Box 2 The impact of the banks' new mortgage loans on private consumption

As described in Box 1, major changes have taken place in mortgage supply this year. In the spring, the Central Bank produced an in-depth analysis of the economic impact of plans by the Housing Financing Fund (HFF) to offer a 90% loan-to-value ratio and raise its maximum loan amounts.[1] The study assumed an increase in the maximum loan amount from 9.2 m.kr. for secondary market housing and 9.7 m.kr. for new housing to 15.4 m.kr. for both categories, an increase in the loan-to-value ratio from 65-70% to 90% of purchase price (and from 85% to 100% of fire insurance value), a requirement that the loan would be on a first priority pledge, and shortening of the maturity of maximum loans from 40 to 30 years. Certain assumptions need to be changed before the same methodology can be applied to evaluate the impact of the commercial banks' recent mortgage loan offers. The banks do not specify absolute loan ceilings, so this restriction does not apply, but set a maximum loan-to-value ratio of 80% of purchase price (except in the case of 100% loans, which are capped at 25 m.kr.). Bank mortgages are also limited to 100% of fire insurance value (but this can be exceeded for 100% mortgages by buying extra insurance cover). The banks insist on a first priority pledge for their new loans, which are generally for a term of 40 years.

In its report, the Central Bank assumed that the average mortgage term would be shortened from 34 to 29 years. The commercial banks' new mortgage offers, however, are not likely to result in a shortening of the average mortgage term, since bank mortgages are for 25 and 40 years, like previous HFF loans, and not for 30 years as the new HFF loans were expected to be. Shorter maturities have a constrictive effect, since other things being equal they will increase the debt service burden and thereby dampen private consumption. The new bank loans do not have this effect, so they will probably serve to ease the debt service burden, despite increased borrowing. Since these loans can be used for refinancing without a housing transaction taking place, they are likely to lead to even longer maturities.

The HFF's planned changes in its lending arrangements were expected to leave only 2.5% of homebuyers' debt service capacity unused (compared with 7% previously) due to loan ceilings and priority pledge requirements. Virtually no such scope can be expected to remain now, since the 100% fire insurance value factor will probably cap mortgages in most cases, regardless of whether the loan-to-value ratio is 80% or 90%.

The report expected that the average amount of new loans would increase by roughly 5%, corresponding to a 2½% rise in average household debt at the new equilibrium level. At a cautious estimate the new bank loan offers will increase the average amount of new loans by around 7½%, in particular since housing transactions are no longer a precondition for borrowing.

On the basis of these assumptions, and allowing for the transmission of the new loans through disposable income, interest rates, access to credit and the wealth effect, the outcome is that private consumption will grow over the next three years by a total of 1½-2 percentage points more than would otherwise have been the case, and that the main impulse will be delivered during the first year under these new arrangements.

1. Central Bank of Iceland, *Efnahagsleg áhrif breytinga á fyrirkomulagi lánsfjármögnunar íbúðarhúsnæðis* (The economic impact of changes in housing financing arrangements), report to the Minister of Social Affairs, June 28, 2004.