Major reform of housing finance system in Sweden

Percy Bargholtz explains important changes in Sweden's housing subsidy system

COMPREHENSIVE reform of the Swedish housing finance system had been scheduled for 1986, following the setting up of a Public Commission three years earlier. The brief for the Commission, which submitted a massive report early in the year, had been to find a way to curb the spiralling cost of the system of guaranteed interest rate levels for the new and rebuilt housing.

However, problems that had been seen as critically urgent in 1982 were no longer seen as equally urgent in 1986. Price inflation had slowed and interest rates had come down by several percentage points, so that the budgetary cost of the subsidies had fallen. Given this, there was no real support for the Commission's main proposal, which was for a system of loans with partially deferred interest charges, so that the house-owner would be *borrowing* to reduce the initial cash outlays for the loan, instead of receiving outright *grants* as under the old system.

So, the important reform concerning the working of the Swedish housing finance system, that has been introduced from 1 December, 1986, is an entirely different one. Indeed, its background is really in capital market reform, rather than in housing policy considerations. Nevertheless its immediate practical effects are considerable and the potential implications quite far-reaching. To appreciate this, some knowledge of the main features of the Swedish system is required.

The Swedish system

The mainstay of Swedish housing finance is a long-term, fixed interest rate, transferable mortgage loan. The peculiar Swedish twist is that while the amortisation schedule may foresee a 30-50 year repayment period, the formal maturity of loans nowadays is much shorter. This means that a succession of shorter loans, rarely longer than 10 years and most often only five years, make up the full (theoretical) loan schedule. If the maturity is longer than five years, there is almost always a provision for periodical interest rate adjustments.

A new loan is granted automatically when the earlier one falls due for repayment, but the borrower is free to shift his source of finance if at that time he can get better offers elsewhere. During the life of each loan, however, prepayment penalties rarely make it economic to break a loan contract.

Loans of this kind covering up to 75% or sometimes 85% of the property value are given by the Urban Mortgage Bank (a mutual institution) or by one of the mortgage credit companies (all of which are currently bank-owned). These lenders in turn raise their funds in the capital market, mainly through the sale of bonds. Traditionally, major buyers of these bonds are the insurance companies and the National Pension Insurance Fund, and also the banks themselves. Households do not buy much directly, but invest indirectly through unit trusts and similar vehicles. In recent years, a number of the large industrial companies have found themselves with surplus liquid funds to invest, part of which have gone to the bond market.

For state-aided new housing construction or rebuilding (virtually all projects now have such aid), the first mortgage loan is complemented by a second loan covering the financing up to a total of 95-100% of the full cost, depending on category of housing. Funds for these loans came directly from the state budget, until mid-1985, but now the financing has been moved off-budget.

A new state-owned Housing Finance Company has been created. This issues bonds and makes fixed-term loans similar to the first mortgage loans. The interest rate subsidy covers interest both on this top loan and on the underlying first mortgage loan. It works by guaranteeing a very

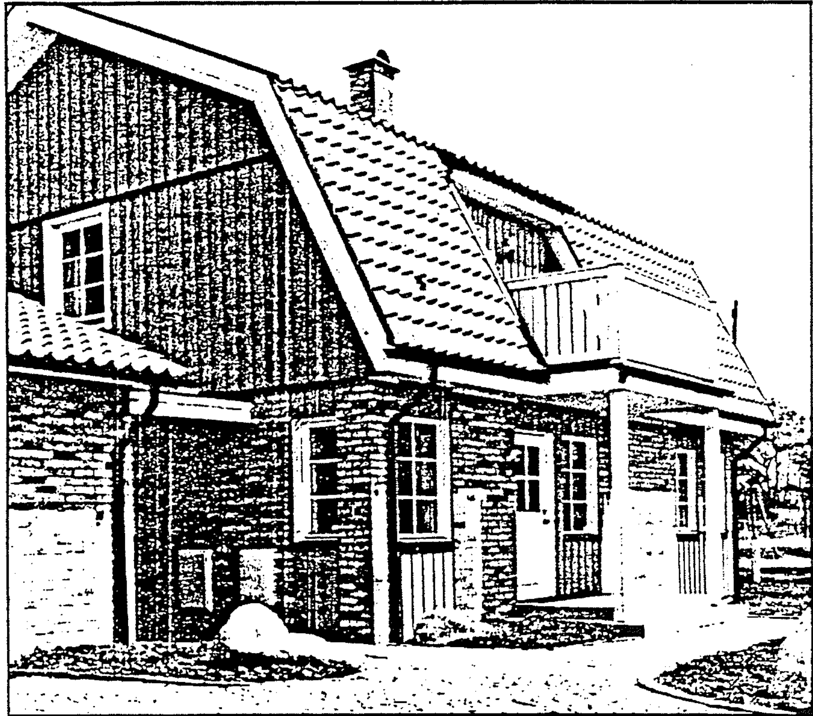
low first year interest cost to the house-owner, and this guaranteed level is gradually raised over time until the full rate of the loan is reached. The money for this subsidy comes from the budget, and takes the form of an outright grant.

The priority system

For many years, a fact of life in the Swedish credit market has been the division, by the regulatory agencies, between a priority sector and a non-priority one. The system initially developed as a credit rationing rule: available credit resources must primarily go to cover the financing needs of the very ambitious housing investment programme of the 1960s and early 1970s.

Banks, insurance companies and the National Pension Insurance Fund had to buy enough of the so-called priority bonds issued by the Urban Mortgage Bank or mortgage credit companies as to make available the required funds for priority lending purposes. The specialised housing finance institutions during these years were practically barred from financing purchases of secondhand homes; that was a non-priority matter and had to find its financing in other ways.

