[1] In this memorandum, the term *newcomers to the mortgage market* refers to actors that issue mortgages but are not credit institutions. The term *banks* is used as an umbrella term for credit institutions that conduct business in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council or the Banking and Financing Business Act (2004:297).

e.g. when they buy a new home. However, a decision to repay the loan should be optional for the borrower, not compulsory. FI therefore takes the position that the average maturity of the financing for newcomers to the mortgage market should reflect the mortgages' expected maturity.

FI considers that it should be possible to find financing solutions with long maturities. There are investors with long-term debts that thus have the capacity to hold long-term (and less liquid) assets ‑ particularly insurance companies and pension managers. By turning to these types of investors, actors on the mortgage market could raise financing that reflects the expected maturity of the mortgages. This could also – if the scope of these activities were to grow in scope in the future – reduce maturity imbalances in the financial system and systemic risks.

Introduction

The way the mortgage market functions is crucial for the economy. For most Swedish households, their home is their most important asset and their mortgage their single largest debt. Predictable and reliable access to credit in the form of a mortgage is therefore an economically important function. A central issue in this respect is how mortgage activities are financed.

As the supervisory authority, FI is tasked with monitoring financial firms and actively promoting long-term stability and efficiency as well as a high level of consumer protection on the financial markets. The mortgage market is also central for FI's macroprudential assignment to counteract financial imbalances with the goal of stabilising the credit market. Risks associated with how mortgage activities are conducted and financed thus affect much of FI's work.

In Sweden, mortgages are traditionally issued by banks and retained on the banks' balance sheets. Banks are subject to regulation and supervision, such as requirements on loss-bearing capital, stable financing and liquidity buffers, with the aim of ensuring that the critical functions provided by the banks can be maintained even during times of crisis. Newcomers using alternative financing models are now challenging this structure.

The consumer protection regulations apply regardless of who is providing the mortgage. However, from a stability perspective, the regulations that apply to newcomers to the mortgage market are less extensive than the regulations that apply to banks, which indirectly could mean that borrowers will be exposed to larger risks.

In this memorandum, FI describes a set of preconditions that need to be met to ensure that newcomers to the mortgage market do not increase the risks for consumers or the financial system. FI will place special emphasis on these preconditions when assessing applications for authorisation and in its supervision of actors on the mortgage market.

Fundamental consumer protection regulations regarding mortgages

Firms that offer mortgages must have authorisation from FI in accordance with the Mortgage Business Act (2016:1024) or the Banking and Financing Business Act (2004:297). These acts contain a number of rules that aim to protect the interests of consumers. Additional rules to protect consumers are found in the Consumer Credit Act (2010:1846).

Firms that issue mortgages shall run their business in a sound manner. This means, for example, that the firm shall conduct its business honestly, fairly, transparently and professionally and take into consideration the interests and rights of the consumer. The business shall be based on information about consumers' circumstances and special requirements as well as reasonable assumptions about the risks the consumer may face during the term of the loan. The firm also shall maintain a sufficiently high level of quality in its business that confidence in the market is maintained, which means that the business shall be organised and operated in such a manner that it is possible to obtain an overview of the firm's structure and position.

A central requirement in the Consumer Credit Act is that lenders must observe generally accepted standards for granting loans. This means, for example, that the lender must consider consumers' interests with due care and ensure that consumers receive the requisite explanations and information. The requirements do not only apply to the initial lender but also to a firm that takes over the loan. This means that both the issuer of the loan and the party that takes over the loan must have an organisation that protects the interests of the borrower and handles any issues that may arise during the term of the loan. Such issues may include if the firm needs to discuss a new amortisation schedule or new interest rate terms with the borrower or inform or explain to the borrower how the loan can be repaid early or how late payments are handled. It is therefore important for all firms involved to have the resources, knowledge and experience necessary to protect the interests of the consumer. It should also be clear for the borrower who to contact regarding information about the mortgage.

Another requirement set out in the Consumer Credit Act is that the borrower must ensure that the consumer has the financial capacity to repay the loan in accordance with the credit agreement. This means, for example, that the maturity of the mortgage must be long enough to enable a borrower to pay back the loan during its term without needing to sell the collateral (the home) or borrow money from another lender. For most new mortgages, this means a long contractual maturity. The practice in Sweden is 30–50 years.

In practice, many borrowers pay back their mortgages early, e.g. when they buy a new home. However, a decision to repay the loan should be optional for the borrower, not compulsory.

The interest rate adjustment period is shorter than the maturity of the loan in all but a few cases. It is therefore important from a consumer protection perspective to limit the lender's possibilities for unilaterally raising the interest rate in conjunction with interest rate adjustments. The borrower could otherwise be pressured to pay off the loan in advance.

The main rule in the Consumer Credit Act is therefore that the interest rate may only be raised if this is specified in the agreement and increases can be justified. This might be through increased financing costs for the lender or other cost increases that could not be predicted when entering into the loan agreement. However, for a mortgage with a maturity of at least ten years, the lender can introduce conditions in the agreement that the interest rate must be set so it corresponds to the interest rate the lender applies to new loans when interest rates are adjusted.

