No. 1 15/01/2020

15/01/2020

Economic Commentaries

New challengers on the mortgage market – Increased competition and possible pressure on interest rates

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In Sweden, mortgages have been traditionally issued by banks. But since the end of 2016, there are new players on the market, known as mortgage credit companies, which have a slightly different business model. In this commentary, I describe the development of these new players, how they affect household mortgages and may affect the Swedish mortgage market and households in the future. A comparison is also drawn with developments in other countries.

Lending by mortgage credit companies does not currently affect total lending to households to any significant degree, and it is difficult to predict how it will affect the Swedish mortgage market and households going forward. Although the Swedish mortgage market resembles mortgage markets in other countries in several ways, there are nevertheless structural differences. It is therefore difficult to draw any conclusions about developments on the Swedish mortgage market based on comparisons with other countries.

Over the past year, lending by mortgage credit companies has steadily increased despite there being only a few of them issuing mortgages. If their loan volumes continue to increase, they may affect the Swedish mortgage market and households to a greater extent in the future. They are probably already having an impact by increasing competition and pushing down interest rates.

At the end of 2016, the market for mortgage-issuing financial corporations, excluding traditional banks, was regulated.[2] The new law paved the way for new players, known as mortgage credit companies, which have a slightly different business model compared to traditional banks.[3] Mortgage credit companies sell mortgages to other companies which, in turn, create investment products based on these mortgages. The mortgage credit companies normally retain administration of the mortgages and are therefore still the contact for the mortgage borrowers. The business model enables the institutions to compete with low interest rates, primarily with short interest-rate fixation periods. So far, mortgages issued by mortgage credit companies constitute only a small share of total household mortgages, but this may increase in the future.

The aim of this Economic Commentary is to describe the development of new players on the mortgage market and how they affect total lending to households for housing purposes with the help of new data. The commentary also describes developments in other countries. In conclusion, the commentary discusses how mortgage credit companies might affect the Swedish mortgage market and households in the future.

Different business model to traditional banks

Traditionally, mortgages have been issued by banks, mortgage institutions and other credit market companies, collectively termed Monetary Financial Institutions (MFIs). They have normally funded mortgages by issuing covered bonds and combined this with other types of borrowing.[4] Funding has also been obtained via securitisation to a limited extent.[5]

As the result of a legislative amendment in 2016, new players have emerged on the market – mortgage credit companies that are also licensed to issue mortgages to households. But as these institutions are not classified as MFIs, they are currently not included in the published statistics on household mortgages.

[1] The author would like to thank Daniel Hansson, Jyry Hokkanen, Björn Lagerwall, Anders Lindström, Carl-Johan Rosenvinge, Vanessa Sternbeck-Fryxell, John Svanäng and Peter van Santen for valuable comments. The opinions expressed are those of the author and are not to be seen as the Riksbank's view.

[2] Traditional banks are regulated by the Banking and Financing Business Act (2004:297).

[3] Prior to 2016, mortgages in the form of equity release loans were issued outside the MFI sector to a limited extent. These mortgages were previously only regulated by the Consumer Credit Act (2010:1846) and the Certain Consumer Credit-related Operations Act (2014:275).

[4] MFIs are defined as banks, credit market companies and other financial undertakings that both offer deposit facilities and lend to the general public.

[5] Securitisation takes place when loans are sold from a bank's balance sheet to a Special Purpose Vehicle (SPV) that issues bonds to fund the purchase of the loans.

Seventeen companies are currently classified as mortgage credit companies.[6] Ten of these are authorised to issue mortgages to households, of which four have so far done so. The other seven are not authorised to issue mortgages, although they are authorised to broker them. Mortgage credit companies authorised to issue mortgages have distinguished themselves by offering low interest rates to customers at traditional banks to get them to move their loans. Some of the institutions also offer loans to new mortgage customers. These offers have been aimed at customers under a certain loan-to-value ratio or a maximum loan amount.

