Box 2 Household debt and the planned extension of public housing finance

The Government of Iceland's policy statement from May 2003 contains the following policy point on housing: "...reorganisation of the housing market will continue, in accordance with the objectives for the Housing Financing Fund. The mortgage ceiling for ordinary housing loans will be raised in stages during the Government's term of office to as much as 90% of the value of the property, to a certain limit. The market for rental housing will be strengthened."

Details of extending mortgage entitlements have not been announced, but some developments are likely after the EFTA Surveillance Authority ruled in August that the activities of the Housing Financing Fund (HFF) and ideas for changing them were consistent with European Economic Area rules.

Ideas have been examined for raising the loan-to-value ratio for HFF loans from 65%-70% to 90% and increasing the maximum loan amount by up to half. This would be balanced by shortening the maximum loan term from 40 years to 30 years and tightening requirements for collateral. The loan-to-value ratio has already been raised to 90% in connection with secondary mortgages for lower-income borrowers. In 2003, almost one out of every three borrowers apparently borrowed at least some amount on a second mortgage. The recent reduction in interest rates on second mortgages will spur demand for them.

The effect of these changes will compound the rise in household debt that has already taken place under the existing rules. As a rough estimate, the new financing arrangements will lead to a relatively modest increase in debt, in the range 2%-5%. This will peak after a few years, then the impact will begin to wane as the effect of shorter mortgage maturities gradually filters through. Furthermore, average interest rates on new household borrowing are estimated to drop temporarily by roughly ¼ of a percentage point due to changes in loan composition.

Studies of the relationship of consumption, housing prices and residential housing with income, interest rates and debt suggest that lower interest rates and easier access to borrowed funds increase consumption and housing prices in the short term, while greater indebtedness subdues consumption in general and may have a downward impact on housing prices in the longer run. Higher housing prices encourage construction. The planned changes in housing financing arrangements will probably have an expansionary effect on the economy when they go into effect. Output growth is estimated at ¼ of a percentage point higher during the first year, after which the impact will soon abate. The new arrangements can be expected to give households more scope for mortgage equity withdrawal in order to finance their consumption, as there is some evidence of in Iceland and other countries recently. In the long run, however, private consumption would end up half a percentage point less than if the system had not been changed, due to the impact of higher debt. The inflationary impulse is estimated at ¼ of a percentage point during the first year and will outlast the impact on output growth.

Although they are not expected to mark a turning point, the proposed changes will increase the already high level of household debt. A growing share of this debt is in the form of price-indexed annuity loans, which create a highly back-loaded payment burden. Since housing prices are volatile, a problem could arise if the value of the property drops and thereby brings down the loan-to-value ratio to below the ceiling specified in the loan agreement. Studies suggest that if the initial debt is high, this risk may be significant: namely that the value of the property could drop below the claims secured against it. This probability is very sensitive to changes in loan-to-value ratio when the ratio is high, and increases significantly if the property is purchased while prices are buoyant. Calculations show that if housing is purchased with an annuity loan equivalent to 80% of its value, the probability of its price falling below the value of loans secured against it can increase from virtually nil if it is bought at a price 0-10% below the long-term average, to 20-65% if it is bought at a price 10-20% above the long-term average. Raising the loan-to-value ratio to 90% increases the probability of negative net housing equity to 10-35% for housing purchased at 0-10% below the average price and up to 80-90% for housing purchased at 10-20% above average price. This risk is caused by both the back-loaded nature of annuity loan repayments and the inherent volatility of housing prices. There is a strong correlation between changes in real wages and real estate prices. Household real incomes fluctuate by less than real estate prices, however, and homebuyers are in general relatively young and moving up the pay ladder. Households also have considerable scope for cutting back their consumption when squeezed. These three factors mean that the probability of homebuyers not being able to meet their payment obligations is likely to be lower than that of the value of the housing dropping below its mortgageability. The probability of such a squeeze on a collateral, and its sensitivity to the loan-to-value ratio, is nonetheless worth pondering when it is planned to usher in a 90% general loan-to-value ratio at the same time as housing prices in the Greater Reykjavík Area are more than 20% above the 10-year average in real terms.

If the proposed changes to housing financing arrangements are put into practice in part or in full, the main restriction on homebuying will probably be estimates of the borrowers' ability to service their debt. In such circumstances it is crucial for lenders to strengthen substantially their vetting of borrowers' ability to pay because, obviously, more opportunities for borrowing also mean more opportunities for overreaching oneself.