Current market structure

The structure of the Swedish mortgage market has remained more or less the same for many years. It is primarily the banks that issue mortgages, and they then keep these mortgages on their balance sheets. The banks' mortgages are largely financed by issuing covered bonds, which normally have a maturity of five years. The fact that the banks' financing (liabilities) have a shorter maturity than the loans (assets) means that the banks must perform maturity transformation.

Maturity transformation within the banking system normally allows a larger supply of loans, which increases the activity level in the economy and creates added economic value. At the same time, maturity transformation introduces a vulnerability in that the banks are exposed to refinancing risk, i.e. they are dependent on regularly renewing their liabilities that fall due and keeping their deposits.

In order to increase the resilience in critical functions provided by the banks, they are therefore subject to special regulations, for example, in the form of capital and liquidity requirements. Banks also have access to more stable financing sources than the markets, through their access to deposit insurance, liquidity support from central banks[2] and special rights for investors in covered bonds. Should these preventive measures prove to be insufficient and a bank were to fail, there are resolution regulations to ensure that the bank's significant functions can continue to operate.

A less bank-dependent mortgage market

Stable and efficient markets do not necessarily require that banks must carry out the financial functions that are important for the economy, such as

[2] Actors other than banks subject to FI's supervision can receive liquidity support from the Riksbank depending on the nature of the situation.

payments, investments and loans. Other actors – with different ways of producing services – can carry out these functions instead.

Over the past year, several new business models have been presented for financing and distributing mortgages in Sweden. One thing these newcomers to the mortgage market have in common is that they are not banks. There are several reasons why new business models are being established in the mortgage market right now. Because these newcomers are not subject to capital or liquidity requirements, they are not burdened by the costs these requirements entail. Neither are they subject to the rules on resolution and thus pay no resolution fee. Other important driving forces are likely the high demand for loans, low interest rates that the banks compensate for through high lending margins and good access to non-risk-adverse capital and financing. Mortgages as a product are also becoming increasingly standardised, which in combination with digitalisation and changed customer behaviour makes it possible to produce mortgages in a new way.

Newcomers to the mortgage market still represent a very small part of the new loans, but interest has been strong both from households and from businesses – both new and established – intending to apply for authorisation. Under certain conditions, a change in the market structure could create advantages for both individual borrowers and the economy at large. Greater competition can lead to higher customer benefit, for example through more efficient distribution and improved terms. This assumes, however, the presence of sound competition and that new business models are sustainable even in a weaker market.

From a systemic perspective, there are weaknesses associated with lending that are strongly dependent on the banking system, especially in situations like in Sweden where the banking system is highly concentrated. If the percentage of new loans from newcomers to the mortgage market were to increase, this would also increase diversification of the market. Distributing credit risks and financing risks across an increasing number of heterogeneous actors would lower systemic risks in the long run and increase the financials system's resilience to crises. Banks would become less systemically important than before, and access to loans would instead become dependent on the securities market and other types of financial firms.

However, a more market-based mortgage market could also carry risks. The most recent financial crisis illustrated the risks of the selling and repackaging of loans if the market and investors are not sufficiently knowledgeable about the risks they contain. Newcomers to the mortgage market might also have a different relationship with the borrower compared to banks, which can also offer a number of other products and services. There is therefore a risk that the long-term business relationship with borrowers could be weakened since it is not a given that the newcomers will face the same incentives and traditions to nurture a long-term relationship with borrowers.

Risks associated with the business models of newcomers to the mortgage market

A long-term approach and predictability on the mortgage market are of utmost importance for both individual households and the economy at large. This primarily means that access to credit should not be negatively affected by financial shocks.

Refinancing risks for banks that arise due to the maturity transformation can be justified from an economic perspective. They are also an identified risk, which is managed through capital and liquidity requirements as well as other operational regulations for banks. There are also separate protective mechanisms for maintaining systemically important functions in banks even during crises, for example deposit insurance and resolution rules for failing banks.

There are, however, no corresponding rules and tools for newcomers to the mortgage market that will enable them to counteract refinancing risks and manage shocks. As mentioned above, this is one of the drivers behind the interest in establishing new business models on the mortgage market. Depending on the size of the refinancing risks to which these newcomers are exposed, both borrowers and the financial system may be exposed to greater risks than in the current bank-based system.

Newcomers to the mortgage market normally have a business model that focuses on a market niche, both in terms of earnings and financing. This may make them more vulnerable to an economic downturn if their financing needs to be renewed during a period of serious shock with risk aversion becoming more prevalent in the financing market. This refinancing risk is greater for short-term financing.

Refinancing problems for lenders can threaten the continued supply of loans for borrowers. If financing costs for newcomers to the mortgage market increase, borrowers may face sharply deteriorating terms and conditions. In a crisis during which a mortgage provider is not able to borrow the funds needed to cover outstanding mortgages on reasonable terms, the provider may be forced to call in the loan. This could have a negative impact on individual borrowers if, for example, they are not able to get a loan from a different lender due to e.g. weakened finances.