The mortgage credit company business model is based on selling mortgages to separate institutions which, in turn, create investment products based on these mortgages.[7] Through this arrangement, institutional investors have the opportunity for direct exposure to Swedish mortgages. When investing in mortgage funds, the investor only has a claim on the fund in contrast to when investing in covered bonds, where the investor has a claim on the issuer and ultimately also on the underlying assets. As mortgage credit companies impose strict demands on mortgage borrowers, such as a certain maximum loan-to-value ratio, the credit risk to investors is limited, while the mortgage borrowers can be offered competitive interest rates.

The specialised, digitalised and standardised mortgage process of mortgage credit companies, generally with a fixed interest rate and with no bargaining margin, should also lead to lower costs. This efficient mortgage process also provides investors with higher returns and means that mortgage credit companies can offer competitive interest rates to mortgage borrowers.

Mortgage credit companies often issue mortgages that they then sell on to alternative investment funds (AIFs) which, in turn, offer investment products based on the mortgages. AIFs fund their mortgage purchases by issuing securities, very similar to mutual fund units, which are then offered to institutional investors. A similar business model is to securitise mortgages via a Finance Vehicle Corporation (FVC) which, in turn, offer investors the opportunity to invest in a bond with the mortgages as collateral, known as mortgage-backed securities.

Mortgage customers seldom notice this arrangement, as the mortgage credit companies normally retain the administration of the mortgages, i.e. the handling of amortisations and interest payments from mortgage customers.

Low but rapidly growing share of lending

For some time now, the Riksbank has been compiling statistics on Swedish MFI lending to households in the Riksbank's financial market statistics.[8] In total, household loans at MFIs amounted to SEK 4,190 billion in November 2019. Household mortgages at MFIs constitute 82 per cent of total household loans at MFIs and amounted in November 2019 to SEK 3,429 billion.

Since December 2018, data on mortgages issued by mortgage credit companies has also been collected.[9] Their lending to households amounted in November 2019 to SEK 19.3 billion, which is 0.6 per cent of the total volume of household mortgages. Lending to households has increased by an average of almost one billion kronor every month since data collection began, see Figure 1. Lending by mortgage credit companies to households for housing

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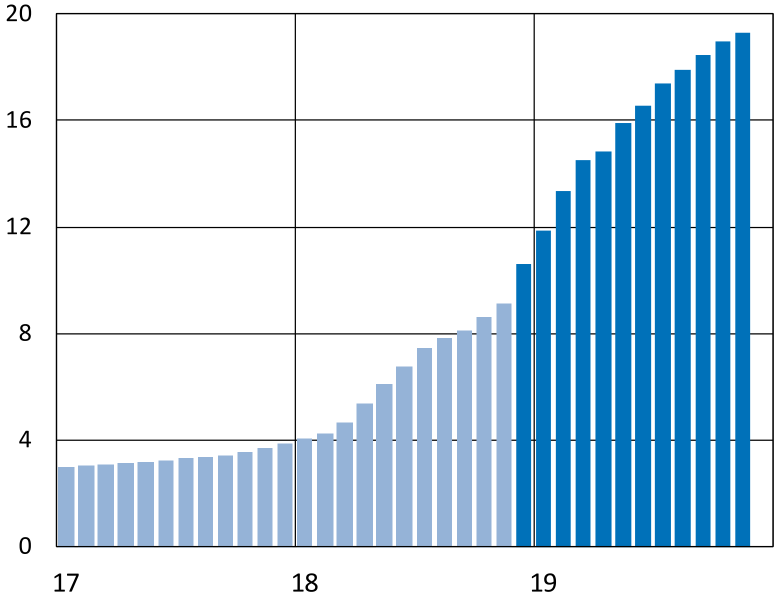
[6] Finansinspektionen (2019)
[7] Sveriges Riksbank (2018)
[8] Riksbank's financial market statistics
[9] For the sake of simplicity, loans from mortgage credit companies include henceforth loans sold from mortgage credit companies to AIFs or sold or securitised to other SPVs for which Statistics Sweden has data on outstanding loan volumes.

purposes is not currently included in the financial market statistics as it only covers lending from MFIs. However, Statistics Sweden is planning to start publication of this data in the financial market statistics on 27 February 2020.

