Box 3 Changes to housing finance arrangements and their impact on financial stability

The following survey provides a broad assessment of the impact that planned changes to the housing finance system could have on the stability and efficiency of the financial system.[1] It forms part of a report requested by the Ministry of Social Security housing project director and submitted to him on October 23, 2003. Full details of the proposed changes to housing finance arrangements were not available at that time. The report was published in its entirety, in Icelandic, on the Central Bank's website. It is based on the assumptions of raising the general housing loan-to-value ratio to 90%, charging an interest rate premium for higher loan-to-value ratios, and increasing the loan ceiling.

Impact on the stability and efficiency of the financial system

Easier access to credit from the Housing Financing Fund (HFF) will probably increase total household debt.[2] This would increase their debt service burden. In the event of unexpected shocks to household finances, the higher loan-to-value ratio would leave them less scope for borrowing from the banking system. Given the expected timing of the changes, households would make their borrowing decisions on the basis of financial assumptions during an upswing in the economy. This could exacerbate the risk of arrears by households and subsequent loan losses by financial companies, especially when the economy enters a downswing.

The changes may be expected to drive up housing prices for some years, but in the long run prices will reflect construction costs. A temporary surge in housing prices could entail a risk for financial stability when they turn down again, due to the greater probability of arrears and loan losses. A higher loan-to-value ratio could heighten the risk that both the HFF and credit institutions would lose claims to mortgage collateral. This could then lead to higher loan losses within the financial system.

The HFF would have a more systemically important role. It would face a greater risk of arrears and loan losses even if housing prices remained buoyant. This risk would be amplified by a substantial downturn in housing prices and/or an economic contraction. It should be noted that the HFF operates under separate legislation and is not classified as a financial institution.[3] Thus it is not obliged by law to meet conditions set for financial companies such as the minimum capital adequacy requirement of 8%. The Housing Act, No. 44/1998, stipulates that the FME (Financial Supervisory Authority) shall monitor whether the Fund operates in accordance with that legislation.[4] However, the nature of this surveillance is different from other financial companies, and much more limited.[5]

Growth in HFF lending could subdue demand for credit within the banking system and the pension fund system. On first impression, this would appear to have a positive effect on financial stability. Within the financial service sector, however, the mortgage market is generally regarded as more secure than others such as those for consumption, operations or investment. Housing loans have been regarded to some extent as the anchor of banking operations, in that they entail

1. For a discussion of the impact of these changes on price stability and monetary policy, see *Monetary Bulletin* 2003/3, pp. 24-25.
2. It is particularly the higher loan ceiling rather than the increased loan-to-value ratio which would have this effect.
3. See Article 4, paragraph 2 of Act No. 161/2002.
4. Article 27, paragraph 1 of the Act is as follows: *The FME shall monitor whether the operations of the Housing Bonds Department are in accordance with the provisions of this act and regulations set under it. Monitoring shall be conducted according to the provisions of the Act on Official Supervision of Financial Operations. The issue of Housing bonds and the finances of the Housing Bonds Department shall be under surveillance. The Housing Financing Fund shall provide FME with all the information that the latter deems necessary. To the degree that FME deems it necessary to evaluate the financial position of the Housing Bonds Department, it is entitled to collect information and make on-site examinations of other departments in the Housing Financing Fund.*
5. The latest IMF Article IV Consultation urges the Housing Finance Fund to be made subject to prudential guidelines. See IMF: *Iceland – Staff Report for the 2003 Article IV Consultation*, July 30, 2003, p. 21 (para. 22).

less risk than other lending categories.[6] The HFF's share in the housing finance market has made it difficult for Icelandic banks to reap such benefits from offering mortgages. The proposed changes would constrict the Icelandic banking system even further in this respect, which could lead to wider interest margins.

Furthermore, the proposed reforms would substantially increase the state's share and influence in the domestic credit market. Such a development is generally deemed undesirable, provided that secure financial companies operate in that market and are able to provide reliable and cost-effective services. Accordingly, the government's policy has been to reduce direct participation by the Treasury in financial activities. Competition in the credit market and in financial services must be considered crucial for the evolution of an efficient financial system and financial markets. Iceland currently has one of the largest state shares in the housing finance market by international comparison. Increasing this share still further would pose the risk of creating less competitive financial companies in the credit market, with undesirable effects on financial system efficiency.

