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

Reasoning behind Finansinspektionen's position

FI has taken the position for a number of years that it is a natural feature of a well-functioning credit market to amortise high levels of debt. In order to establish amortisation as a norm, FI introduced an amortisation requirement in 2016. This requirement has had the intended effects: households are taking slightly smaller mortgages and purchasing homes that are not as expensive.

The amortisation requirement currently in effect is linked to the size of the mortgage in relation to the value of the home, just like the mortgage cap introduced by FI in 2010. The mortgage cap limits new mortgages to 85 per cent of the value of the home. The current amortisation requirement supplements this by also requiring that mortgages above a certain loan-to-value ratio must be amortised at a specified rate. This allows the borrower over time to build up greater resilience to shocks to their own finances or the economy in general.

It is a natural to impose a limit on the size of a loan in relation to the value of the home. It is just as natural to impose a limit on the size of the loan in relation to the borrower's income. While the mortgage cap is used to establish the former limit, the latter limit is established through a loan-to-income (LTI) cap. FI considered proposing an LTI cap, but analyses conducted by the authority indicates that, given current circumstances, such a cap could have unfavourable side-effects. The decision was therefore made not to pursue such a proposal.

The fundamental issue remains, however, and high LTI ratios can be problematic for individuals and the economy in general. The combination of a housing shortage, low interest rates and high house prices may tempt households to take on commitments that are too large. LTI ratios are also continuing to rise. This means that there is a risk that the imbalances in the credit market will grow, which can threaten the stability of the economy and the financial markets. Such a development needs to be prevented.

Whether or not households with a high level of debt are vulnerable is a point of debate. Normally, during an economic downturn, the central bank lowers its policy rate, thus giving these households more room by lowering their interest rate payments. As a result, they do not need to reduce their consumption. This mechanism, however, assumes that there is room for the central bank to lower the policy rate, which is not obviously the case when interest rates are already low. It also assumes that households with a high level of debt will maintain the same level of consumption after their interest rate payments have been reduced, which is not a given. For example, in the UK during the financial crisis, households with high levels of debt aggravated the fall in consumption by two percentage points, despite reduced interest rates.

Things also do not always play out as expected. Households may face rising interest rates even if the central bank lowers the policy rate. And the elevated degree of uncertainty during a crisis could itself influence highly leveraged households to lower their consumption.

FI therefore proposes a stricter amortisation requirement that is linked to the LTI ratio. Under this requirement, households that borrow more than 4.5 times their gross income must amortise at least one per cent a year (in addition to the amortisation required under the current amortisation requirement). This requirement introduces a soft limit, i.e. it does not set a cap for the LTI ratio. Instead, borrowers with high LTI ratios must include an amortisation payment in the calculation of their mortgage payments. Much like with the current amortisation requirement, the stricter amortisation requirement should result in somewhat smaller loans and less expensive homes among households with high LTI ratios. Households that borrow above this limit must gradually pay off their debt, thus reducing the risk associated with a high LTI ratio.

FI’s calculations indicate that approximately 15 per cent of new mortgagors will be affected by the stricter requirement given current conditions. This is not a dramatic change, but rather an effort to slow the rapid rate at which loan-to-income ratios have been increasing for some time. If house prices continue to rise, more households will be affected. If house prices stagnate, fewer households will be affected. The requirement thus works as a stabilising mechanism.

FI’s calculations also show that the ability of households with lower incomes to borrow is not affected by the requirements. Banks’ credit assessments impose limits on these households preventing them from borrowing 4.5 times their income. For this reason, it is not primarily young first-time buyers or pensioners with lower incomes that will be affected to the stricter amortisation requirement. Instead, the requirements will primarily affect households with higher incomes.

It is more than natural that banks set limits for the size of a household’s loan based on the value of the home and the household’s income. And the tightening of the requirements and credit assessments in recent years is healthy. It can also be mentioned here that the turnaround in this regard has been fuelled by FI’s actions. The measures themselves have been important, but the open debate FI has fostered about what needs to be done has played an important role in how banks and mortgagors act and think. The current amortisation requirement was questioned before it was introduced. Today, amortisation is a natural element in the banks' and the customers' calculations and considerations. The same can be said about the mortgage cap.

The recent debate surrounding the situation in the housing market has brought the stricter amortisation requirement to the forefront. The attention the requirement has received cannot be explained by its direct effects. In a market where banks conduct thorough credit assessments and set a limit for the LTI ratio at around five times the household's income, an amortisation requirement of one per cent that goes into effect for LTI ratios greater than 4.5 is not a big deal.

One explanation for the attention the stricter amortisation requirement has received is that the work on FI's proposal has coincided with a period of uncertainty about the direction in which our house prices are headed. Even if it is too early to define what is happening as a trend-break, there are signs that prices have slowed and – primarily in the major cities – may even have fallen slightly. This is not surprising. That the upward trend was going to bend sooner or later was obvious. There is a limit for how much households can and want to borrow.

A stabilisation or even slight reduction in house prices is a fundamentally healthy development. It is beneficial for both households that want to enter the housing market and the economy. This aspect is captured in neither the discussion about the developments on the housing market nor the consultation responses to FI's proposal for a stricter amortisation requirement. In particular, it is not mentioned by groups who benefit from high prices and continued rising debt levels.

However, it is also important to be aware of the psychological mechanisms in asset markets. Fears of falling prices can in some situations turn out to be self-fulfilling. And concerns that a stricter amortisation requirement will have drastic effects can be influential in this respect, even if objective reasoning indicates the opposite.

In such a situation, it is important to turn to the facts. And the facts are that the requirement will not affect a large percentage of new mortgagors, interest rates are still low, households' repayment capacity is just as strong as before and the Swedish economy is still strong. This means that even if house prices were to fall, the economy is resilient.

It is also important in general to keep a sense of proportions. Lenders naturally consider a borrower's income when conducting a credit assessment. FI takes the position that it should also be natural for borrowers to amortise when they have a high level debt in relation to their income. To this extent, an amortisation requirement linked to the LTI ratio is a codification of what should characterise a well-functioning credit market. The proposal aims to establish such a norm and ensure that credit assessments will not give a little if house prices continue to rise. Once again, this is not a big deal.

Several responses to the official consultation commented that a stricter amortisation requirement is not the best measure for reducing the risks associated with household debt. FI has already spoken out about the need for a unified policy approach to control the developments on the credit and housing markets. This means that regulatory work focused on maintaining a healthy lending market needs to be supplemented with measures that create a better balance on the credit and housing markets. FI would therefore welcome, for example, less generous interest rate deductions and measures that promote mobility and a more effective use of existing housing.

Several of the consultation responses received regarding FI’s proposal for a stricter amortisation requirement also express a concern for a continued rise in debt and house prices. Even the responses that reject or are sceptical to a stricter amortisation requirement thus express support for measures in other areas. These viewpoints are positive, but they do not fundamentally affect FI’s deliberations. FI cannot just wait for something to happen. FI has been given the assignment to stem emerging risks. And FI makes the assessment that the best tool the authority currently has at its disposal is a stricter amortisation requirement in accordance with the proposal that is now being submitted to the Government.