Diagram 1. Lending by mortgage credit companies to households
SEK billion

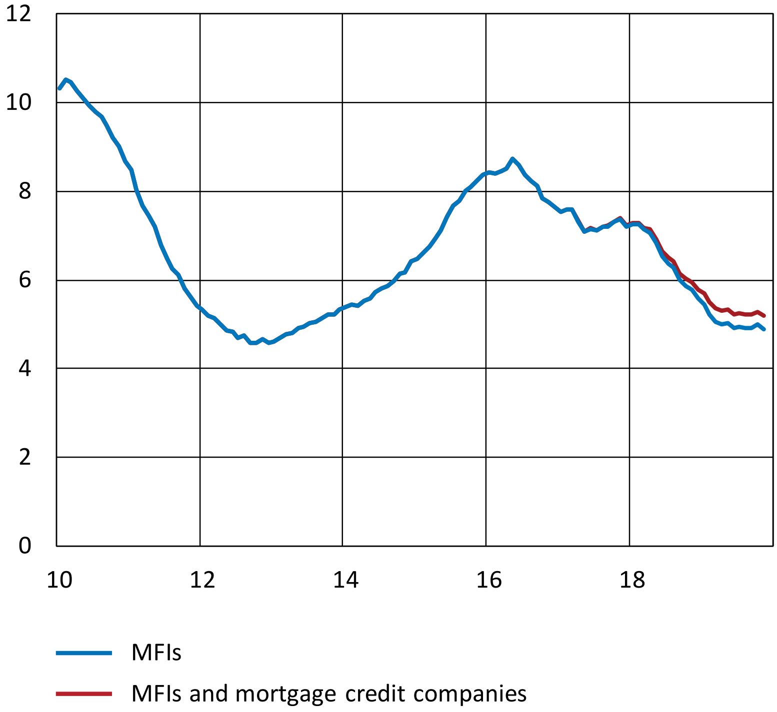


Note. Light-blue bars are based on the Riksbank's own calculations. Dark-blue bars are reported amounts from mortgage credit companies and alternative investment funds.

Sources: Statistics Sweden and the Riksbank

In recent years, there has been a declining trend in the annual growth rate in household mortgages issued by MFIs. Growth has also slowed if mortgages issued by mortgage credit companies to households are included in the annual growth rate, see Figure 2.

Diagram 2. Lending to households for housing purposes
Annual growth rate, per cent



Sources: Statistics Sweden and the Riksbank

Competitive interest rates should attract more customers

As from January 2019, interest rate statistics have also been collected for mortgage credit companies. The average variable mortgage rate was 1.27 per cent for new agreements in November 2019, which can be compared with a corresponding interest rate among MFIs of 1.52 per cent during the same period. It is primarily for shorter interest-rate fixation periods that mortgage credit companies are lending at a lower interest rate than banks, see Table 1.

As the business idea of mortgage credit companies is to only lend to mortgage borrowers who have a relatively low level of debt, it is reasonable that the interest rates for these mortgages are lower than the average lending rate for housing purposes among MFIs.

In November 2019, about 80 per cent of household mortgages at mortgage credit companies had an interest-rate fixation period of up to three months, which can be compared to household mortgages at MFIs where around 60 per cent of mortgages had a similar interest-rate fixation period.

Tabell 1. Mortgage rates to households
New and renegotiated loans during November 2019, per cent

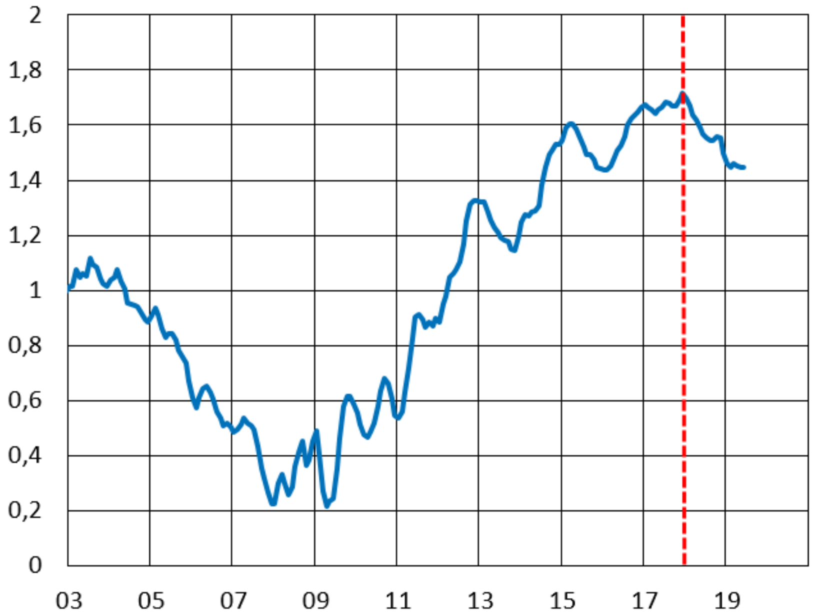
Interest-rate fixation period	Mortgage credit companies	MFIs	Difference Mortgage credit companies - MFIs
≤ 3 months	1.27	1.52	-0.25
> 3 months ≤ 1 year	1.29	1.35	-0.06
> 1 year ≤ 2 years	1.33	1.32	0.01
> 2 years ≤ 3 years	1.21	1.39	-0.18
> 3 years ≤ 5 years	1.32	1.41	-0.09
> 5 years	-	1.38	-