In their credit market activities, Icelandic banks comply with comparable legislation to that which is in effect elsewhere in the European Economic Area in fields including prudential regulation, surveillance and competition. It is worth considering the impact that the changes would have on the position of Icelandic banks in this respect. Conceivably, the effect of state activity in this area could weaken the competitiveness of Icelandic banks within the EEA. Article 59 of the EEA Treaty should also be borne in mind.[7]

Another likely consequence would be increased purchases of Icelandic bonds by foreign investors.[8] Although such a development could have a favourable short-term effect on interest rates and the exchange rate under certain economic conditions, it likewise entails risks, especially in the form of foreign exchange and interest rate risks, for the Icelandic financial system. A change in domestic or foreign market conditions could prompt foreign investors to decide without notice to divest bonds from their portfolios on a large scale over a short space of time, as has happened in markets in other countries.[9] This could have serious consequences for Iceland's FX, bond and money markets, and thereby for financial and economic stability.

Alongside greater foreign bond portfolio investment in Iceland, the changes would probably increase Iceland's total external liabilities. On a short-term view this could hinder the upgrading of the Republic of Iceland's credit rating. Rating agencies have announced that the high level of national debt, especially the short-term debt position, is a negative factor for Iceland's ratings. In the long run, a downgrading of ratings cannot be ruled out, if the agencies consider that the changed housing loan framework will have an expansionary impact, raise the level of national debt and create the risk of instability if expectations change suddenly.[10] This could have a detrimental effect on capital markets and on the credit access and terms enjoyed by the Treasury, credit institutions and domestic non-financial corporations. A further consideration might be that if it is decided under the proposed Basel II Rules to calculate financial companies' CAD ratios on the basis of sovereign ratings, a downgraded rating could directly impair their competitiveness.

Conclusion

The impact of the proposed changes to the Housing Financing Fund's lending arrangements is difficult to

6. In the IMF report (p. 25/para. 29) the authorities are furthermore urged to limit gradually the Housing Financing Fund's role to strictly social objectives and open the bulk of the mortgage market to banks. The IMF mission also underlined the importance of housing finance for the banking system.
7. The provision is as follows:
1. In the case of public undertakings and undertakings to which EC Member States or EFTA States grant special or exclusive rights, the Contracting Parties shall ensure that there is neither enacted nor maintained in force any measure contrary to the rules contained in this Agreement, in particular to those rules provided for in Articles 4 and 53 to 63. 2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Agreement, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them...
8. Such an increase is assumed in a memo by project director Hallur Magnússon concerning restructuring of the housing market, dated August 25, 2003.
9. See also *Monetary Bulletin* 2003/3, pp. 2 and 24-25.
10. It should be noted that the IMF unequivocally discourages a rise in the Housing Financing Fund's loan-to-value ratio which under the current circumstances would prove expansionary and lead to higher real interest and exchange rates See, IMF, op. cit., pp. 12 (para. 11), 18 (para. 14) and 27 (para. 37).

Financing Fund's lending arrangements is difficult to evaluate as long as details of them remain unannounced. However, they are almost certain to stimulate demand in the economy. Probably the effect will be greater in the short run than in the long run. The economic conditions under which the short-term impact is transmitted will be crucial. If it takes place at the same time as the aluminium investments – which will put the economy under great strain – are at a peak, the outcome could be severe economic instability with unforeseeable consequences. Thus it would be desirable to phase them in over a long adjustment period, making only modest changes before 2007 and exercising great caution about raising the loan ceiling.

Changes to housing finance arrangements could have a considerable impact on the Icelandic financial system. The framework for these changes, and economic developments over the next few years, will prove crucial. They may be expected in advance to raise the risk profile for household arrears, loan losses in the financial system and financial instability. In the long run they are also likely to handicap competitiveness in financial markets and the efficiency of the financial system. All in all, the proposed changes must be deemed to have an undesirable impact on the Icelandic financial system and its stability and efficiency.