Gradually, in the late 1970s and early 1980s, the practical effect of the priority system changed. New housing investment fell, while inflationary price increases made financing of secondhand houses ever more difficult. Beginning in 1980, growing volumes of non-priority lending were then permitted for the mortgage institutions. While priority bonds and



Typical modern Swedish house.

loans had interest rates and maturities determined by central bank regulation, this new non-priority business was at market terms, ie with shorter maturities and higher rates of interest.

Gradually it became clear that the capacity of the credit market was such as to make it possible to raise all the financing needed for the housing sector without any compulsion. The remaining effect of the priority system was to create a hidden tax on those institutions still obliged to buy priority bonds, and to maintain a sub-sector of the credit market practically insulated from the competitive forces that were otherwise making themselves felt.

Priority system scrapped

In November 1985, the Central Bank suddenly abolished all volume restrictions on non-priority lending. Banks, finance companies and mortgage institutions were free to lend as much as the market asked for. Combined with the falling interest rate trend this produced an enormous expansion, primarily in the non-priority business of the mortgage institutions. During 1986, this business became much larger than the stagnant remaining priority lending. Most observers concluded that it was only a matter of time before the regulations maintaining the priority system would be scrapped. The question was

→ 30

Priority and non-priority new loans from Swedish housing finance institutions. 1982 — November, 1986[1], SEK billion.

	1982	1983	1984	1985	1986 Jan-Nov
Priority[2]	21.1	26.2	26.0	31.7	27
Non-priority	5.3	6.6	17.0	12.7	48

1) Priority system ended 30 November, 1986.
2) Prior to 1 July, 1985, part of these loans came from the state budget (now State Housing Finance Company).
Note: At end-November 1986 there were SEK 14.1 to the dollar.

←29

just how the transition would be managed.

Despite this anticipation, the actual move was unexpected. On 12 September, the Government simply announced that the rules forcing certain institutions to buy priority bonds would not be prolonged beyond 30 November, 1986. The system of interest rate subsidies for new and rebuilt housing would continue, but the loan funds would have to be raised entirely at market terms. Those concerned had two-and-a-half months to prepare.

Effects in the credit market

The most immediately visible effects of the scrapping of the priority system can be seen in the credit market. Banks, insurance companies and the National Pension Insurance Fund no longer have to pay the hidden tax implied by the below-market rates of priority bonds. A rough estimate would be that the 10-year priority bonds of 1986 would have had to be discounted by some 8-10% in order to reach market yield. With a total volume of some SEK 26 billion in new priority bonds issued, that indicates a substantial monetary figure.

More important for the longer term, the institutions concerned are now free from the constraint on their portfolio composition. Not only do they not have to buy bonds at below market rates, they do not have to buy bonds at all. In practice, the alternatives are limited, but the likely effect is that the market rate for longer-term bonds will rise relative to other interest rates. This in turn will then affect the balance between the cost of financing in the short-term money markets and the long-term capital markets. The financing of real estate investments by money-market related debt instruments may well become more popular. If so, that will certainly affect the ways of the mortgage institutions also, as until now they have not been allowed to extend permanent loans except on fixed terms. One can already see the growth of various so-called temporary bridging loans for larger investment projects, with sophisticated borrowers.

For the mortgage institutions the scrapping of the priority system means more competition. Before, only the Urban Mortgage Bank and two of the mortgage credit companies were allowed to issue priority bonds, while the remaining companies had only non-priority business. Now the field is free for all of them, with no market shares being fixed by central bank allocation of issuing permits. Entry into the sector is restricted for new institutions, so there is still some protection, but compared with the old way of life it is a revolution.

The most obvious effect for the housing finance system is that the budgetary cost to the Ministry of housing will increase. As borrowers (house-owners) have been promised unchanged levels of guaranteed interest rates, the increase in the loan rates will have to be met in full by larger subsidies. The previously hidden subsidy provided by the 'tax' on bond-buying institutions will in future be visible. Given the original intention of cutting back on the budgetary cost, this may appear as a paradoxical result. Cynics conclude that it will not be long before the urge to cut reappears, thus making the future of the system as uncertain as ever.

There are also more technical, but still important, effects on how the subsidy system operates. Previously, it was always clear what the gross rate to be subsidised was. The priority interest rate was at each time set by the Central Bank. Now, the loans are extended at market rates, which may change daily and may not be precisely the same for all institutions. The government has thus felt compelled to announce for each week the highest loan rate it is prepared to subsidise, based on actual market conditions during the previous week. Obviously, it wishes to keep that rate low to minimise costs. On the other hand, it must not make the rate so low that the mortgage institutions find it impossible to provide the financing required.

Experience with this system is limited as yet, but it appears quite clear that it makes life much more complicated for the mortgage institutions and their ultimate borrowers than it was under the old system. Freedom has its price. ■

Long Term Mortgage Loans Outstanding, End 1985

Institution and ownership	Amount SEK bn	Percentage of total
Governments	84.8	22
Urban mortgage bank	133.5	34
Spintab (central bank for savings banks)	59.9	15
BOFAB (commercial banks)	50.0	14
Spafi (central bank for savings banks)	18.9	5
SKF (SEB commercial bank)	14.7	4
Sigab (Handlesbanken commercial bank)	10.3	2
Gigab (Gotabanken commercial bank)	5.0	1
PK — Kredit (PK Banken — state owned, based on post offices)	3.9	1
Agro Kredit	2.2	1
Stockholme Tomtrattskassa (Municipal)	4.0	1
Total	387.2	100

PERCY BARGHOLTZ has been with the Urban Mortgage Bank of Sweden since 1983. He is mainly involved in an advisory capacity and not in day-to-day operations. Previously, he has worked as a tax policy advisor to the Minister of the Budget and an economist at the World Bank.