Note. Excluding equity release loans.
Sources: Statistics Sweden and the Riksbank

It is unclear how much of an effect the new mortgage players have had on interest rates on the Swedish mortgage market. In terms of volume, they only constitute a small share of total mortgages issued to Swedish households, but their entry into the mortgage market and the fact that they offer lower interest rates to households than traditional banks have done should have increased competition and possibly squeezed banks' mortgage margins. Since December 2017, banks' mortgage margins have also decreased, which occurred during the period after the dotted red line in Figure 3. This also coincides with a greater rise in mortgage credit companies' outstanding volumes than previously.

The average interest rate for household mortgages at MFIs is currently on approximately the same level as in December 2017, at the same time as banks' borrowing costs have increased. Given the level of mortgage margins in recent years, banks may feel they have scope to keep their mortgage rates down, with reduced margins as a result, in order to meet the increasing competition on the mortgage market.

Diagram 3. Banks' mortgage margins
Per cent



Note. The dotted red line shows the point in time at which mortgage credit companies' outstanding volumes start to increase more than previously, which coincides with falling mortgage margins.

Source: Finansinspektionen

Higher share of lending in certain other countries

Similar to the Swedish market, the majority of all mortgages on the European housing market are issued by MFIs, and only in a few countries are there players with business models similar to those used by Swedish mortgage credit companies. The most common funding forms for European mortgages are bank deposits, covered bonds and also securitisation to a certain extent.[10]

Investors in the Dutch housing market can issue mortgages themselves or invest in investment funds that have mortgages in their own balance sheet. Dutch pension funds and insurers have themselves issued or purchased Dutch mortgages and in 2010 had a share of 5.5 per cent of all Dutch mortgages in their own balance sheets, a share that had risen to 9.5 per cent by the end of 2018. Dutch investment funds had 5.3 per cent of Dutch mortgages in their own balance sheets at the end of 2018, which can be compared with 0.3 per cent at the end of 2010.[11] This means that almost 15 per cent of Dutch mortgages were to be found in the balance sheets of investment funds, pension funds and insurance firms at the end of 2018.

According to a report from the central bank of the Netherlands, DNB, the generally low level of interest rates is one explanation for pension funds and insurers showing increasing interest in the housing market. Quite simply, they have had to look for new investments with limited risk and attractive returns. DNB also points to a high level of confidence in the Dutch housing market and to amended regulatory frameworks as other possible explanations.[12] Finally, it also alludes to the lowering of the threshold for investors to establish themselves on the housing market in the Netherlands. Mortgages have been transformed into a standardised product, largely thanks to limits being imposed on households' loan-to-value ratios, the tightening of requirements for specific income levels for borrowers and the existence of tax benefits for households who amortise their loans.[13]