Problems could also arise for the economy as a whole. If several lenders were forced to terminate their mortgage agreements and cease issuing new loans, the access to credit would be restricted. If banks in such a situation would take over borrowers or entire mortgage portfolios from newcomers to the mortgage market, their capital needs would increase. In the presence of shocks on the financial markets, there is no guarantee that the banks would have the financial capacity to take over the loans. This could potentially further restrict the supply of loans in an already weak market, thus deepening an economic recession. It could also mean that many borrowers may not receive new loans for financing the purchase of their homes.

The possibility of maintaining predictable access to mortgages, which is a systemically important function, could be weakened if newcomers to the mortgage market have business models that are not robust and sustainable in the long run. If significant credit volumes are being financed via such business models, refinancing problems could lead to less stability in the credit supply.

Risk-mitigation measures for newcomers to the mortgage market

Rules that fundamentally aim to create resilience and maintain confidence in both individual firms and the system at large often lead to stronger consumer protection. They are supplemented by additional rules that aim to safeguard the interests of individual borrowers, for example the duty of care.

In a system where banks provide loans in the form of mortgages, there has not been a need for specific requirements to limit the refinancing risks associated with mortgages other that the general liquidity requirements that banks are already obligated to fulfil. These risks are covered by the general rules. In a more market-based system where mortgages are issued by and transferred to newcomers in the mortgage market that are not covered by mechanisms limiting refinancing risks, the vulnerability of such business models needs to be managed separately.

As mentioned above, consumer protection rules ensure that mortgages normally have long contractual maturities. Borrowers have the *option* of repaying their loan before the contractual maturity, for example to switch banks or buy a new home, but they have the *right* to hold the loan to maturity. It is therefore important for a mortgage provider to have a financing model that is robust, so borrowers can trust the loan to be financed for the entire term. The refinancing risk that arises for newcomers to the mortgage market is primarily linked to the actual expected maturity of borrowers' mortgage agreements.

The average actual maturity for Swedish mortgages in recent years has been around seven years. This figure represents an average and refers to a period of high economic growth and a strong housing market, which has two important consequences. First, there are borrowers who hold their loan longer than seven years. Second, it is probable that the average maturity on mortgages is significantly longer during recessions. Turnover on the housing market could contract then due to general uncertainty and limitations for borrowers due to lower house prices, which increases the average maturity of the loans.

Therefore, in order not to weaken the function of the mortgage market during periods of recession, the average maturity for the financing of newcomers to the mortgage market needs to reflect a mortgage's expected maturity and take into consideration that the maturity may be extended during periods of economic recession and a fall in house prices.

FI takes the position that the operations of newcomers to the mortgage market should not be based on far-reaching maturity transformation to the extent that borrowers and the financial system are exposed to greater risks due to business models with an excessive risk of difficulties refinancing in a recession.

On the plus side, financial solutions with long maturities *both* reduce the stability risks and protect borrowers. And it should be possible to find such solutions. There are investors with long-term debts that have the capacity to hold long-term (and less liquid) assets, particularly insurance companies and pension managers. By turning to these types of investors, actors on the mortgage market could raise financing that reflects the expected maturity of the mortgages. This could also – if the scope of these activities were to grow in scope in the future – reduce the maturity imbalances in the financial system and thus the systemic risks.

Conclusions

Greater competition on the mortgage market is fundamentally positive, but not at the expense of stability or consumer interests, which the regulations related to the mortgage market are intended to protect. A well-functioning mortgage market must have responsible actors who will be there for their customers in the long term.

Newcomers to the mortgage market must follow the same consumer protection rules as existing actors. In order to protect consumers – and counteract the exposure of the financial system to greater risks – the financing methods of newcomers to the mortgage market need to reflect the mortgages' expected maturity and take into consideration that the maturity can be longer in the event of a recession. Newcomers to the mortgage market should therefore clearly describe how their refinancing risks are limited and managed.

To ensure that they live up to the other requirements in the consumer protection regulation, newcomers should also explain how, for example, borrowers are informed about any transfers, how the newcomer intends to transfer the loan to other actors and how the credit matter is followed up after the loan has been transferred. They also need to describe how the duty of care is protected when a loan is transferred.

Rules for mortgages aim to promote a mortgage market with a high degree of consumer protection, controlled risk-taking and stability in the credit supply, even during periods of financial uncertainty. FI will therefore take steps to ensure that all actors on the mortgage market avoid taking risks that could result in undesirable consequences for individual borrowers or the mortgage market as a whole. The prerequisites that are presented in this memorandum will be in focus during FI's authorisation assessment and supervision of mortgage providers.

Newcomers to the mortgage market and alternative models for mortgages can also increase the need for supervision to ensure that other rules are followed, for example the importance of a good credit assessment, compliance with the duty of care even when loans are transferred, potentially in several steps, and when the original lender does not carry any risk. FI will therefore carefully follow individual actors and the development on the market.