Insurance firms and pension funds look for long-term investment opportunities at a specific risk level and required rate of return. In the Netherlands, these investors have, for example, invested in mortgages with long interest-rate fixation periods, primarily between 16 and 20 years. The conditions for making such investments have been favourable as mortgages with long interest-rate fixation periods are common. At the end of 2018, almost 70 per cent of all mortgages in the Netherlands issued by banks had an interest-rate fixation period of over 5 years.[14] Regarding return on housing investment, there are signs that new lenders, other than traditional banks, have managed to reduce their costs for issuing mortgages by specialising specifically in mortgages.[15] This allows them to develop a more efficient process than, for example, traditional banks, that have a wider range of products to manage, and probably improves the return on investment in mortgages. The margins of Dutch banks have decreased in recent years, primarily on new loans with interest-rate fixation periods of more than 5 years, partly due to greater competition from other players such as pension funds.[16]

On the housing market in Ireland, there are also mortgages on the balance sheets of companies outside the MFI sector. These companies are referred to as 'retail credit firms' (RCFs) and 'unregulated loan owners' (ULOs). RCFs are companies under the supervision of

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[10] European Mortgage Federation (2019)
[11] Statistics Netherlands (2019)
[12] As an example, they highlight the stricter capital requirements introduced for banks in recent years.
[13] De Nederlandsche Bank (2016)
[14] De Nederlandsche Bank (2019)
[15] Dutch mortgage funding company (2019)
[16] See note 13.

authorities while ULOs, as the name suggests, are not under such supervision.[17] RCFs both purchase mortgage portfolios and issue their own mortgages while ULOs only purchase mortgage portfolios. At the end of the first half of 2019, RCFs and ULOs had an 18-percent share of Irish mortgages, with RCFs making up the majority of this share.[18] The majority of the loans, around two thirds, are loan portfolios purchased from MFIs while the rest are self-issued mortgages. These companies do not use a specific business model. Instead different models exist, one of which is mortgage securitisation.

The United Kingdom mortgage market has a similar structure to the market in Sweden, where players not classified as MFIs can issue mortgages to households. These companies are referred to as other specialist lenders (OSLs) and other non-MFIs, including, for example, public companies, pension funds and insurance firms. Similar to certain mortgage credit companies in Sweden, some players in the United Kingdom securitise mortgages.

At the end of the first half of 2019, OSLs were responsible for 7.6 per cent and other non-MFIs for 3.6 per cent of the total volume of issued mortgages in the United Kingdom.[19] This can be compared with 8.8 per cent and 5.5 per cent respectively at the end of 2014.

The significance of mortgage credit companies in Sweden may increase in the future

It is currently difficult to predict how mortgage credit companies will develop and how they might affect the Swedish mortgage market and Swedish households in the future. There are, however, several similarities with the mortgage market in the Netherlands. For example, mortgages on both markets have become an increasingly standardised product and the new players have specialised mortgage operations, which in combination suggest that the significance of mortgage credit companies may well increase going forward. Another similarity with the mortgage market in the Netherlands is that banks' mortgage margins have decreased in recent years. A contributory cause of this may well be the increased competition from other players. In Sweden, banks' mortgage margins began to decrease at about the same time as the outstanding volumes of mortgage credit companies started to increase, which may suggest that mortgage credit companies may be affecting the Swedish mortgage via competitive mortgage rates.

However, there are also structural differences between the Swedish and the Dutch mortgage markets. For example, a large share of mortgages in the Netherlands have long interest-rate fixation periods whereas mortgages in Sweden mostly have short interest-rate fixation periods. It is therefore difficult to draw any conclusions as to whether the Swedish mortgage market will develop in the same way as in the Netherlands.

A possible limitation for mortgage credit companies in Sweden may be their strict requirements on mortgage borrowers. This may limit the number of potential customers in the longer term. But it is also possible that mortgage credit companies might relax their strict requirements in the future and offer mortgages to a broader group of borrowers.

Looking at the development over recent years, mortgage credit companies' outstanding volumes of loans have nevertheless increased steadily despite there so far only being four mortgage credit companies issuing mortgages to households. If the loan volumes of mortgage credit companies continue to increase, at a similar or higher rate, at the same time as the number of mortgage credit companies continues to rise, they may affect the Swedish mortgage market and households to a greater extent in the future.

[17] New legislation is in the pipeline, however, which will bring ULOs, or as their new name will be: credit servicing firms, under central bank supervision.
[18] Central Bank of Ireland (2019)
[19] Bank of England (2019)

They are probably already having an impact by increasing competition and pushing down interest rates.

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